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UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Day

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I. INTRODUCTION

Did recent revisions to Article 8 of the Uniform Commercial Code[1] accomplish their purpose without sowing seeds that could result in either an unintended restructuring of the securities markets or in an unanticipated financial crisis?

Article 8's recent revisions represent a bold and long overdue advance that facilitates the day-to-day transfer and registration of securities in the country's active securities markets. They established a new legal regime to comport with the market realities of transferring and registering securities held indirectly (through a broker or other intermediary)[2] and streamlined the legal regime governing the transfer and registration of securities held directly. Article 8 is a more comprehensive statute than the 1977 version it replaced, yet for the most part, it covers the legal landscape in more concise and functional terms. The drafters generally did not fall prey to the common tendency of making legal revisions more complicated

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1. UNIF. COMMERCIAL CODE art. 8 (amended 1994), 2C U.L.A. 58 (Supp. 2001). Significant conforming amendments were made to Article 9 in connection with the promulgation of the 1994 revisions to Article 8. When Article 9 was revised, those revisions were more carefully integrated into Article 9 and conforming amendments were made to Article 8. *See* UNIF. COMMERCIAL CODE art. 9 (amended 2000), 3 U.L.A. 5 (2000).

Hereinafter, citations to the Uniform Commercial Code and its official comments are to the reproduction contained in Uniform Laws Annotated. Citations to Article 8 without further indication are to the 1994 version as amended by the conforming amendments promulgated with revised Article 9. The prior version of Article 8 is referred to as the 1977 version. Citations to Article 9 without further reference are to revised Article 9. Citations to Article 3 without further reference are to the 1990 version as subsequently amended. And citations to Article 1 without further reference are to the 1962 version as subsequently amended.

As of July 1, 2001, all states except South Carolina had adopted the 1994 version of Article 8 and all states had adopted revised Article 9. *See* U.C.C. REP. SERV. STATE U.C.C. VARIATIONS, xxi-xxii, xxv-xxvi (Supp. Sept. 2001).

2. Holding securities indirectly means "ownership" is evidenced by book-entries in accounts maintained by securities intermediaries. It is often referred to as holding securities in "street name." An intermediary holds such securities directly by being the person in possession of the security certificate or the person to whom the security is registered on the books of the issuer. The owners holding indirectly are sometimes referred to as beneficial owners, a term defined in federal securities law. *See* 17 C.F.R. § 240.13d-3 (2000).

by overly detailed provisions or unduly complex structures. Labeling the effort a *tour de force* for the securities industry would not be an exaggeration. However, interwoven with the simplicity of Article 8 are provisions that create concerns about the legal framework for the indirect holding system. Did the securities industry overreach in critical areas and thereby lay the foundation for the demise of the system? If so, the *tour de force* may be a Pyrrhic victory.

The goals guiding the work of the Article 8 drafting committee are readily determined. The prefatory note justifies Article 8 because the legal uncertainties that surrounded the indirect holding system adversely affected everyone involved in the securities markets.[3] The reporter, Professor James Steven Rogers, explains that the elimination of this uncertainty was one key element in a broader effort to reduce "systemic risk" in the securities markets.[4] Systemic risk refers to the real or theoretical risk that the financial failure of one participant in the securities markets could have a domino effect on other participants (due to intricate interrelationships) and threaten the entire system.[5] Finally, the drafters espoused a neutrality principle in drafting to avoid influencing the method of security ownership participants in the market would select.[6]

Even though the appropriateness of these goals is not without some controversy,[7] they provide three important and relevant questions to address in evaluating Article 8 and the changes to Article 8 made in connection with Revised Article 9.[8] Does it create functional rules for the indirect holding of securities? How effectively does it reduce systemic risk in the securities markets? Does it affect an investor's choice of methods of holding securities?

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3. UNIF. COMMERCIAL CODE art. 8 (amended 1994), Prefatory Note, 2C U.L.A. 59, at Part I.D. (Supp. 2001) [hereinafter Prefatory Note].

4. James Steven Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 UCLA L. REV. 1431, 1436-41 (1996).

5. *See id.* at 1437.

6. The drafters claimed no express intent "to influence [the development of securities holding practices] in any specific direction." Prefatory Note, *supra* note 3, at Part II.A.

7. *See* Francis J. Facciolo, *Father Knows Best: Revised Article 8 and the Individual Investor*, 27 FLA. ST. U. L. REV. 615, 624-41 (2000) (arguing that systemic risk is an inadequate justification).

8. *See supra* note 1.

The comparison of Article 8's direct holding system with its indirect holding system that follows, arrives at several interesting conclusions. The rules for the indirect holding system are functional, with a few important exceptions. Systemic risk has been reduced to the extent that Article 8 can reduce it, but some methods of reduction have shifted risks in the securities markets from lenders to intermediaries and investors (and potentially taxpayers) in ways that weaken rather than strengthen the securities markets. Finally, Article 8 falls short of the goal of neutrality. Persons holding securities indirectly have two types of increased risks: risks inherent in the indirect holding system and risks created by Article 8.

The higher risks in the indirect holding system should be reduced in light of the following facts: (1) a significant number of the increased risks are not inherent in indirect holding; (2) an investor's risks can be significantly reduced by holding securities directly; and (3) holding uncertificated securities directly would not recreate the paper-crunch which was the *raison d'etre* for the indirect holding system.[9] The provisions in Article 8 which create increased risks for those who hold securities indirectly could be readily improved without threatening the functioning of the securities markets and without complicating those parts of the statute which are elegantly simple. In fact, the resolutions would clarify and simplify the few obtuse provisions of the Article. Such improvements to the legal regime governing the indirect holding system would more closely embrace the neutrality principle espoused by the drafters and permit the pattern of security ownership to develop unhindered or undirected by legal rules.

Failure to restructure the indirect holding system may result in its gradual demise. All that is needed is a market-based clearing and settlement system for uncertificated securities because, similar to indirectly held securities, they are based on book entries. Transfer agents would necessarily be directly involved in the process.[10] There

9. *See infra* note 17 and accompanying text.

10. In 1994 the Securities and Exchange Commission solicited comments on a system whereby investors could choose to have their ownership of securities evidenced by entries on the books of a transfer agent, rather than requesting a stock certificate. *See* Transfer Agents Operating Direct Registration System, 59 Fed. Reg. 63,652 (Dec. 8, 1994) (to be codified at 17 C.F.R. 240). A pilot program was launched by the Depository Trust Company in November 1996. *See* Order Granting Accelerated Approval of a Proposed

would be supreme irony if the new Article 8, by explicating rules for indirect holding, became an impetus for broad use of uncertificated securities (book entry systems),[11] a primary, but failed, goal of the version it replaced.

A. *Historical Setting*

The legal regime that reigned since the early twentieth century in the transfer and registration of securities[12] is based upon a model involving the reification of the property interest into a physical certificate.[13] Transferring the security involves physical delivery of the certificate and, if registered, changing the registered owner on the books of the issuer or its transfer agent. Article 8 was originally drafted in the 1940s and 1950s (with the 1962 version being widely adopted) and followed that model.[14] Some use of uncertificated securities developed under that version of Article 8. They were analogized to the reification model by eliminating physical delivery (there is no certificate to deliver) and focusing on the registration of ownership.[15] Both certificated and uncertificated securities establish

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Rule Change Relating to the Procedures to Establish a Direct Registration System, 61 Fed. Reg. 58,600, 58,601 (Nov. 15, 1996). By June 2000, eleven transfer agents were participating and there were 292 eligible issues. *See* Revised Transfer Agent Form and Related Rule, 65 Fed. Reg. 36,602, 36,604 n.26 (June 9, 2000) (to be codified at 17 C.F.R. 240, 249(b)).

11. There would be double irony, if this develops. The drafters of the 1977 version operated on the assumption that uncertificated securities would be embraced when the legal regime was in place—it did not occur. The drafters of the 1994 Article 8 prepared a legal regime to recognize and facilitate the indirect holding system—it may doom the system.

12. Originally, certificates and negotiability were not the norm. *See* James Steven Rogers, *Negotiability, Property, and Identity*, 12 CARDOZO L. REV. 471, 471-78 (1990). Negotiable certificates became prevalent in the twentieth century. *See id.* at 477-78; *see also* Egon Guttman, *Transfer of Securities: State and Federal Interaction*, 12 CARDOZO L. REV. 437, 443-46 (1990) (discussing the history of equity ownership in corporations); Jeanne L. Schroeder, *Is Article 8 Finally Ready This Time? The Radical Reform of Secured Lending on Wall Street*, 1994 COLUM. BUS. L. REV. 291, 305 (1994) (providing a brief history of investment securities).

13. Professor Schroeder raises critical questions about the aptness of this physical possession model. *See* Schroeder, *supra* note 12, at 306-07.

14. *See* Martin J. Aronstein, *The New/Old Law of Securities Transfer: Calling a "Spade" a "Heart, Diamond, Club or the Like,"* 12 CARDOZO L. REV. 429, 429-30 (1990).

15. *See* Guttman, *supra* note 12, at 438-41.

a direct relationship between the issuer and the person making the financial investment.

The 1962 version of Article 8 contained limited provisions relating to the transfer and pledge of securities held indirectly through a central depository.[16] Nevertheless, an indirect holding system became widely used beginning in the late 1960s in response to the "paper-crunch" inherent in direct holding of certificated securities.[17]

The 1977 revisions to Article 8 that began in the early 1970s were promulgated in an ill-fated venture to guide development of a paperless securities market in the direction of uncertificated securities.[18] They were made under a narrow charge[19] that presumed the securities industry would move to uncertificated securities (dematerialization) to resolve the mechanical problems created by the physical delivery of certificates.[20] However, by 1977, the indirect holding system (immobilization) had already solved the problems of transferring paper certificates—problems some believed would inexorably lead to the use of uncertificated securities. Moreover, the 1977 revisions virtually overlooked the realities of the indirect holding system.[21]

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16. *See* SANDRA M. ROCKS & CARL S. BJERRE, THE ABCS OF THE U.C.C.—ARTICLE 8: INVESTMENT SECURITIES 3 (1997).

17. *See generally* Prefatory Note, *supra* note 3, at Part I.C (describing the indirect holding system); Guttman, *supra* note 12, at 437-38, 446-49 (discussing the changes in the securities markets that necessitated the development of the system); Schroeder, *supra* note 12, at 310-11, 322-24 (discussing the effect of volume increases on securities handling processes).

18. *See* Prefatory Note, *supra* note 3, at Part I.B; Charles W. Mooney, Jr., *Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries*, 12 CARDOZO L. REV. 305, 313 (1990); Schroeder, *supra* note 12, at 311-21; Jeanne L. Schroeder & David Gray Carlson, *Security Interests Under Article 8 of the Uniform Commercial Code*, 12 CARDOZO L. REV. 557, 559-60 (1990).

19. *See* Prefatory Note, *supra* note 3, at Part I.B; Aronstein, *supra* note 14, at 433-34; Rogers, *supra* note 4, at 1435, 1452-53.

20. *See* Prefatory Note, *supra* note 3, at Part II.A.

21. The 1977 version did not completely ignore the indirect holding system. Its provisions on transferring within a central depository system, § 8-320, and on transfer of securities, § 8-313 (an intricate provision describing relationships in the indirect holding system), recognized the existence of the system. The 1977 version, however, made no attempt to treat indirect holding any differently than direct holding or to spell out the rights and obligations between the participants in the indirect holding system. *See* Schroeder, *supra*

The use of uncertificated securities has not significantly expanded. Hindsight and the relatively short life of the 1977 version reveal that incomplete and unrealistic presumptions were made at the time it was conceived. The naivety of the presumptions was that the indirect holding system would happily give way to another solution to the problem that had spawned it with no impetus beyond the creation of an explicit legal framework. But indirect holding developed without an explicit legal framework as did some use of uncertificated securities. The most that could be expected of a legal framework was to facilitate more rapid development. However, there is a great impediment to change. The indirect holding system has a number of major private sector players with vested interests in maintaining the system. The forces against changing from indirect holding to uncertificated securities are most readily understood by analyzing the impact on securities brokers. With indirect holding, an investor does not make a trade without coming back to the broker through whom it indirectly holds the security.[22] This customer-broker adhesive and its economic benefit to the broker are not going to be changed by brokers without significant pressure. The pre-1994 incentive for moving to uncertificated securities was merely an alternative to avoid the paper crunch certificates created.[23] There was no incentive for the brokers to seek a change.

When Article 8 was revised in 1994, significant uncertainty existed regarding rights and duties within the indirect holding system.[24] Although the indirect holding system had operated for years,[25] the few legal rules directly governing it were established *ad hoc* through court decisions or federal securities legislation. These uncertainties were especially strongly felt by industry professionals.

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note 12, at 322-24; *see also* Peter F. Coogan, *Article 9—An Agenda for the Next Decade*, 87 YALE L.J. 1012, 1042-45 (1978) (exploring possible problems regarding "possession" in Article 9). Professor Coogan, for some reason, did not focus on these inadequacies when he later criticized the 1977 version. *See* Peter F. Coogan, *Security Interests in Investment Securities Under Revised Article 8 of the Uniform Commercial Code*, 92 HARV. L. REV. 1013, 1022-28 (1979).

22. *See* Nancy Ann Jeffrey, *Your Money Matters: Investors Feel Heat to Keep Securities in 'Street Name,'* WALL ST. J., Mar. 2, 1995, at C1.

23. *See* Rogers, *supra* note 4, at 1442-43.

24. *See id.* at 1445-49.

25. *See id.* at 1449-53.

Article 8's legal regime for securities held indirectly was strongly influenced by these professionals[26] and has removed much of the legal uncertainty by spelling-out relationships and legal rights to govern the indirect holding system. Much of this regime was created on a clean slate and involved significant deviations from the legal regime governing direct holding.

B. Article 8's Limited Role

The drafters of Article 8 are explicit about the limited role it plays in the securities markets. The prefatory note describes Article 8's role as governing the settlement of securities trades not the trades themselves.[27] Article 8 does not govern contracts for the purchase and sale of securities, even though a few such rules were in the 1977 version.[28] Even much of the settlement, especially in the indirect system, is governed by separate rules and agreements concerning clearing arrangements.[29] Article 8 simply encompasses the property rules for the transfer and registration of interests in securities and rules on how securities are evidenced.[30] It does not attempt to regulate the relationship between customer and broker or among brokers and clearing corporations, although its principles have a significant effect on those relationships.

Most important issues regarding the securities markets in the United States are governed by state and federal securities law and are clearly outside the scope of Article 8.[31] The interrelationships and potential interactions between Article 8 and these bodies of law raise a number of fascinating questions, but such an inquiry, with one exception, goes in a different direction than the inquiry undertaken in this Article. That exception is the Security Investors Protection Corporation created in 1970 by the Security Investors Protection Act[32] to provide a partial safety net for investors who use certain securities intermediaries. The drafters relied upon that act and a

26. The strong influence is chronicled by the list of acknowledgements at the end of the prefatory note. *See* Prefatory Note, *supra* note 3, at Part V.

27. *See id.* at Part III.B.

28. *See id.* at Parts III.B, IV.B.8.

29. *See id.*

30. *See id.* at Part III.B.

31. *See id.*

32. 15 U.S.C. §§ 78aaa-78lll (1994).

number of federal securities regulatory provisions to mitigate some of the risks in the indirect holding system.[33]

II. IMPROVEMENTS TO DIRECT HOLDING

Article 8 restructured the rules governing securities held directly[34] to resolve some longstanding issues. The major changes involved simplifying the rules governing uncertificated securities and increasing protections for purchasers of directly held securities. The law that governs directly held securities bears some important similarities to Article 3 of the Uniform Commercial Code.[35] Thus, the drafters also had the benefit of centuries of case law and statutory developments in that area when determining how to resolve many issues in the direct holding system.

A. Simplified Framework for Uncertificated Securities

Article 8 completely revamps the rules regarding uncertificated securities by providing greater flexibility for market and judicial developments. The drafters dropped from Article 8 all requirements for delivering transaction statements based upon a determination that transfer and registration of uncertificated securities could work efficiently without them.[36] Transaction statements were an innovation of the 1977 version designed to provide notices to security holders and perform certain other functions of a securities certificate.[37] The idea had been to make the rules for uncertificated securities as closely analogous as possible to those for certificated securities.[38] There was some concern that transaction statement requirements impeded widespread use of uncertificated securities.[39]

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33. *See* U.C.C. § 8-511 cmt. 2; Mooney, *supra* note 18, at 414; Schroeder, *supra* note 12, at 300-01. Many of these protections are outlined and their adequacy questioned by Professor Facciolo. *See* Facciolo, *supra* note 7, at 675-88.

34. The rules governing direct holding have been consolidated in Part 2 (obligations and rights of issuers), Part 3 (transfer of securities and rights of adverse claimants), and Part 4 (registration of transfer) of Article 8. The definitions and general rules contained in Part 1, of course, also apply.

35. *See* Prefatory Note, *supra* note 3, at Parts II.B, IV.B.8.

36. *See id.* at IV.B.4.

37. *See* U.C.C. § 8-408 (1977).

38. *See* Prefatory Note, *supra* note 3, at Part IV.B.4.

39. *See id.*

Important questions arise regarding the elimination of transaction statements. How are holders of uncertificated securities given notice of the terms of a security or of restrictions on transfer? Both of these items need to be referenced on security certificates.[40] The terms of an uncertificated security are in documents pursuant to which it was issued but there is no required procedure under Article 8 whereby a purchaser of the security obtains knowledge of them.[41] They are valid regardless of lack of knowledge or notice.[42] The lack of a notice mechanism is simply a risk inherent in uncertificated securities. In contrast, for an issuer's restrictions on transfer to be valid against the purchaser of an uncertificated security, the purchaser must have knowledge of them or the issuer must have notified the registered owner of them.[43] By leaving the method of giving notice up to the party seeking to enforce the restriction, Article 8 leaves room for market and judicial development in this area.

The other noteworthy change in Article 8 relating to uncertificated securities is the reduction in legal distinctions between certificated and uncertificated securities.[44] It distinguishes between certificated and uncertificated securities only when necessary or to ensure clarity.[45] The most common example is whenever a rule refers to delivery of a physical certificate, the corresponding rule for uncertificated securities simply focuses on the registration of the new owner.[46] The detailed provisions for registered pledges that were in the 1977 version to facilitate pledging uncertificated securities[47] were eliminated because the mechanisms exist elsewhere in Article 8 for similar transactions, if important in the market.[48] By minimizing special provisions for uncertificated securities, the drafters kept the law simple and flexible to facilitate future market developments.

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40. *See* U.C.C. §§ 8-202(a), 8-204(1).
41. *See id.* § 8-202(a).
42. *See id.* § 8-202 cmt. 2.
43. *See* U.C.C. § 8-204(2).
44. *See* Prefatory Note, *supra* note 3, at Part II.B.
45. *See id.* at IV.B.3.
46. *See, e.g.*, U.C.C. § 8-301(a)-(b) (defining delivery of a security).
47. *See* U.C.C. §§ 8-108, 8-207, 8-320, 8-401 (1977).
48. *See* Prefatory Note, *supra* note 3, at Part IV.B.5; U.C.C. § 8-106 cmts. 3, 4 ex.6; § 8-303 cmt. 3. Relevant rules would be the control provisions in § 8-106, with a control agreement providing the mechanism.

B. Streamlining Negotiability

The common law concept that a transferee take exactly what the transferor owned and no more, especially regarding being subject to claims to the property transferred,[49] has frequently been cited as an impediment to efficiently functioning markets. Early English law made exceptions to this derivative rights doctrine for goods purchased in "market overt"[50] and for bills and notes transferred as substitutes for currency.[51] These exceptions were rules of negotiability that developed to protect bona fide purchasers for value. They have played a significant role in commercial law and the functioning of markets.[52] Negotiability rules focus not on the history of the transferred property, but on the deserving attributes of the purchaser acquiring the property in an appropriate market. Naturally, negotiability rules increase the risk on parties wanting to assert claims. These increased risks can be justified by the fact that regular participants in the market will be in a position to benefit from the rules more often than they will suffer any detriment from the rules.[53]

Many commentators have questioned the advisability of negotiability rules in the context of negotiable instrument law in current society.[54] A key ground for the critique has been that the

49. This doctrine is commonly referred to by the Latin maxim *nemo dat qui non habet* (one who has not cannot give). *See* Rogers, *supra* note 4, at 1461.

50. After centuries, the English Parliament changed the rule to avoid the protection it gave thieves. See Schroeder, supra note 12, at 493 n.459.

51. *See* Peacock v. Rhodes, 99 Eng. Rep. 402, 402 (K.B. 1781) (holding that there is no difference between a bill of exchange indorsed in blank, a banknote payable to bearer, and currency); Miller v. Race, 97 Eng. Rep. 398, 398-90 (K.B. 1758) (holding that banknotes are treated as currency for the purposes of commerce).

52. *See* Jane Kaufman Winn, *Couriers Without Luggage: Negotiable Instruments and Digital Signatures*, 49 SO. CAR. L. REV. 739, 745-50 (1998).

53. In the market, as many financial assets are sold as are purchased. This excludes sales upon original issuance, where purchaser rules are not necessary for protection, and redemptions by the issuer, where other rules protect the issuer. Purchaser protections clearly benefit all purchasers, but also benefit sellers by making financial assets more marketable and therefore potentially increase prices due to market efficiency. A detriment from purchaser rules only arises if a participant's interest in a financial asset has been transferred inappropriately, an event quite rare in these high-volume markets.

54. *See, e.g.*, Vern Countryman, *The Holder in Due Course and Other Anachronisms in Consumer Credit*, 52 TEX. L. REV. 1 (1973); Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441 (1979); Grant Gilmore, *The Good Faith Purchase Idea and the Uniform*

rules are most frequently used to cut off defenses of the obligor in contexts where the negotiable instrument is not needed as a substitute for currency.[55] This was the basic reason for their development when currency was in short supply in eighteenth-century England.

Whatever the merits of these trenchant criticisms, our securities markets are one context in which negotiability concepts are as important today as they were when they developed.[56] Securities are widely and frequently traded without the direct involvement of the issuer of the security and in circumstances where many prior purchasers could have had some defect in "title" with no way for a subsequent purchaser to learn of the defect.[57] In these markets the key role of negotiability rules is to cut off ownership claims of persons previously having rights in the security, not the defenses of the issuer.[58] The negotiability rules make completed transactions final if the requirements of the rules are met.[59] This decreases the risk that settled trades can be upset and reduces systemic risk.[60] Thus, in the context of investment securities, public policy supports facilitating negotiability rather than constricting it.

The drafters of Article 8 took a number of steps to increase the negotiability of directly held securities. They eliminated an independent good faith requirement.[61] Because "good faith" is an

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Commercial Code: Confessions of a Repentant Draftsman, 15 GA. L. REV. 605 (1981); James Steven Rogers, *The Irrelevance of Negotiable Instruments Concepts in the Law of the Check-Based Payment System*, 65 TEX. L. REV. 929 (1987); James Steven Rogers, *Negotiability As a System of Title Recognition*, 48 OHIO ST. L.J. 197 (1987) [hereinafter Rogers, *Title Recognition*]; Albert J. Rosenthal, *Negotiability: Who Needs It?*, 71 COLUM. L. REV. 375, 375 (1971); M.B.W. Sinclair, *Codification Of Negotiable Instruments Law: A Tale Of Reiterated Anachronism*, 21 U. TOL. L. REV. 625 (1990).

55. *See* Rosenthal, *supra* note 54, at 378-80.

56. *But see* Rogers, *Title Recognition*, *supra* note 54, at 213-17 (arguing that registration or issuance of a new certificate is the real mechanism protecting purchasers); Rogers, *supra* note 12, at 477-78 (arguing that negotiability of stock certificates developed late and is useful only while stock is certificated).

57. *See* Schroeder, *supra* note 12, at 352-56.

58. Separate rules govern cutting off defenses or restrictions by issuers. Issuers of investment securities are more sophisticated about these defenses and restrictions than are issuers of negotiable instruments.

59. *See* Schroeder, *supra* note 12, at 355-56.

60. *See* Rogers, *supra* note 4, at 1460-65. Professor Rogers's view is criticized by Professor Facciolo. *See* Facciolo, *supra* note 7, at 629-33.

61. *See* Rogers, *supra* note 4, at 1472.

English equivalent of "bona fide,"[62] the elimination of that requirement resulted in replacing the term "bona fide purchaser"[63] with a new Article 8 term, "protected purchaser."[64] The drafters also made several changes affecting the "no notice" requirement making it easier to qualify as a protected purchaser. These changes included redefining the nature of adverse claims, changing the type of notice of adverse claims that defeat protected purchaser status and limiting duties to adverse claimants.[65]

1. Eliminating good faith

Good faith was eliminated as a requirement for becoming a protected purchaser for two basic reasons. First, the requirement had developed out of an interpretation of good faith different from its original "authentic" or "legitimate" meaning.[66] One reason for this development is probably linked to the uneasiness with which many view negotiability rules blocking obligors (particularly consumers) from raising defenses to negotiable instruments. Second, attempts to separate the good faith inquiry from the no-notice inquiry when analyzing court opinions is often extremely difficult.[67] In fact, it appears that good faith may often be the requirement courts have relied upon to expand the imputation of knowledge to purchasers without actual knowledge.[68]

Because ensuring predictability is so fundamental to the securities markets in which Article 8 operates, the drafters took care to avoid rules that could be used in sympathetic cases to defeat protected purchaser status. The good faith requirement of the 1977 version was a classic example of such a rule.[69]

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62. *See id.* at 1470.

63. U.C.C. § 8-302(1) (1977).

64. This term was derived from "protected holder," a term used in the Convention on International Bills and Notes. U.C.C. § 8-303 cmt. 4.

65. *See* Prefatory Note, *supra* note 3, at Parts II.B, IV.B.2, IV.B.6.

66. *See* Rogers, *supra* note 4, at 1470. *But see* Egon Guttman, *Mediating Industry and Investor Needs in the Redrafting of U.C.C. Article 8*, 28 UCC L.J. 3, 31 n.137 (1995).

67. Official comment 10 to § 8-102 implicitly recognizes this problem by explaining that questions regarding a purchaser taking a security under suspicious circumstances are addressed by the rules on notice of adverse claims, not those on good faith.

68. *See* Rogers, *supra* note 4, at 1471-72.

69. *But see* Facciolo, *supra* note 7, at 650-53 (arguing that these revisions

2. Limiting notice of adverse claims

A purchaser of directly held securities is protected from adverse claims to the securities unless it has notice of an adverse claim.[70] Although the 1977 version's provisions on "notice of adverse claims" simply described five specific circumstances that gave the notice,[71] the official comments clarified that it was an open-ended concept and referred approvingly to "reason to know" cases.[72] Constructive notice, however, is problematic in high liquid securities markets.

Notice of adverse claim was redefined in Article 8 to make it harder to find constructive notice.[73] Article 8 provides three rules to establish whether notice exists: actual knowledge, willful blindness to information that would establish a claim, or a statutory or regulatory duty to investigate (such as a duty to check a stolen securities registry) that would result in learning of the adverse claim.[74] The willful blindness standard requires that the purchaser "deliberately avoid" information in the face of facts indicating a

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to Article 8 were inappropriate); Guttman, *supra* note 66, at 31-33 (arguing for use of good faith).

70. *See* U.C.C. § 8-303.

71. U.C.C. § 8-304 (1978) charged a purchaser with notice of adverse claims if: (1) a certificated security was indorsed "for collection" or "for surrender;" (2) a certificated security was in bearer form and contained an unambiguous statement that it was the property of someone other than the transferor; (3) the adverse claim was noted on an initial transaction statement sent to the registered owner or registered pledgee; and (4) it had knowledge that the transfer was for, or proceeds were being used for, the personal benefit of a fiduciary. U.C.C. § 8-305 (1978) charged a purchaser with notice of adverse claims when a certificated security was transferred one year after the date set for presentment or surrender for redemption or exchange or six months after the date set for payment of money against presentation or surrender.

72. *See* U.C.C. § 8-304 cmt. 1 (1977).

73. *See* U.C.C. § 8-105 cmts. 1, 2.

74. U.C.C. § 8-105(a) provides:

> A person has notice of an adverse claim if:
>
> (1) the person knows of the adverse claim;
>
> (2) the person is aware of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim; or
>
> (3) the person has a duty, imposed by statute or regulation, to investigate whether an adverse claim exists, and the investigation so required would establish the existence of the adverse claim.

"significant probability" of an adverse claim.[75] The clear thrust of this new structure was to limit a court's discretion in finding notice of an adverse claim.[76] Article 8 also restates the four relevant specific situations from the 1977 version that constituted notice of an adverse claim: (1) acquiring a certificated security more than six months or a year after a date set for payment or surrender; (2) acquiring a certificated security indorsed "for collection," "for surrender," or a purpose other than transfer; (3) acquiring a certificated security in bearer form containing an unambiguous statement that it was the property of someone other than the transferor; and (4) having knowledge (not notice) that the transfer by a representative was a transaction for, or proceeds were being used for, the personal benefit of the representative.[77] Finally, Article 8 delineates two situations that do not create notice of an adverse claim. As under the 1977 version, knowledge that the transferor was a representative does not give notice that the party represented has an adverse claim and creates no duty to inquire.[78] Article 8 authorized perfection of security interests in financial assets by filing a financing statement but negated the argument that such filings provide notice of an adverse claim to the financial asset.[79] The definition of adverse claim was also narrowed by further limiting when one has notice of adverse claims.[80]

III. INDIRECT HOLDING—THE FRAMEWORK

As its most important contribution, Article 8 explicates rules governing the way the vast majority of securities are held in our economy—indirectly through intermediaries.[81] Article 8 was prepared under a mandate recognizing the existence of the indirect

75. *See* U.C.C. § 8-105 cmt. 4.

76. *But see* Facciolo, *supra* note 7, at 644-49 (arguing that these revisions were not justified).

77. U.C.C. § 8-105(b)-(d). Article 8 eliminated notice via initial transaction statements, because they are no longer required.

78. *See* U.C.C. § 8-105(b); *cf.* § 8-304(3) (1977) (setting forth the prior, virtually identical, rule).

79. *See* U.C.C. § 8-105(e).

80. *See id.* cmt. 2; *see infra* notes 200-209 and accompanying text.

81. Approximately sixty to eighty percent of the securities trading on exchanges or over-the-counter are held indirectly. *See* Prefatory Note, *supra* note 3, at Part I.C.

holding system and directing development of legal rules to govern its operations.[82]

Because the indirect holding system developed in the marketplace out of the direct holding system, the legal rules used to govern it were the rules for directly held securities, rather than rules tailored to the characteristics and needs of the indirect holding system.[83] A significant body of case law did not develop.[84] The reported cases did not establish well-reasoned legal doctrines to resolve competing policies unique to the indirect holding system. There is support for the notion that courts deciding cases involving the indirect holding of securities applied whatever principles were necessary to protect innocent investors.[85] Because an intermediary was holding property for the benefit of another, the 1977 version was based on principles of agency or bailment so courts could readily rely upon and apply these principles.[86] Many of the obligations and property rights of the parties to the indirect system were uncertain[87] or, when resolved by the courts, were the source of significant consternation to the securities industry.[88]

The drafters had the benefit of effectively starting with a clean slate. Troubling precedents could be overruled by the adoption of contrary concepts that matched the perceptions of those most familiar with the operation of the system—securities professionals. The interest and experience of securities professionals were essential to an Article 8 that could successfully govern the indirect holding system.[89] The securities industry did not want to use principles of

82. *See* Rogers, *supra* note 4, at 1435-37, 1445-48; Schroeder, *supra* note 12, at 349. As these references indicate, the impetus was heightened concern over the functioning of the existing system and the recognized need to address it explicitly in the law and improve its operation.

83. *See generally* Mooney, *supra* note 18 (examining issues concerning property rights that arise in modern securities markets and proposing certain legal reforms); Rogers, *supra* note 4, at 1447-49 (discussing the conceptual inadequacies of the 1977 version); Schroeder & Carlson, *supra* note 18 (discussing the inadequacies of the 1977 version for secured lending).

84. *See generally* Schroeder & Carlson, *supra* note 18, at 679 (attributing the lack of litigation to the diligent federal regulation of the securities industry).

85. *See* Schroeder, *supra* note 12, at 335-48.

86. *See id.* at 328-31.

87. *See* Rogers, *supra* note 4, at 1449.

88. *See* Schroeder, *supra* note 12, at 336.

89. The extensive involvement of the securities industry can be seen in the

bailment, agency, or trust law to describe the basic operations of the indirect holding system, even though agency law governs much in the relationship between the securities industry and its customers.[90] They preferred a *sui generis* structure for their custodial role in the indirect holding of securities.[91]

One important goal in revising Article 8 was to simplify transfer rules for the indirect holding system. The rules in the 1977 version governing transfers and pledges were unduly complex because they tried to cover the relationships existing in the indirect holding system[92] using direct holding concepts. By defining rights and obligations among the parties in the indirect holding system, Article 8 eliminated the complex legal provisions for transferring and pledging indirectly held securities.[93]

The indirect holding rules are set forth in Part 5 of Article 8 and include the definitions and general rules contained in Part 1. These rules can be studied most readily by breaking them into two functional divisions. This section explores the definitions and legal framework for indirect holding. A later section explores the rights of third parties.

A. Basic Structure

Article 8's legal regime for indirect holding is built around four basic concepts: (1) the securities account, the account to which an indirectly held investment is credited if the one maintaining the account treats the account holder as entitled to exercise the rights comprising the investment;[94] (2) the securities intermediary, the

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acknowledgments at the end of the prefatory note. *See* Prefatory Note, *supra* note 3, at Part V.

90. *See* U.C.C. § 8-509 official comment; Prefatory Note, *supra* note 3, at Part III.B; Rogers, *supra* note 4, at 1496; Schroeder, *supra* note 12, at 348-49, 358-59.

91. *See* Prefatory Note, *supra* note 3, at Part III.B; Rogers, *supra* note 4, at 1494-96; Schroeder, *supra* note 12, at 363-64.

92. Much of this law was contained within U.C.C. §§ 8-313, 8-320 (1977), which were very complex sections of the U.C.C. *See* Rogers, *supra* note 4, at 1447-48; Schroeder, *supra* note 12, at 318-20; Schroeder & Carlson, *supra* note 18, at 575-619.

93. *See* Prefatory Note, *supra* note 3, at Parts IV.B.1, IV.B.2, IV.B.5.

94. U.C.C. § 8-501(a) defines a securities account as "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for

person through whom an investment is held indirectly; (3) the financial asset, the investment held indirectly; and (4) the securities entitlement, the name given to the property rights and interests of the person holding a financial asset indirectly.[95] One additional concept follows logically from these four. An entitlement holder is the person having a security entitlement to a financial asset against its securities intermediary.[96]

1. Credit to securities account

A securities account is created if the person maintaining the account "undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset."[97] This requirement excludes trust relationships where legal title is in the trustee, because the trustee exercises the rights and ownership for the benefit of the beneficiary.[98] The requirement also eliminates mutual funds because the shareholders are not entitled to exercise the rights in the assets. The relationships created by a deposit account and by a guaranteed investment contract are also excluded because in those arrangements the person with whom the money is invested becomes the debtor of the person making the investment.[99] While most securities accounts will be formalized by a detailed written agreement, a written agreement is not necessary to create a securities account.[100]

By statute, an entitlement holder acquires a security entitlement in one of three ways: (1) the securities intermediary credits a financial asset to the entitlement holder's securities account; (2) the securities intermediary accepts a financial asset for credit to the entitlement holder's securities account; or (3) the securities intermediary is obligated by law to credit a financial asset to the entitlement holder's securities account (a security entitlement

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whom the account is maintained as entitled to exercise the rights that comprise the financial asset." The term "account" is not defined in Article 8. The key requisite for an account appears to be a custody agreement.

95. *See* U.C.C. § 8-102(a)(17).
96. *See id.* § 8-102(a)(7).
97. *Id.* § 8-501(a).
98. *See id.* § 8-501 cmt. 1.
99. *See id.*
100. *See id.* cmt. 2.

implied in law).[101] The security entitlement is created by any such credit to a securities account even if the securities intermediary has no rights to the financial asset.[102]

One consequence of these methods of acquisition is that they treat a stock certificate in the possession of a securities intermediary as a security entitlement if indorsed to the intermediary or in blank. This is true even if the certificate was registered, issued or specially indorsed in the name of another person.[103] This means that delivering a directly held security to a broker just before executing a trade generally converts that security to a security entitlement (an indirectly held financial asset) at least until the trade is completed. Thus, the majority of securities' trades[104] occur in the indirect holding system even if shortly before the trade the security is held directly.[105]

Various custody relationships could be swept into the indirect holding system if the nonholding party is entitled to exercise the rights embodied in the asset. In fact, the drafters identify the question of classifying whether an investment product or arrangement is governed by the indirect holding system as "the most difficult—and important—issue" raised by Article 8.[106] The drafters also caution courts not to use "mechanical jurisprudence" but to interpret the definitions based upon the suitability of applying Article 8's substantive rules.[107]

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101. *See id.* § 8-501(b).

102. *See id.* § 8-501(c).

103. *See id.* §§ 8-301(a)(2), (3) (negative implication); *see id.* § 8-301 cmt. 2; *see id.* § 8-501(d) (negative implication); *see id.* § 8-501 cmt. 4.

104. Delivery to a securities intermediary after the trade, but in time to affect settlement is one exception. A broker trading for its own account directly with another broker trading for its account would not necessarily involve a security entitlement. Note, however, that if done through a clearing corporation or other intermediary, a security entitlement may be involved.

105. Note that a prime justification for the indirect holding system is the ability to settle trades rapidly by not requiring physical delivery of securities. *See* U.C.C. § 8-507 cmt. 1. *See generally* Facciolo, *supra* note 7, at 673-74 (discussing the impracticality of traders holding directly).

106. *See* Prefatory Note, *supra* note 3, at Part III.C.14.

107. *See id.*; *see also* U.C.C. § 8-501 cmt. 1.

2. The securities intermediary

The securities account is maintained by a securities intermediary. Article 8 defines securities intermediaries to include clearing corporations and banks, brokers, and those who in the ordinary course of their business maintain securities accounts.[108] Some important differences between the two distinct groups of securities intermediaries, clearing corporations and persons maintaining securities accounts, will be explored later.[109]

Clearing corporations include federal reserve banks, clearing agencies registered under federal securities laws, and clearing agencies not required to register because they are regulated by state or other federal authority.[110] Generally, clearing corporations also maintain securities accounts for their participants. They are separately defined as securities intermediaries to simplify the analysis in arrangements like the system involving the National Securities Clearing Corporation and the Depository Trust Company (NSCC-DTC) which plays the largest role in indirect holding. Although those two companies function as an integrated system, the clearance and netting functions are handled by NSCC while DTC is the depository for the securities.[111] NSCC is a securities intermediary which does not need to hold financial assets for another because it meets the separate definition of a clearing corporation by providing clearing or settlement services in connection with financial assets.

Securities intermediaries also include brokers or dealers under federal securities law,[112] banks,[113] and others when maintaining

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108. *See* U.C.C. § 8-102(a)(14).

109. *See infra* notes 352-357 and accompanying text.

110. *See* U.C.C. § 8-102(a)(5).

111. *See id.* cmt. 14.

112. The definition of securities intermediary in § 8-102(a)(14) specifically refers to brokers. Broker is defined in § 8-102(a)(3) to include persons defined as brokers (those acting as agents) or dealers (those acting as principals) under federal securities laws. Thus, they are included for Article 8 purposes whether or not they are required to be registered under federal law, if they meet the federal law definitions.

113. The definition of securities intermediaries in § 8-102(a)(14) specifically refers to banks performing these functions. In addition, the definition of broker under § 8-102(a)(3) includes banks that are excluded from the definition of broker or dealer under federal securities laws by virtue of their status as banks.

securities accounts for others in the ordinary course of their business. The securities intermediary designation is limited to their custodial role in holding the securities.[114] Brokers effecting trades are agents of their customers or principals, not securities intermediaries.[115] Similarly, banks could be transfer agents, dealers, or lenders holding the securities as collateral, without becoming securities intermediaries.[116] Note that the broad scope of the securities intermediary definition to include "others" could have surprise consequences for a nonbank or nonbroker whose activities inadvertently fall within the definition of maintaining a securities account that holds financial assets under an agreement whereby the entitlement holder is entitled to exercise the rights comprising the asset.[117]

3. Property held indirectly

Financial asset is intentionally defined to be broader than the basic Article 8 term security.[118] In addition to securities, financial assets include: (1) property which a securities intermediary agrees to treat as a financial asset[119] and (2)

> an obligation of a person or a share, participation, or other interest in a person or in property or an enterprise of a person, which is, or is of a type, dealt in or traded on

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114. *See* U.C.C. § 8-102 cmt. 14.
115. *See id.*
116. *See id.*
117. *See id.* § 8-501(a). The securities account concept is sufficiently broad to cover many custody arrangements. Does this bring transactions such as mortgage servicing and loan participations within Article 8? A mortgage servicer holds the notes and mortgages or deeds of trust, collects payments, and deals with delinquencies and default, yet is holding the assets for another who can exercise rights in the notes. In some loan participations, one participating lender holds the note and collects payments and otherwise deals with the maker of the note, yet ownership of and the ability to exercise rights in the note is in each participant. Certainly, few loan participants or mortgage servicers think they are creating security accounts governed by Part 5 of Article 8.
118. *See* U.C.C. § 8-102 cmt. 9; Prefatory Note, *supra* note 3, at Part III.A.
119. U.C.C. § 8-102(a)(9)(iii) includes the following as financial assets: "any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under this Article."

> financial markets, or which is recognized in any area in which it is issued or dealt in as a medium for investment . . . .[120]

The second type of financial asset closely tracks the definition of security.[121] It substitutes the word "person" for "issuer" and the term "financial markets" for "security exchanges or securities markets." More importantly, a financial asset need not be one of a class or series[122] and does not require a security certificate or registration on the books of the issuer.[123] The broader definition expands the scope of Part 5 of Article 8 beyond the remainder of Article 8.[124] The broadened scope further reveals the inadequacy of prior law to address the issues raised by indirect holding.

The Code expressly addresses whether four types of investment products are financial assets or securities: (1) options and similar obligations issued by clearing corporations to their participants are not securities, but are financial assets;[125] (2) commodity contracts are neither securities nor financial assets;[126] (3) negotiable instruments which do not qualify as securities (they are not part of a series, yet are investment devices) are financial assets, if held in a securities account;[127] and (4) an interest in a limited liability company or partnership that is not traded in a securities market is not a security (the partnership did not opt into Article 8 coverage as a security), but is a financial asset, if held in a securities account.[128]

Some financial assets, notably many municipal bonds, meeting the definition of securities, can only be held indirectly because they are issued in book-entry form. That is, on the books of the issuer the only holder is a clearing corporation, but that single interest is

120. U.C.C. § 8-102(a)(9)(ii).

121. *Id.* § 8-102(a)(15).

122. *Cf. id.* § 8-102(a)(15)(ii) (which includes the class or series requirement in the definition of security).

123. *Cf. id.* § 8-102(a)(15)(i) (which includes the certificate or registration requirement in the definition of security).

124. *See id.* § 8-102 cmt. 9.

125. *See id.* § 8-103(e). This rule clarifies the treatment of traded stock options.

126. *See id.* § 8-103(f).

127. *See id.* § 8-103(d); Prefatory Note, *supra* note 3, at Parts III.C.8-9. For example, bankers' acceptances are governed by Article 3, but commonly held in securities accounts. *See* U.C.C. § 8-104 cmt. 1.

128. *See* U.C.C. § 8-103(c); Prefatory Note, *supra* note 3, at Parts III.C.8-9.

divided among all those having a security entitlement on the books of the clearing corporation.[129]

In summary, a financial asset is a security or other property held indirectly in a securities account. The term financial asset can include a security entitlement held indirectly.[130] The term financial asset refers, depending on the context, to either the underlying asset, or the means by which ownership thereof is evidenced (the certificated security, the uncertificated security, or the security entitlement).[131]

4. Who holds indirectly?

The vast majority of publicly held securities are represented by jumbo certificates registered in the name of Cede & Co., the nominee of the Depository Trust Company (DTC).[132] Approximately 600 banks and brokers have accounts at the Depository Trust Company for their own holdings and for the holdings of those for whom they act as securities intermediaries.[133] There are frequently additional tiers of indirect holding whereby intermediaries who are not members of DTC hold through securities accounts with intermediaries who are members.[134] In other words, the Depository Trust Company holds the securities directly and the banks and brokers, as well as their customers hold them indirectly as security entitlements. This same system can be used for corporate and municipal debt securities and for commercial paper.[135] This is not the only indirect holding system in existence but it is the largest.

Some concerns that have been raised regarding Article 8 relate to the perception that it does not adequately protect consumers.[136] This seems to presume that consumers are the primary indirect holders. Essential to understanding security entitlements and the indirect holding system is the realization that securities intermediaries are generally also entitlement holders. Usually, the securities intermediary is a bank or broker and the financial asset is

129. *See* U.C.C. § 8-102 cmt. 15; *see id.* § 8-508 cmt. 1.
130. *See id.* § 8-102(a)(9); *see id.* § 8-102 cmt. 9.
131. *See id.*
132. *See* Rogers, *supra* note 4, at 1443-44.
133. *See* Prefatory Note, *supra* note 3, at Part I.C.
134. *See* Schroeder, *supra* note 12, at 327-328.
135. *See* Prefatory Note, *supra* note 3, at Part I.C.
136. *See* Facciolo, *supra* note 7, at 617-20; Guttman, *supra* note 66, at 5-7.

held indirectly by that intermediary and held directly by the Depository Trust Company or another clearing corporation.[137] There may be more than two tiers of indirect holding for any financial asset. While this could be criticized as creating multiple levels of risk for the ultimate entitlement holder, these levels of risk are mitigated to a significant extent by the fact that Article 8 makes the immediate securities intermediary effectively a guarantor of any upper tier securities intermediaries.[138]

B. What Does an Entitlement Holder Hold?

For years, those holding securities indirectly have considered themselves "owners" of the securities—having all rights and property interests in the securities. Article 8 does not support that view, although it was "designed to ensure that parties will retain their *expected* legal rights and duties . . . ."[139] To understand why this is true a distinction must be drawn between the property interest in the security entitlement itself and the property interest in the underlying financial asset. An entitlement holder has all rights and property interests in the security entitlement. The question is what rights and property interests the security entitlement provides to the underlying financial asset.

Security entitlement is defined broadly as the "rights" and "property interest" of an "entitlement holder" specified by Part 5 of Article 8 with respect to a "financial asset."[140] The drafters are clear in their intent that the property rights of an entitlement holder are created by Article 8 and not by common law property concepts.[141] Thus, an analysis of the eleven sections comprising Part 5 of Article 8 is necessary to understand the nature of the "property interests" and "rights" relating to a financial asset which comprise a security entitlement.[142]

137. *See* Facciolo, *supra* note 7, at 621.

138. *See* WILLIAM D. HAWKLAND & JAMES S. ROGERS, REVISED ARTICLE 8: INVESTMENT SECURITIES, 7A UNIFORM COMMERCIAL CODE SERIES 652 (1996); *infra* notes 176, 298-299 and accompanying text. *But cf.* Facciolo, *supra* note 7, at 668-71, 706 (arguing that the Article 8 language can be construed to limit this duty when an upper-tier intermediary fails).

139. U.C.C. § 8-104 cmt. 3 (emphasis added).

140. *See id.* § 8-102(a)(17).

141. *See id.* § 8-503 cmt. 2.

142. The drafters state that Part 5 of Article 8 can be viewed as the definition

1. The "property interest"

The essence of property is a bundle of rights in something of value that can be enforced against others. Limitations on the types of rights to a financial asset that can be enforced or the persons against whom they can be enforced are necessarily limitations on the property interest.

A security entitlement includes a property interest in the financial asset.[143] Unfortunately, extracting from Article 8 the nature of this property interest is not easy. Subsections 8-104(a)(2), (b) provide that a person "acquires" a financial asset or "an interest" therein if one obtains a security entitlement in the financial asset. Similarly, subsection (d) provides that a person fulfills his/her legal obligation to "transfer, deliver, present, surrender, exchange, or otherwise put in the possession of another" a financial asset by causing the transferee to acquire a security entitlement in it. While those provisions give the appearance that a security entitlement in a financial asset is equivalent to ownership of the financial asset, their purpose is not to delineate rights and property interests, but to "translate" indirect holding terminology so that it does not conflict with terminology in agreements and documents establishing and governing the rights under a financial asset when transfers involve indirect holding.[144] It was necessary to include such provisions because a security entitlement involves something less than ownership of the financial asset.

A security entitlement involves a property interest in the financial asset (as contrasted with in personam rights against the securities intermediary) only to the extent it includes rights to the financial asset enforceable against other persons.[145] Subsection 8-104(c) limits an entitlement holder's interest as a "purchaser" of a financial asset to the rights enumerated in section 8-503. The picture gets simultaneously clearer and murkier by examining section 8-503. Subsection 503(a) provides that financial assets held by a securities

of security entitlement. *See* U.C.C. § 8-102 cmt. 17.

143. *See id.* § 8-102(a)(17).

144. *See id.* § 8-104 cmt. 3.

145. Official comment 17 to § 8-102 makes essentially this same assertion by describing a security entitlement as "both a package of personal rights against the securities intermediary and an interest in the property held by the securities intermediary."

intermediary are "*not* property of the securities intermediary" and are exempt from claims of general creditors of the securities intermediary (but not certain secured creditors). The subsection further provides that financial assets are held by a securities intermediary for its entitlement holders "to the extent necessary" to meet its obligations to entitlement holders. This provision protects the entitlement holder from the securities intermediary's general creditors and, thus, provides some property interest,[146] but it does not empower the entitlement holder to assert rights against any person.

Subsection 8-503(b) describes the entitlement holder's property interest in a financial asset as a "pro rata property interest" in all interests in that financial asset held by the securities intermediary. Although it is not explicitly stated, the pro rata interest is implicitly limited to the amount of the financial asset credited to the securities account. In other words, if the security entitlement is to 100 shares of IBM stock and the securities intermediary holds 100,000 shares of IBM stock, the security entitlement is a 1/1000 interest in each share of IBM stock held by the intermediary. It is important to note that this pro rata interest extends to financial assets acquired by the securities intermediary before the entitlement holder acquired the security entitlement as well as to those acquired thereafter.[147] Thus, the fungible bulk in which an entitlement holder has a pro rata interest regularly changes. This pro rata interest in the fungible bulk of a particular financial asset, however, is not a claim to a specific asset held by the financial intermediary.[148] The drafters refer to the entitlement holder as having obtained a property interest "only in the sense that under section 8-503 a security entitlement is treated as a *sui generis* form of property interest."[149]

146. After describing the limitations on a securities intermediary's rights and those of its general creditors to the financial asset held for an entitlement holder, the drafters declare: "Thus, a security entitlement is itself a form of property interest not merely an *in personam* claim against the intermediary." Prefatory Note, *supra* note 3, at Part II.C.

147. Section 8-503(b) describes the entitlement holder's property interest to be "without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset."

148. *See* U.C.C. § 8-104 cmt. 2; *see id.* § 8-503 cmt. 2.

149. *Id.* § 8-104 cmt. 2.

Under subsection 8-503(c), enforcement of that property interest against the securities intermediary is limited to the rights enumerated in sections 8-505 through 8-508. These are discussed below in the section on rights against the securities intermediary. More profoundly, under subsections 8-503(d) and (e) enforcement of the "property interest" against third parties is severely limited. These limitations are discussed in the next section.

Notably, section 8-116 makes the securities intermediary, not the entitlement holder, the "purchaser for value" of the financial asset. Thus, the securities intermediary has the rights of a purchaser when it needs to assert those rights against third persons. To this extent, the entitlement holder obtains the benefit of purchaser status indirectly through the actions of the securities intermediary. Note that the entitlement holder has no rights to direct the securities intermediary in asserting that status. Remember in this regard that subsection 8-503(a) states that the financial asset is *not* property of the securities intermediary, but held for entitlement holders to the extent necessary for the securities intermediary to meet its obligations to them.

2. The "rights"

The "rights" embodied in a security entitlement under Article 8 reveal significant limitations on an entitlement holder's enforceable "property interest" in the financial asset.

a. rights against third parties

Article 8 provides an entitlement holder only extremely limited rights in the financial asset against persons other than its securities intermediary. There are no rights against the issuer of the financial asset which is the essence of a property interest in a financial asset.[150] Much of the indirect holding system involves at least two tiers of securities intermediaries (meaning that the financial asset is a securities entitlement).[151] An entitlement holder is not given any

150. *See id.* § 8-102 cmt. 17. Part 5 of Article 8 only enumerates limited property interests enforceable against "purchasers." These are contained in § 8-503. No rights against the issuer of the financial asset are described. *See In re* County of Orange, 219 B.R. 543, 553-56 (Bankr. C.D. Cal. 1997).

151. *See supra* notes 133-138 and accompanying text.

rights against an upper tier intermediary.[152] In summary, there are no legal rights under Article 8 against persons up the indirect holding chain.

While this absence of rights may be distressing to an entitlement holder, it is not astounding because it is inherent in the indirect holding system. No one in the indirect holding chain, except the immediate securities intermediary, has any way of knowing that the entitlement holder has an interest in the financial asset.

In contrast, Article 8 includes rights of an entitlement holder against purchasers of a financial asset underlying a security entitlement, but only in extremely limited circumstances.[153] Four explicit requirements must be met:[154] First, the securities intermediary must be subject to insolvency proceedings. Before the entitlement holder can pursue rights against the purchaser, the trustee in the securities intermediary's insolvency proceeding must have elected not to pursue those rights.[155] Second, the securities intermediary cannot have sufficient financial assets to meet its

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152. *See* U.C.C. § 8-102 cmt. 17; *see id.* § 8-503 cmt. 2; Rogers, *supra* note 4, at 1455-56.

153. The drafters state that "except in extremely unusual circumstances" there are no rights against third party transferees. U.C.C. § 8-503 cmt. 2.

154. U.C.C. § 8-503(d) provides:

> An entitlement holder's property interest with respect to a particular financial asset under subsection (a) may be enforced against a purchaser of the financial asset or interest therein only if:
>
> (1) insolvency proceedings have been initiated by or against the securities intermediary;
>
> (2) the securities intermediary does not have sufficient interests in the financial asset to satisfy the security entitlements of all of its entitlement holders to that financial asset;
>
> (3) the securities intermediary violated its obligations under section 8-504 by transferring the financial asset or interest therein to the purchaser; and
>
> 4) the purchaser is not protected under subsection (e).
>
> The trustee or other liquidator, acting on behalf of all entitlement holders having security entitlements with respect to a particular financial asset, may recover the financial asset, or interest therein, from the purchaser. If the trustee or other liquidator elects not to pursue that right, an entitlement holder whose security entitlement remains unsatisfied has the right to recover its interest in the financial asset from the purchaser.

155. *See* U.C.C. § 8-503(d).

obligations to entitlement holders.[156] Third, the transfer of the financial asset to that particular purchaser must have violated the securities intermediary's obligation to maintain sufficient interests in the financial asset.[157] The sole effect of this third requirement is to limit the identity of the purchaser who can be pursued because of insufficient financial assets. Meeting the second requirement will also violate the securities intermediary's duty described in this third requirement.[158] Fourth, the purchaser cannot be protected under subsection 8-503(e). Subsection 8-503(e)[159] protects any purchaser who has given value and obtained control of the financial asset from any action based on the entitlement holder's property interest unless that purchaser colluded[160] with the securities intermediary in violating its duties to the entitlement holder. The vast majority of purchasers qualify for this protection (the requirements are certainly easier to satisfy than those of a "protected purchaser" of a security).

In summary, it is an extraordinarily rare circumstance in which an entitlement holder's rights will be enforceable against a purchaser. Some of these limitations on rights against third persons are inherent in an indirect holding system because the entitlement holder is to look first, and almost exclusively, to its securities intermediary in claiming the underlying financial asset. The higher standards of purchaser protection in subsection 8-503(e), however, are not inherent in the indirect holding system. The advisability of these limitations will be explored in the section exploring indirect holding and third persons.

156. *See id.*
157. *See id.*
158. *See id.* § 8-504(a).
159. U.C.C. § 8-503(e) provides:

> An action based on the entitlement holder's property interest with respect to a particular financial asset under subsection (a), whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against any purchaser of a financial asset or interest therein who gives value, obtains control, and does not act in collusion with the securities intermediary in violating the securities intermediary's obligations under Section 8-504.

160. The selection of a no-collusion requirement raises some important issues that are explored in depth in a subsequent section. *See infra* notes 536-564 and accompanying text.

b. rights against its securities intermediary

Article 8 gives an entitlement holder a number of specific rights against its securities intermediary.[161] These rights are the essence of a securities entitlement and virtually its sum total.[162] This conclusion is presaged by the definition of entitlement holder itself, "a person ... having a security entitlement *against* the securities intermediary,"[163] and the definition of security entitlement, "the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5."[164] In other words, an entitlement holder has the rights and property interest enumerated in Part 5 of Article 8 against its securities intermediary and little else.

The rights an entitlement holder may enforce against the securities intermediary are limited to enforcement of the securities intermediary's Article 8 obligations. These obligations are described in detail below.

3. Obligations of a securities intermediary

A securities intermediary satisfies its obligations and effectuates all rights the entitlement holder has against it to the financial asset by performing eight statutory obligations. Central to these obligations is the concern that the entitlement holder receives the economic and corporate rights that comprise the financial asset.[165]

a. statutory obligations

Two of these obligations are fundamental to the entire system, because they encompass the key expectation of an entitlement holder. The securities intermediary must take action to obtain a payment or distribution made by the issuer of a financial asset.[166] This is accompanied by an almost absolute obligation[167] to the

161. *See* U.C.C. § 8-503(c).

162. That little more than in personam rights against the securities intermediary are included in a securities entitlement is implied from several references in the official comments to the security entitlement being a bundle of rights against the securities intermediary. *See id.* § 8-110 cmts. 1, 3; *see id.* § 8-501 cmt. 4.

163. *Id.* § 8-102(a)(7) (emphasis added).

164. *Id.* § 8-102(a)(17).

165. *See id.* § 8-503 cmt. 2.

166. *See id.* § 8-505(a).

167. The obligation is subject to set-off or counterclaim. *See id.* § 8-505

entitlement holder to pass along payments or distributions made by the issuer of a financial asset and received by the securities intermediary.[168] The obligation to pass through economic benefits of the financial asset is the only obligation of a securities intermediary not subject to limitation by agreement or a commercial reasonableness standard.[169]

Together with the obligation to obtain and pass through to the entitlement holder payments and distributions, the obligation of the securities intermediary to exercise ownership rights with respect to the financial asset on behalf of the entitlement holder constitutes the essence of a security entitlement.[170] These rights encompass such things as voting rights, conversion rights, rights to make demand for payment of an instrument which is a financial asset, and rights to enforce legal obligations.[171] There are two important contrasts between the obligation to pass through economic benefits and the obligation to pass through other rights of ownership. First, the securities intermediary must exercise the other rights of ownership only if directed to do so by an entitlement holder.[172] A securities intermediary can satisfy this obligation by placing the entitlement holder in a position to exercise the rights directly.[173] Note that Article 8 gives the securities intermediary no express obligation to make the entitlement holder aware of the existence or terms of such rights.[174] Second, the obligation to exercise those rights is dependent upon the agreement between the securities intermediary and the entitlement holder.[175]

The next two obligations are important in minimizing the entitlement holders' financial risks. The securities intermediary must obtain and maintain sufficient quantities of the financial asset to satisfy the claims of its entitlement holders.[176] The only exception to

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cmt. 3; *see id.* § 8-509(c).

168. *See id.* § 8-505(b).

169. *Id.*

170. *See supra* notes 97-102 and accompanying text.

171. *See* U.C.C. § 8-506 cmts. 3-4.

172. *See id.* § 8-506.

173. *See id.* § 8-506(2).

174. Federal securities laws create a number of statutory obligations in this area for securities intermediaries subject to those laws. *See id.* § 8-506 cmt. 4.

175. *See id.* § 8-506(1).

176. U.C.C. § 8-504(a) provides as follows:

this requirement is for "a clearing corporation that is itself the obligor of an option. . . .[177] Second, the securities intermediary has an obligation not to grant security interests in the financial assets held for entitlement holders *without agreement*.[178] The exception for contrary agreements has important justifications but raises troubling questions which are discussed in a later section.[179]

The final three obligations relate to complying with entitlement orders or directions from the entitlement holder. An "entitlement order" directs the securities intermediary to "transfer or [redeem] a financial asset to which the entitlement holder has a security entitlement."[180] The entitlement order only directs the transfer, it is not an order to sell the financial asset.[181] It is the indirect holding system's analog to indorsement and delivery of a certificated security or an instruction[182] to transfer an uncertificated security. Any other instruction to the securities intermediary is referred to as a direction.[183]

> A securities intermediary shall promptly obtain and thereafter maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset. The securities intermediary may maintain those financial assets directly or through one or more securities intermediaries.

The provision is based on federal securities law requirements, 17 C.F.R. § 240.15c3-3 (2000), and recognizes that a security entitlement is a pro rata claim to the fungible bulk of interests in the financial asset maintained by the securities intermediary.

177. U.C.C. § 8-504(d). This exception, although not so limited, was necessary to accommodate the Options Clearing Corporation, which does not hold options, but guarantees the obligations of its participants. *See id.* cmt. 5. The operation of the Options Clearing Corporation is explained in the prefatory note. *See* Prefatory Note, *supra* note 3, Part III.C.12.

178. *See* U.C.C. § 8-504(b).

179. *See infra* notes 505-512 and accompanying text.

180. U.C.C. § 8-102(a)(8).

181. *See id.* § 8-507 cmt. 5.

182. The definition of entitlement order parallels the defined term "instruction," which relates to transfer and redemption directions given to the issuer of directly held uncertificated securities. *See id.* § 8-102(a)(12).

183. Direction is not a defined term in Article 8, but it is the term used in §§ 8-506 and 8-508 to describe instructions from an entitlement holder to a securities intermediary and the intermediary's duties in connection therewith. Note, however, that official comment 8 to § 8-102, as supplemented by the conforming amendments to revised Article 9, explains that the "direction" referred to in § 8-508 is an entitlement order.

The securities intermediary must comply with an entitlement order, if originated by the appropriate person and the securities intermediary has (1) reasonable opportunity to assure itself of genuineness and authenticity and (2) reasonable opportunity to comply.[184] The appropriate person is the entitlement holder,[185] unless the entitlement holder is deceased or incapacitated.[186] An entitlement order not issued by an appropriate person is nevertheless effective if ratified by the appropriate person or made by its agent.[187] This would include an entitlement order issued by a purchaser obtaining control of the security entitlement by agreement.

The securities intermediary's obligation to comply with entitlement orders from the appropriate person is bolstered by a second obligation. If the securities intermediary acts on an *ineffective* entitlement order, it must reestablish a security entitlement and pay or credit any distributions or payments not received as a result of a wrongful transfer.[188] If the securities intermediary does not reestablish the security entitlement, it is liable for damages.[189] There is an important limitation on these duties. While the securities intermediary is only required to comply with an entitlement order from an appropriate person, it is not liable if it transfers a financial asset pursuant to an "effective" entitlement order that is not from the appropriate person.[190]

Finally, the securities intermediary has a duty to "act at the direction of an entitlement holder to change a security entitlement into another available form of holding for which the entitlement holder is eligible, or to cause the financial asset to be transferred to a securities account of the entitlement holder with another securities intermediary."[191] Changing the form of security holding, of course, permits an entitlement holder to demand to hold the financial asset directly rather than indirectly. The right to transfer a security

184. *See* U.C.C. § 8-507(a).
185. This includes a purchaser obtaining control of the security entitlement by becoming the entitlement holder.
186. *See* U.C.C. § 8-107(a)(3)-(5).
187. *See id.* § 8-107(b)-(e); *see id.* § 8-507 cmts. 3, 4.
188. *See id.* § 8-507(b).
189. *See id.*
190. *See id.* § 8-115 (allowing transfers of financial assets subject to exceptions for violating legal process or acting in collusion with a wrongdoer).
191. *Id.* § 8-508.

entitlement to a securities account with another securities intermediary makes an important inroad into the practical monopoly a securities intermediary has which would otherwise require the entitlement holder to use it in connection with any transfer of the indirectly held financial asset. Although the term "direction" in section 8-508 would imply that changing the form of holding can only be done by entitlement holders, in contrast with entitlement orders which may be effective when issued by others as provided in subsections 8-107(b)-(e), that "direction" is an entitlement order.[192]

All things considered, the obligations to comply with entitlement orders and directions create the strongest "property interest" the entitlement holder has.

b. standards of performance

A securities intermediary satisfies its obligations under Article 8 by complying with other legal requirements, by exercising due care in accordance with reasonable commercial standards, or by performing its duties as specified by agreement.[193] A securities intermediary's compliance with another statute, regulation, or rule satisfies its Article 8 duty if the substance of the duty is the subject of that other legal requirement.[194] To the extent not covered by statute, regulation, rule, or by the party's agreement, duties are to be performed and rights are to be exercised in a commercially reasonable manner.[195] The agreement of the parties can specify how the securities intermediary satisfies most of its obligations without observing due care in accordance with reasonable commercial standards.[196] This provision raises a significant issue. Should there be an independent standard requiring securities intermediaries to observe due care in accordance with reasonable commercial standards? This question is explored in a later section.[197]

192. *See id.* § 8-102 cmt. 8.

193. *See id.* §§ 8-504(c)(1)-(2), 8-505(a)(1)-(2), 8-506(1)-(2), 8-507(a)(1)-(2), 8-508(1)-(2), 8-509.

194. *See id.* § 8-509(a).

195. *See id.* § 8-509(b).

196. *See id.* §§ 8-504(c)(1), 8-505(a)(1), 8-506(1), 8-507(a)(1), 8-508(1). Note that this formulation is intended to avoid the normal inability to disclaim a duty of care under § 1-102(3), but it does not eliminate the duty to act in good faith under §§ 1-203, 8-102(a)(10). *See id.* § 8-504 cmt. 4.

197. *See infra* notes 499-504 and accompanying text.

A securities intermediary may withhold performance of its obligations because of unfulfilled obligations the entitlement holder has to the securities intermediary.[198] This right to withhold performance may arise out of a security interest, under a security agreement with the entitlement holder or otherwise, or under other law or agreement.[199]

IV. CHANGES AFFECTING THIRD PERSONS IN BOTH SYSTEMS

A. Revised Concept of Adverse Claims

Article 8 narrowed the definition of "adverse claim." The 1977 version had an open-ended definition: "Adverse claim *includes* a claim that a transfer was or would be wrongful or that a particular adverse person is the owner of or has an interest in the security."[200] This definition was broad enough to cover any restriction on transfer and any claim of ownership to or interest in the security. Article 8 limits an adverse claim to a "claim that a claimant has a property interest in a financial asset and that it is a violation of the rights of the claimant for another person to hold, transfer, or deal with the financial asset."[201]

The revised definition makes several significant changes. The change from "security" to "financial asset" was necessitated because the indirect holding system includes "financial assets" that are not "securities."[202] Restrictions on transfer are no longer expressly defined as adverse claims,[203] although they have not been expressly eliminated. More importantly, a claim is limited to a property interest and the claim is not an adverse claim unless the claimant's rights are violated by "holding, transferring or dealing with" the financial asset.[204]

198. *See* U.C.C. § 8-509(c).
199. *See id.*
200. U.C.C. § 8-302(2) (1977) (emphasis added).
201. U.C.C. § 8-102(a)(1).
202. *See id.* § 8-102 cmt. 9.
203. The language in § 8-302(2) of the 1977 version, "adverse claim includes a claim that a transfer was or would be wrongful," was broad enough to include restrictions on transfer.
204. *See* U.C.C. § 8-102(a)(1).

1. Violated property interest limitation

The drafters included the property interest limitation to avoid the suggestion "that any wrongful action concerning a security, even a simple breach of contract, gave rise to an adverse claim."[205] While the limitation to a "property interest" is intuitively correct, it is new. The difference between a property interest and some other interest is not a clear legal distinction. Will this change provide a meaningful benefit to purchasers? The requirement that the claimant's rights must be violated by holding, transferring, or dealing with the financial asset also has intuitive appeal, but may inadvertently limit purchaser protections. These questions are explored in a later section.[206]

2. Restrictions on transfer

Understanding the effect of eliminating the express inclusion of restrictions on transfer as adverse claims requires distinguishing transfer restrictions created by issuers from those imposed by statute or among shareholders. Issuer restrictions on transfer are covered separately in Article 8—similar to the treatment they were given in the 1977 version.[207] An issuer restriction is ineffective against persons without knowledge of it, unless noted on the security certificate or notification of it has been given to the registered owner of an uncertificated security.[208] Note that a person holding securities indirectly has no guaranteed way to learn of effective issuer restrictions on transfer.

Transfer restrictions imposed by statute or among shareholders are not expressly covered.[209] Treatment of statutory restrictions will depend on the statutory provisions and their legal effect. Shareholder transfer restrictions receive the same treatment they had under the 1977 version, only if they meet the new requirements for

205. *Id.* § 8-102 cmt. 1.

206. *See infra* notes 460-496 and accompanying text.

207. *See* U.C.C. § 8-204 (1977).

208. *See* U.C.C. § 8-204. The differential treatment of certificated and uncertificated securities is simply the difference in what is required to complete a transfer. Delivery of the certificate accomplishes the transfer of a certificated security, while the uncertificated security is not transferred until the transfer is registered on the issuer's books. *See id.* cmt. 3.

209. The drafters explain that they have been left to other law. *See id.* cmt. 5.

an adverse claim. They should easily meet the "violation" requirement because they preclude transfers. The issue becomes whether they are property interests. Transfer restrictions are not always accompanied by an option to purchase, a right of first refusal or a forfeiture provision. The shareholders may simply want to enjoin a prohibited transfer. Is such a right a property interest or a mere contractual right outside the definition of adverse claim?

If these transfer restrictions are not covered by Article 8's narrower definition of adverse claim, they are left in a legal never-never-land. There are two possible outcomes. First, a protected purchaser does not take free of the restrictions, whether or not the purchaser has notice because they are not adverse claims (a reading that would not be supported by the drafters). Alternatively, the restrictions are completely outside the rules of Article 8, requiring courts to fashion whatever rules seem appropriate. This second possibility is unacceptable to shareholders seeking to impose transfer restrictions without any way of knowing whether they will be enforceable against third parties. The incentive created is to make sure the restriction includes a property interest.

B. Duties to Adverse Claimants

Several provisions in Article 8 facilitate free transferability of securities or security entitlements by limiting the duties issuers, financial intermediaries, or certain other parties have to one asserting an adverse claim to the security or security entitlement.[210] Such provisions insulate holders of securities from legal pressure brought against record keepers involved with the security.[211] These protections are new to Article 8.[212]

1. Protecting those in administrative roles

Those acting in an administrative capacity or as conduits for transfers are given important protections from liability.[213] Although issuers, authenticating trustees, transfer agents, registrars and securities intermediaries, brokers, agents, and bailees are liable for

210. *See* U.C.C. §§ 8-115, 8-404, 8-407.
211. *See* Rogers, *supra* note 4, at 1497-503.
212. *See, e.g.*, Prefatory Note, *supra* note 3, at Part IV.B.6.
213. *See* U.C.C. § 8-115 cmt. 1; *see id.* § 8-404 cmt. 2.

acting on ineffective indorsements, instructions, or orders,[214] it is difficult to block their compliance with effective indorsements, instructions or orders.

Section 8-115 protects brokers, agents, or bailees in the direct holding system and securities intermediaries in the indirect holding system that transfer a financial asset pursuant to an effective entitlement order or direction from liability to an adverse claimant unless it had been timely served with legal process or was in collusion with the wrongdoer.[215] Absent this protection, these persons could have liability in common law conversion. The policy behind this protection is to facilitate prompt action on customer orders and thereby facilitate securities settlement systems despite notice of adverse claims to the securities.[216] The drafters did not want to require those entities to make a legal judgment in the face of such a claim.[217] Section 8-115 provides greater rights to the adverse claimant if a security certificate was stolen. In this situation, the person acting as a conduit is liable if he/she had notice of the adverse claim.[218] This different treatment is in deference to public policy against facilitating transfers of stolen security certificates.[219]

In a similar way, sections 8-404 and 8-407 protect issuers, authenticating trustees, transfer agents, and registrars registering transfers pursuant to effective indorsements or instructions from assertions of adverse claims unless section 8-403's stop-registration

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214. Issuers are expressly liable under § 8-404(c) and that liability has been newly extended to authenticating trustees, transfer agents, and registrars under § 8-407. Securities intermediaries, agents, and bailees have potential liability under general principles of conversion law. *See id.* § 8-115 cmt. 1.

215. U.C.C. § 8-115 provides in pertinent part:

> A securities intermediary that has transferred a financial asset . . . or a broker or other agent or bailee that has dealt with a financial asset . . . is not liable to a person having an adverse claim to the financial asset, unless [it] . . .:
>
> (1) took the action after it had been served with an injunction, restraining order, or other legal process . . .
>
> (2) acted in collusion with the wrongdoer . . .; or
>
> (3) in the case of a security certificate that has been stolen, acted with notice of the adverse claim.

216. *See* U.C.C. § 8-115 cmt. 3.

217. *See id.*

218. *See id.* § 8-115(3).

219. *See id.* § 8-115 cmt. 3.

procedure has been complied with, an injunction issued, or they act in collusion with the wrongdoer.[220] They have no duty to inquire into the adverse claims.[221] Under section 8-403, a claimant who is an appropriate person to indorse securities or issue valid instructions can delay registration of the transfer by making a demand not to register a transfer but must ultimately enjoin it or get an indemnity bond.[222] The drafters intended these rules to provide parity with the indirect holding system so that a book entry direct holding system could develop. That parity was in the form of eliminating any issuer's duties to adverse claimants in the same way clearing corporations are protected from adverse claimants under section 8-115 because each is simply performing a record-keeping function.[223]

2. Limited obligations to honor claims

Section 8-112, which did not have a counter-part in the 1977 version, specifies on whom legal process *must* be served by a creditor in order to reach a debtor's security or security entitlement.[224] For each way a security may be held (certificated,

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220. Subsection 8-404(a) provides liability for wrongful registration of a transfer to a person not entitled to it if: the indorsement or instruction was ineffective, there was a demand not to register and the § 8-403 procedure was followed (notice to the demanding party with time to obtain an injunction or indemnity bond), a timely injunction had been served, or the issuer acted in collusion with the wrongdoer. Subsection 8-404(c) exempts the issuer from liability for registration pursuant to an effective indorsement or instruction, except for the reasons set forth in § 8-404(a) or law outside the U.C.C. relating to collection of taxes.

221. *See* U.C.C. § 8-401 cmt. 1; *see id.* § 8-402 cmt. 4.

222. Although § 8-403 provides a procedure for one who is authorized to indorse a security certificate or give instructions on an uncertificated security to demand that the issuer not register a transfer, the procedure only buys time (up to 30 days) for that person to obtain a court order or to file a bond. U.C.C. § 8-403(d) provides in pertinent part: "An issuer is not liable to a person who initiated a demand that the issuer not register transfer . . . if the person . . . does not . . . (1) obtain an appropriate restraining order . . . enjoining the issuer from registering the transfer; or (2) file with the issuer an indemnity bond . . . ."

223. *See* U.C.C. § 8-404 cmt. 2; Rogers, *supra* note 4, at 1503 n.98.

224. U.C.C. § 8-112 provides:

> (a) The interest of a debtor in a certificated security may be reached by a creditor *only* by actual seizure of the security certificate . . . except as otherwise provided in subsection (d). . . .
>
> (b) The interest of a debtor in an uncertificated security may be reached by a creditor *only* by legal process upon the issuer at its chief

uncertificated, or as a security entitlement) there is only one way to reach it. Delaware corporate law, unlike the law of many other states, treats a securities certificate as mere evidence of the security rather than the security itself.[225] Delaware corporate law contains a provision preempting the Delaware Commercial Code whenever there is an inconsistency with corporate law.[226] As a result, for securities of a Delaware corporation, attachment against the record owner may be made by legal process under provisions of law different from section 8-112. A recent amendment to section 324 of the Delaware General Corporation Law requires compliance with section 8-112 when attaching a certificated security.[227] This significantly reduces concerns that stock of a Delaware corporation could be attached without obtaining possession of the certificate.

C. Expanded Protection for Secured Creditors

Priority for secured parties under the Code is generally linked to perfection of the security interest. Article 8 and revised Article 9 expanded the ways to perfect security interests in financial assets. Concomitant changes in priority rules accommodated the new ways to perfect.

> executive office . . . except as otherwise provided in subsection (d).
>
> (c) The interest of a debtor in a security entitlement may be reached by a creditor *only* by legal process upon the securities intermediary . . . except as otherwise provided in subsection (d). (Emphasis added).

Subsection (d) permits legal process on the debtor's secured party if it has possession, is registered as the owner, or has the security entitlement in its name.

225. Note that this is the conceptual approach taken by the drafters of Article 8 in their definitions of security and security certificate. *See* U.C.C. § 8-102(a)(15), (16); *see also* Prefatory Note, *supra* note 3, at Part II.B (discussing Article 8's treatment of certificates as a way to evidence ownership).

226. *See* DEL. CODE ANN. tit. 8, § 201 (1991). The relevant sections of Delaware law are cross-referenced in Delaware's Article 8 to aid interested parties in locating the provisions that may supersede the provisions on serving process to make adverse claims in certain circumstances. The relevant sections are in title 8, §§ 169 and 324 and title 10, §§ 365, 366, and 3501-513 of the Delaware Code.

227. Title 8, § 324 of the Delaware Code was amended in 1998 to require compliance with U.C.C. § 8-112 when attaching a certificated security. DEL. CODE ANN. tit. 8, § 324(a) (1998).

1. Perfecting security interests

Prior law required a security to be transferred to the secured party to perfect a security interest in it.[228] In essence, transfer required the secured party to either obtain possession of a certificated security or have an uncertificated security registered in its name.[229] Possession or registration could be accomplished through a third party. Because indirectly held securities were in the possession of, or registered in the name of, someone other than the debtor, a secured party under the 1977 version of Article 8 had to either obtain a registered pledge[230] or comply with one of the more complicated provisions on transfer in section 8-313.[231]

Under Article 8 and revised Article 9, perfection of a security interest in either directly or indirectly held investment property can be obtained by filing a financing statement under subsection 9-312(a). In addition, secured parties of brokers and securities intermediaries are automatically perfected under subsection 9-309(10).[232] Perfection can still be accomplished through possession

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228. Technically, U.C.C. § 8-321 (1977) required transfer for a security interest to attach and a security agreement, the giving of value, and the debtor to have rights in the security (the U.C.C. § 9-203 requirements for attachment) as additional steps for perfection. U.C.C. § 8-313 (1977) described what was required to constitute a transfer of the security. Because perfection requires attachment, the transfer requirement was the key element of the entire process. Under the 1977 version an unperfected security interest was highly unlikely. *See* U.C.C. § 8-321 cmt. 2 (1977).

229. *See id.* § 8-313.

230. *See id.* § 8-320.

231. The provisions in U.C.C. § 8-313 (1977) which governed transfer when the certificate was in the possession of a third party or the security was registered to a third party included: confirmation and book entry by a financial intermediary identifying securities in the possession of or registered to the intermediary as belonging to the secured party, *see id.* § 8-313(1)(d); entry on the books of a clearing corporation to a secured party's account under § 8-320 (1977), *see id.* § 8-313(1)(g); and receipt by a financial intermediary of written notification of a security interest in a security held on its books for a debtor, *see id.* § 8-313(1)(h)-(i). Courts had construed some of these provisions in ways that broadened protection of purchasers. *See* Schroeder, *supra* note 12, at 343-47.

232. This automatic perfection is best understood as a codification and expansion of the practice that had developed of rolling over short-term loans under "agreements to pledge" to take advantage of the 21-day automatic perfection rule in § 9-304(4) (1972). *See* Mooney, *supra* note 18, at 341 n.121; Schroeder, *supra* note 12, at 320. It reflects an understanding in the securities

of a certificated security and registration of an uncertificated security, actions that are included in perfection by "delivery" or "control"[233] under Article 8 and revised Article 9.[234] Perfecting a security interest in a security entitlement by control[235] requires the secured party (or a third party on its behalf) to either become the entitlement holder, or obtain the agreement of the securities intermediary to follow its entitlement orders without further consent of the entitlement holder.[236] A securities intermediary granted a security interest by its entitlement holder in a security entitlement has control.[237]

These rules facilitating perfection of security interests simplify financing in the securities markets.[238] Greater and easier access to credit is another way systemic risk has been reduced.[239] That reduction is particularly apparent for those financing brokers and securities intermediaries—they are now automatically perfected.

2. Priority of secured parties

Under prior law, priority between secured creditors went to the first to perfect[240] unless the requirements of the bona fide purchaser

industry that the norm is for security industry professionals to have encumbered their assets. *See* Schoeder, *supra* note 12 at 399.

233. Delivery under § 8-301 requires obtaining possession, directly or through an appropriate third person, of a certificated security and being registered, directly or through an appropriate third person, as owner of an uncertificated security. Control is defined in § 8-106(a),(b) and (c) as delivery and any appropriate indorsement or registration for a certificated security, and delivery or agreement by the issuer to follow the purchaser's instructions for an uncertificated security.

234. *See* U.C.C. § 9-313(a) (delivery of certificated securities); *see id.* § 9-314(a) (control of any investment property).

235. *See id.* § 9-314(a).

236. *See id.* §§ 8-106(d), 9-106(a).

237. *See id.* § 8-106(e).

238. Professor Schroeder sets forth the primary types of lending against investment property under the 1977 version and points out that a primary purpose of the revisions was to facilitate credit secured by investment property. *See* Schroeder, *supra* note 12, at 450.

239. *See id.* at 375.

240. *See* U.C.C. § 9-312(5) (1972).

rule were met by the subsequent perfected secured party.[241] Priority over lien creditors was obtained by perfection.[242]

Article 8 and revised Article 9 provide secured parties greater protection from lien creditors, most notably a trustee in bankruptcy. Priority over lien creditors is obtained either by perfecting the security interest or by filing a financing statement and having an authenticated security agreement.[243] Perfection of security interests is also made easier with the possibility of perfecting by filing a financing statement or perfecting automatically.

The new perfection options created new issues making priority for secured creditors a more complex question under Article 8 and revised Article 9. A perfected secured party without control loses to a secured party who has obtained control,[244] even if the control comes later and the later secured party has knowledge of the earlier perfected interest.[245] If both secured parties have control, they rank according to the time control was obtained.[246] Between secured parties, if neither has control, the first to file or perfect wins,[247] unless the debtor is a broker or securities intermediary in which case the secured parties rank equally.[248] This last rule introduces a pro rata priority concept among secured creditors.[249] Perfected secured

241. U.C.C. § 9-312(1) (1972) provided that § 9-312 only applied when no other rule in part 3 of Article 9 applied and § 9-309 (1972) provided that nothing in Article 9 limited the rights of a bona fide purchaser under § 8-302 (1977).

242. *See* U.C.C. § 9-301(1)(b) (1972).

243. *See* U.C.C. § 9-317(a)(2).

244. *See id.* § 9-328(1).

245. U.C.C. § 9-328(1) is not limited by the knowledge of the secured party. The rule also prevails over the first to file or perfect rule in U.C.C. § 9-322(a)(1), due to the language in § 9-322(f)(1).

246. *See* U.C.C. § 9-328(2)(A).

247. U.C.C. § 9-322(a)(1) applies to these disputes and awards priority to the first to file or perfect.

248. *See* U.C.C. § 9-328(6).

249. Prior to the revision of Article 9, the conforming amendments to Article 9 promulgated with revised Article 8 created a second pro rata priority between any two secured parties having control. *See* U.C.C. § 9-115(5)(b), (e) (1994). Reflection on the problems created by a pro rata priority rule apparently convinced the drafters of revised Article 9 to eliminate it except between creditors of brokers or securities intermediaries.

parties still lose to purchasers qualifying for the benefits of the protected purchaser rule.[250]

Two issues raised by these new priority rules are explored in a subsequent section. Should knowledge of a prior security interest (relevant under the protected purchaser rule but irrelevant under control priority rules) play a role in these priority rules?[251] Does the pro rata priority concept improve the functioning of the system?[252]

D. Choice of Law and Adverse Claimants

The choice of law rules in Article 8 mandate that the local law of the securities intermediary's jurisdiction governs adverse claims to security entitlements and the securities intermediary's duties to adverse claimants.[253] The securities intermediary's jurisdiction is determined by reference to the contract between the securities intermediary and the entitlement holder. Preference is given to an explicit designation in the document governing the securities account.[254] If such designation is not expressly made, other statements in the account documentation or circumstances surrounding the account help "locate" the securities intermediary's jurisdiction.[255] The drafters, while eliminating great uncertainty

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250. *See* U.C.C. §§ 8-303, 9-331(a).

251. *See infra* notes 576-583 and accompanying text.

252. *See infra* notes 606-609 and accompanying text.

253. *See* U.C.C. § 8-110(b)(3)-(4).

254. The Article 8 rules for determining the securities intermediary's jurisdiction were sufficiently problematic that the conforming amendments to Article 8 made by revised Article 9 changed § 8-110(e) to give first preference to an express provision of governing law for purposes of Article 8.

255. U.C.C. § 8-110(e) provides as follows:

> (e) The following rules determine a "securities intermediary's jurisdiction" for purposes of this section:
>
> (1) If an agreement between the securities intermediary and its entitlement holder governing the securities account expressly provides that a particular jurisdiction is the securities intermediary's jurisdiction for purposes of this part, this article, or this [Act], that jurisdiction is the securities intermediary's jurisdiction.
>
> (2) If paragraph (1) does not apply and an agreement between the securities intermediary and its entitlement holder [governing the securities account] expressly provides that the agreement is governed by the law of a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.
>
> (3) If neither paragraph (1) nor paragraph (2) applies and an

under prior law,[256] sought to provide contractual flexibility in this determination with a hierarchy of rules.

This contractual flexibility makes sense as an abstract proposition.[257] The securities intermediary's jurisdiction, however, cannot readily be determined by an adverse claimant applying Article 8. That claimant in most cases has no access to the information necessary to make the determination. The rights of third-party claimants should not be determined by a body of law which cannot be readily, independently, and objectively determined by those claimants. From the perspective of third parties, governing law should be determined by the most objective of the options given in subsection 8-110(e), the jurisdiction in which the securities intermediary's chief executive office is located.

A similar, although less serious problem, is that Article 9 mandates the application of the law of the securities intermediary's jurisdiction to govern priority, perfection, and the effect of perfection or nonperfection of a security interest in either a security entitlement or securities account unless perfection is by filing a financing statement or automatic.[258]

In the context of obtaining a security interest, the secured party will be able to get access to the agreement upon which the determination is based. This agreement, however, is subject to amendment without notice to the secured party. Even including a covenant in the security agreement to prevent amendment without notice is unsatisfactory. A claim of breach is of no value when the

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agreement between the securities intermediary and its entitlement holder governing the securities account expressly provides that the securities account is maintained at an office in a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.

(4) If none of the preceding paragraphs applies, the securities intermediary's jurisdiction is the jurisdiction in which the office identified in an account statement as the office serving the entitlement holder's account is located.

(5) If none of the preceding paragraphs applies, the securities intermediary's jurisdiction is the jurisdiction in which the chief executive office of the securities intermediary is located.

256. *See* Rogers, *supra* note 4, at 1457-60.
257. *See* U.C.C. § 8-110 cmt. 3.
258. *See id.* § 9-305(a)(3), (c).

security interest has become unperfected due to the change of governing law.[259]

These same two problems arise to a lesser degree in the direct holding system. They result from the flexibility given issuers of securities under subsection 8-110(d) to specify a jurisdiction other than the jurisdiction under which it is organized to govern adverse claims to securities, the duties of the issuer to adverse claimants,[260] and the priority, perfection and the effect of perfection or nonperfection of a security interest perfected by a means other than filing or automatically.[261] How and where this "specification" is to be made is not stated. Likewise, there is no provision governing future changes to the specification. A third party is again potentially unable to determine what law will govern its claim. Whatever justifications support the choice of law provisions in section 8-110 do not apply here. The need for objectively determinable and relatively stable rules is the paramount guiding principle for the choice of law rules in sections 9-301 to 9-307 and subsections 8-110(a)(4)(5), (b)(3)(4). From the perspective of third parties, the governing law should be determined in the same manner as it was prior to the revisions to Article 8—the law of the jurisdiction under which the issuer is organized.

E. Issuer Defenses

Article 8 did not make significant changes to the rules regarding an issuer asserting defenses to its securities. A summary of those rules, however, provides a useful basis for contrasting and understanding other rules in Article 8. An issuer's defense that a security certificate is not genuine can be asserted against anyone, including a protected purchaser.[262] Other defenses, such as: invalidity (except constitutional defects asserted against one taking upon original issuance or asserted by some governmental issuers), nondelivery or conditional delivery, an unauthorized signature on a security certificate, or an incorrectly completed security certificate

259. U.C.C. § 9-307(f)-(g) provide that upon a change in the securities intermediary's jurisdiction, the secured party has up to four months in which to take any necessary action without becoming unperfected.

260. *See* U.C.C. § 8-110(a)(4)-(5).

261. *See id.* § 9-305(a)(2), (c).

262. *See id.* § 8-202(c).

cannot be asserted against a purchaser for value without notice of the particular defect.[263] These rules differ in two important ways from the protected purchaser rule. First, the purchaser is not required to have control. Second, only notice of the particular defect, as contrasted with notice of any adverse claim, subjects the person to the issuer's defense based on that defect.[264] These protections are extended to entitlement holders in the indirect holding system by subsection 8-202(f).

An important difference between protection against issuer restrictions and defenses and protection against claims to a certificated security[265] is manifested in the different standards used when imputing notice based upon acquiring the security beyond the maturity date or the date fixed for redemption or exchange. Notice of an issuer's defects or defenses is imputed to purchasers after one-year or two-year time periods.[266] However, when imputing notice of a claim to the security, the time periods are reduced to one year and six months.[267] The difference evidences a clear preference to give issuers less protection than adverse claimants.

V. INDIRECT HOLDING—THIRD PERSONS

The indirect holding system differs significantly from the direct holding system when viewed from the perspective of the rights of and the rights against third persons. The differences between the rules in the two systems, the justifications for those differences, and the circumstances under which each rule applies need to be examined to understand the protections available to—and the risks and uncertainties created for—those who hold securities indirectly. The indirect holding rules are more complex because they involve both an underlying financial asset and a security entitlement to that asset. Indirect holding rules are further complicated because both the

263. *See id.* §§ 8-202(b), (d), 8-205, 8-206(a)(2). Subsection 8-202(d) refers to "security" then to "certificated security," making it unclear whether uncertificated securities are covered.

264. *Compare* U.C.C. §§ 8-202(b)(1), (d), 8-205(a)(2) *and* 8-206 *with* § 8-303(a)(2)-(3).

265. For issuers, the rules only need to apply to certificated securities, because for uncertificated securities, the issuer is expected to raise the issue when it receives a request to register a transfer. *See id.* § 8-203 cmt. 1.

266. *See id.* § 8-203.

267. *See id.* § 8-105.

entitlement holder and its securities intermediary are involved with the security entitlement and the underlying financial asset.

A. Protecting Purchasers in Indirect Holding

Because the vast majority of trades occur in the indirect holding system,[268] attempts to control systemic risk in securities markets by facilitating the finality of settlements through the operation of rules protecting purchasers focus on the indirect holding system. Rules protecting purchasers in the indirect holding system have changed significantly under Article 8.[269] Under prior law a purchaser of the security prevailed over an adverse claimant by qualifying as a bona fide purchaser for value.[270] Only two limited ways of holding the security indirectly qualified the purchaser to assert bona fide purchaser status.[271]

Conceptually, the direct holding system's protected purchaser rule[272] could have been applied with appropriate modifications in the indirect holding system to each situation needing a rule to protect purchasers. The drafters of Article 8, however, opted for a different approach. In addition to the important informal structural protection inherent in the indirect holding system, they created three unique rules to protect purchasers. One rule protects the entitlement holder from adverse claims asserted against it to the financial asset.[273] The second rule similarly protects those purchasing a security entitlement from an entitlement holder against adverse claims to either the financial asset or the security entitlement.[274] The third rule is very different. It protects a purchaser of the financial asset from adverse claims asserted by an entitlement holder.[275] Each rule differs in

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268. *See supra* notes 103-105 and accompanying text.

269. *See* Rogers, *supra* note 4, at 1466-69.

270. *See* U.C.C. § 8-302 (1977).

271. U.C.C. § 8-313(2) (1977) limited the circumstances in which a purchaser of a security held by a financial intermediary could be a bona fide purchaser to having a specific certificated security in the hands of the financial intermediary or being designated on the books of a clearing corporation. Courts misread the statute to broaden this protection. *See* Schroeder, *supra* note 12, at 336-49.

272. *See* U.C.C. § 8-303.

273. *See id.* § 8-502.

274. *See id.* § 8-510(a).

275. *See id.* § 8-503(d)-(e); *see also supra* notes 154-160 and accompanying text.

fundamental ways from the protected purchaser rule. The three rules do not cover all possible purchaser/adverse-claimant disputes over financial assets in the indirect holding system. The other disputes were left to rules outside the indirect holding system or do not have specific purchaser protections.

1. Structural protection—tracing

An adverse claimant to a financial asset in the indirect holding system faces practical problems before it can assert its claim against either the securities intermediary or the entitlement holder. It must first trace the financial asset to the securities intermediary. It is not clear whether tracing the financial asset to the securities intermediary would involve tracing the actual trade—finding the buyer(s) whose order(s) was matched with the seller—or tracing the movement of the financial asset in the settlement of the trade. The drafters imply, without providing any justification, that tracing should be through the settlement process.[276] Those two approaches lead to different analyses and results. Tracing the financial asset through the trade by matching buy and sell orders would be possible, depending on record availability, in an over-the-counter market. However, this would be very difficult in an auction type market like the New York Stock Exchange. Tracing a financial asset through the settlement process is extremely difficult due to the netting of trades which occurs during the clearing process in securities markets.[277] Each intermediary will first net sales and purchases made by it that day. Each clearing corporation involved in the settlement will net trades among its participants on that day. To trace a financial asset through those netting processes is extremely difficult, if not impossible.[278]

276. The official comments contain an example which discounts the possibility of relying on the matching of a particular sell order with a particular buy order (which would also be a significant challenge to trace) in favor of describing the challenges of tracing through the settlement process. *See* U.C.C. § 8-502 cmt. 2. Preferring the settlement process over the trade itself seems very closely tied to the historical physical reification concept of certificated securities, but is much less justifiable for uncertificated securities and completely incomprehensible for security entitlements.

277. The drafters describe this tracing problem in some detail, including an example. *See id.* § 8-502 cmt. 2; *see also* Schroeder, *supra* note 12, at 332-34 (describing the difficulty of tracing when trades are netted against each other).

278. The drafters claim such a task would "ordinarily be impossible." U.C.C. § 8-502 cmt. 2.

If the adverse claimant is somehow successful in tracing the financial asset to the securities intermediary,[279] it must also learn of the entitlement holder's interest before asserting its claim against the entitlement holder. Note that even if the financial asset can be successfully traced to the securities intermediary, a claim against the securities intermediary is as likely as a claim against either one of its entitlement holders or a purchaser from an entitlement holder.[280]

The purchaser protection provided by the tracing problem is not dependent on an Article 8 rule; it is inherent in the indirect holding system.[281] In the final analysis, this structural protection is the most important purchaser protection in the indirect holding system because it will be the protection most frequently relied upon. As the subsequent discussion demonstrates, the Article 8 rules protecting purchasers in the indirect holding system have a much more limited application.

2. Protection of entitlement holders

On a superficial level, the section 8-502 rule protecting purchasers in the indirect holding system is most closely analogous to the direct holding system's protected purchaser rule.[282] It precludes the assertion of an adverse claim to the underlying financial asset against an entitlement holder if the entitlement holder acquired the security entitlement for value and without notice of that adverse claim.[283]

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279. For a firsthand description of the difficulty in tracing what at first blush appeared to be a relatively easy tracing problem, see Schroeder, *supra* note 12, at 491 n.458.

280. If the claimant successfully traces the financial asset, it would of course make its claim against whichever party is not entitled to protection under the relevant purchaser protection rule.

281. *See* U.C.C. § 8-502 cmt. 2.

282. The drafters assert in official comment 1 to § 8-502 that it plays a role in the indirect holding system analogous to the protected purchaser rule in the direct holding system.

283. U.C.C. § 8-502 provides as follows: "An action based on an adverse claim to a financial asset, whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against a person who acquires a security entitlement under § 8-501 for value and without notice of the adverse claim."

a. comparison with protected purchaser rule

Two of the four differences between this rule and the protected purchaser rule are inconsequential. First, the entitlement holder is not required to have control. Requiring control would add nothing to establishing that the entitlement holder deserves protection. While an entitlement holder always has control of a security entitlement,[284] it cannot have control of the underlying financial asset. By the very nature of indirect holding, the entitlement holder is only entitled to exercise the rights constituting the financial asset.[285] Second, the rule does not protect the entitlement holder from adverse claims to the security entitlement itself.[286] That protection would be meaningless because the entitlement holder would necessarily have notice of these claims. They would either be claims against the entitlement holder or claims based on actions taken by the entitlement holder.

The third difference between this rule and the protected purchaser rule is the structure of section 8-502 as a preclusion of the adverse claimant's action rather than as a set of requirements the entitlement holder must meet in order to defeat the adverse claim. Purchaser rules historically are stated from the perspective of the purchaser and provide the qualifications for the purchaser to take free of adverse claims. The section 8-502 rule, however, prohibits a legal action "based upon an adverse claim" (regardless of the legal theory)[287] against the entitlement holder. The rule does not expressly provide who wins if the action can be asserted.[288] The different formulation apparently shifts the burden of proof from the entitlement holder, as part of its defense to the adverse claim, to the adverse claimant as part of any action it pursues based upon its claim to the financial asset. This result is not expressly stated in Article 8,

284. U.C.C. § 8-106(d) includes becoming an entitlement holder in the definition of obtaining "control of a security entitlement."

285. U.C.C. § 8-501(a) defines "securities account" to require that the one maintaining the account agree "to treat the person for whom [it] is maintained as entitled to exercise the rights that comprise the financial asset."

286. *See* U.C.C. § 8-502.

287. Section 8-502 specifies that the claim can be "framed in conversion, replevin, constructive trust, equitable lien, or other theory." The purpose of enumerating these potential types of actions seems to be to ensure that any equity-based claims are included. *See id.* § 8-502 cmt. 2.

288. *See id.* § 8-502.

but the description of a similar rule in the official comments[289] presumes the burden has shifted. A shift in burden would be the natural consequence of the action preclusion formulation. Shifting the burden increases the protection of the entitlement holder.

The fourth difference is that an entitlement holder's protection under section 8-502 is defeated by notice of only the specific adverse claim upon which the action is based while a protected purchaser cannot have notice of any adverse claim. In the extreme, an entitlement holder could acquire a security entitlement with knowledge that the financial asset was subject to numerous significant claims and still be protected from a particular claim, because it did not happen to have notice of that claim. This limitation provides significantly greater protection to the entitlement holder. The appropriateness of these last two differences is analyzed in a later section.[290]

b. who receives this protection

The superficiality in considering this rule the analog to the direct holding system's protected purchaser rule becomes apparent by ascertaining the circumstances under which section 8-502 will come into play. These circumstances are quite limited. The drafters suggest the rule plays some role in a dispute between two entitlement holders using the same securities intermediary.[291] That is, Entitlement Holder A could rely on the rule to defeat a claim of preemptive rights to the financial asset asserted against it by Entitlement Holder B. By virtue of having the same securities intermediary, Entitlement Holder B necessarily has notice of adverse claims of other entitlement holders, including Entitlement Holder

289. The drafters in describing the effect of using a no-collusion standard in § 8-503(e) state that the claimant "must show" wrongdoing by the purchaser rather than the purchaser having "any burden of showing" lack of awareness of the wrongful conduct. *Id.* § 8-503 cmt. 3. In official comment 2 to § 8-503, the drafters state that the rules "operate in a slightly different fashion than traditional adverse claim cut-off rules." However, the only explanation of the different operation is that they "specify the circumstances in which this particular form of claim can be asserted." *Id.* § 8-503 cmt. 2. Professors Facciolo and Schroeder come to the same conclusion about burden of proof. *See* Facciolo, *supra* note 7, at 641-42, 654; Schroeder, *supra* note 12, at 474.

290. *See infra* notes 513-524 and 530-535 and accompanying text.

291. *See* U.C.C. § 8-502 cmt 4.

A.[292] Even if a purchaser rule needs to be invoked in such a dispute, why would it be section 8-502 when the drafters say that subsection 8-503(e) trumps section 8-502 when the claimant is an entitlement holder?[293]

As a result of the practical protection of the tracing problems, the most likely beneficiaries of the rule are secured parties to whom the financial asset may be more readily traced.[294] This conclusion is consistent with the six unusual, perhaps even contrived, examples the drafters give to illustrate how the section will operate. Three of the examples in official comment 3 to section 8-502 require the reader to "assume—implausibly—" that tracing is successful.[295] Of the other three examples, two involve secured parties as entitlement holders—they successfully rely on the rule.[296] In the remaining example, the entitlement holder is the wrongdoer and thus cannot rely on the rule.[297] The drafters' examples illustrate how difficult it is to describe a claim to the financial asset that would be asserted against an entitlement holder who is not a secured party.

c. additional protection for entitlement holders

Section 8-502 protects an entitlement holder indirectly. If the adverse claim to the financial asset is asserted against the securities intermediary, rather than the entitlement holder, and if the securities intermediary holds the financial asset indirectly (which will often be

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292. The result is correct: subsection 8-503(b) gives each entitlement holder a pro rata share, but it is not clear that a purchaser rule has a role to play.

293. *See* U.C.C. § 8-503 cmt 2. Note that § 8-503(e) protects purchasers of "an interest" in a financial asset and, limited though it may be, a security entitlement is an "interest in" the underlying financial asset.

294. The protection afforded by the difficulty of tracing is articulated in the text accompanying notes 276-281.

295. U.C.C. § 8-502, comment 3, examples 3, 4, and 6 involve implausible tracing scenarios and the entitlement holders win for lack of notice. In addition, the sixth example involves a secured party repledging the financial asset, which the drafters point out is not wrongful under § 9-207. Therefore, the original debtor does not even have an "adverse claim" against its secured party's secured party. *See* U.C.C. § 8-102(a)(1).

296. U.C.C. § 8-502, comment 3, examples 2 and 5 involve, respectively, a secured party entitlement holder receiving stolen bearer bonds, and a secured party who is an entitlement holder receiving a wrongfully pledged financial asset.

297. U.C.C. § 8-502, comment 3, example 1 involves an entitlement holder stealing a bearer bond and placing it in a securities account.

the case), then the adverse claim is simply a claim against an entitlement holder of an upstream security entitlement and is governed by the section 8-502 rule.

Another entitlement holder protection arises because a securities intermediary establishing a security entitlement in a financial asset is deemed to be a purchaser for value of that financial asset.[298] If an adverse claim to that financial asset is asserted against the securities intermediary and it fails to qualify for purchaser protection, the securities intermediary is obligated to the entitlement holder to replace the financial asset.[299] That protection is limited only by the solvency of the securities intermediary, a risk inherent in indirect holding.[300]

3. Purchasers of a security entitlement

The second rule protecting purchasers in the indirect holding system, subsection 8-510(a), protects one purchasing a security entitlement from an entitlement holder from an action based upon an adverse claim to either the security entitlement or the financial asset if the purchaser gave value, had no notice of the adverse claim, and obtained control.[301] The rule virtually duplicates the section 8-502 rule protecting entitlement holders. The difference is that this rule requires the purchaser to obtain control and it covers adverse claims to both the financial asset and to the security entitlement.[302] Neither of these features was necessary for the section 8-502 rule, thereby justifying a separate rule. Obtaining control of a security entitlement simply requires that the purchaser either become the entitlement holder or obtain the securities intermediary's agreement to honor the

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298. *See* U.C.C. § 8-116.

299. U.C.C. § 8-504(a) obligates the securities intermediary to maintain a sufficient quantity of the financial asset to satisfy the claims of all entitlement holders.

300. *See* U.C.C. § 8-503 cmt. 1.

301. U.C.C. § 8-510(a) provides:

> [A]n action based on an adverse claim to a financial asset or security entitlement, whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against a person who purchases a security entitlement, or an interest therein, from an entitlement holder if the purchaser gives value, does not have notice of the adverse claim, and obtains control.

302. *See* U.C.C. § 8-510(a).

purchaser's entitlement orders without further approval from the entitlement holder.[303]

a. comparison with protected purchaser rule

This rule contains the same substantive differences from the protected purchaser rule as the section 8-502 rule.[304] It shifts the burden of proof to the claimant and fails to expressly provide who prevails when the claim is asserted. Furthermore, it provides that the notice to the purchaser permitting the adverse claimant's action to go forward is notice of the specific adverse claim rather than notice of any adverse claim.[305] The appropriateness of these changes is analyzed in a subsequent section.[306]

b. who receives this protection

Subsection 8-510(a) protects a narrow range of possible purchasers. Those purchasing a security entitlement from an entitlement holder will be primarily of three types: a secured creditor obtaining a security interest in the security entitlement, a purchaser under a repurchase agreement ("repo purchaser") covering the security entitlement,[307] or a bulk purchaser of the assets of an entitlement holder. Beyond these three situations, there is little need or incentive to transfer a security entitlement. Settling a securities trade in the indirect holding system involves terminating the seller's security entitlement and creating a new one for the buyer.[308] It does not involve the purchase of a security entitlement.[309] Furthermore, securities intermediaries would be necessary parties to transfers of security entitlements and they are unlikely to create such a market.[310] Thus, secured creditors and repo purchasers would be the primary beneficiaries of this purchaser rule. This conclusion comports with the drafter's description of the rule's purpose as protecting persons

303. *See id.* § 8-106(d).
304. *See supra* notes 287-290 and accompanying text.
305. *See* U.C.C. § 8-510(a).
306. *See infra* notes 513-524, 530-535 and accompanying text.
307. Repurchase agreements are described in the prefatory note. *See* Prefatory Note, *supra* note 3, at Part III.C.10.
308. *See* U.C.C. § 8-501 cmt. 5.
309. *See id.*
310. *See id.*

who "take security interests in security entitlements" from the entitlement holder.[311]

c. *protection against which claims*

There are three types of claims to a security entitlement: First, nonconsensual claims against the entitlement holder (or against one obtaining rights from the entitlement holder) such as a lien creditor or the trustee in bankruptcy. Second, consensual claims arising from agreements with the entitlement holder (or with one obtaining rights from the entitlement holder such as agreements to act as trustee, nominee, agent, etc.). And third, consensual claims arising from transfers from the entitlement holder (or from one obtaining rights from the entitlement holder) such as purchasers (including secured parties) of the security entitlement. This third group is the same group that could benefit from the rule.

Adverse claims to the underlying financial asset could also be barred by this rule. However, if the purchaser obtained control by becoming the entitlement holder, it would be protected by section 8-502 against adverse claims to the financial asset. Thus, this aspect of the rule is primarily designed for those who obtain control by agreement.[312] The most common potential claimants, the securities intermediary and other entitlement holders of that securities intermediary, however, are not barred by the rule, because the purchaser of the security entitlement necessarily has notice of their claims.[313] Any other adverse claimant to the financial asset has to overcome the tracing problem.[314] Thus, the subsection 8-510(a) rule protecting purchasers of security entitlements will likely play only a small role in claims to the underlying financial asset.

4. Entitlement holders as adverse claimants

The third rule protecting purchasers in the indirect holding system, subsection 8-503(e), protects purchasers from entitlement

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311. *Id.* § 8-510 cmt. 2.
312. *See id.* § 8-510 cmt. 2; *see also id.* § 8-106(d)(2) (defining control by agreement).
313. A security entitlement by nature is a pro rata claim with other entitlement holders and the securities intermediary to the financial asset. *See supra* note 147 and accompanying text.
314. *See supra* notes 276-281 and accompanying text.

holders claiming the financial asset. This rule, however, is the indirect holding system's linchpin rule protecting purchasers. Because virtually all securities trading occurs in the indirect holding system and because those holding securities in the indirect holding system are entitlement holders, this rule applies to most adverse claims that could arise. This fact explains why the drafters' most involved discussion of policy concerning the indirect holding system's rules protecting purchasers occurs in the official comments to section 8-503.[315] The rule trumps any other rule protecting purchasers that may otherwise apply[316] because it is part of the definition of the entitlement holder's rights.[317]

a. two layers of protection against entitlement holders

Before the entitlement holder can assert a claim to the underlying financial asset against a purchaser claiming the protection of subsection 8-503(e), it must first satisfy four requirements established in subsection 8-503(d): (1) there must be insolvency proceedings against the securities intermediary; (2) the securities intermediary must not have sufficient interests in the financial asset to satisfy all of its entitlement holders; (3) the transfer to the purchaser must have violated the securities intermediary's obligations to maintain sufficient interests in the financial asset to satisfy its entitlement holders; and (4) the trustee or liquidator of the securities intermediary must have elected not to pursue the financial asset. These requirements provide an additional layer of protection for purchasers of financial assets (and conversely an additional level of risk for entitlement holders).

After penetrating the first layer of protection, the entitlement holder (or more typically a trustee on behalf of entitlement holders) has simply proceeded to the point where other adverse claimants begin. Next, it must navigate the shoals of subsection 8-503(e) which protects purchasers of financial assets who give value, obtain control, and do not act in collusion with the securities intermediary in violating its obligations under section 8-504 (the obligation to maintain adequate interests in the financial asset).[318]

315. *See* U.C.C. § 8-503 cmt. 3.
316. *See id.* § 8-503 cmt. 2.
317. *See supra* notes 153-160 and accompanying text.
318. U.C.C. § 8-503(e) provides:

The subsection 8-503(e) rule differs from the protected purchaser rule in two important ways. The rule, like the others in the indirect holding system, is a preclusion of an action rather than a traditional purchaser rule, shifting the burden of proof to the entitlement holder,[319] and rather than focusing on the purchaser's notice of adverse claims, the rule uses a no-collusion standard for the purchaser.

The no-collusion requirement raises a question. When must the "collusion" occur to defeat a purchaser's protection: in purchasing, or in obtaining control?[320] The section does not specify which time is relevant. While a textual argument can be made for the time of the purchase because the collusion relates to the securities intermediary violating its rule to maintain an adequate interest in the financial asset,[321] that argument overlooks the effect of section 8-511 if the purchaser is a secured party. Under section 8-511 the purchaser cannot prevail over an entitlement holder, unless it has obtained control.[322] Because Article 8 is silent, the most meaningful interpretation would be to require that all elements be satisfied at one time, thereby making any collusion effective to defeat protection as

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> An action based on the entitlement holder's property interest with respect to a particular financial asset under subsection (a), whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against any purchaser of a financial asset or interest therein who gives value, obtains control, and does not act in collusion with the securities intermediary in violating the securities intermediary's obligations under Section 8-504.

319. *See supra* notes 287-289 and accompanying text. Note that the fact that § 8-503(e) does not specify who prevails when the adverse claim may be asserted is not important. The § 8-503(d) threshold states that the claim "may be enforced" and that the claimant "may recover" the financial asset.

320. An example of a situation in which the times may be significantly different is a secured party of the securities intermediary. The secured party would become a purchaser when the security interest attached. Control may not be obtained until a later time.

321. *See* U.C.C. § 8-503(d)(3); *see also id.* § 8-503 cmt. 3 (stating that the policy behind the collusion test is to allow purchasers to acquire securities in the indirect system without having to inquire as to the authority of the seller to transfer such an interest).

322. U.C.C. § 8-511(a) gives the entitlement holder priority over the securities intermediary's creditors. U.C.C. § 8-511(b) gives the securities intermediary's secured creditor, if it has control, priority over the entitlement holder.

long as it relates to either purchasing or obtaining control.[323] If that interpretation is not adopted, collusion in obtaining control should be used in applying the rule because control is the critical concept to qualify for protection. The advisability of adopting the no-collusion standard is explored in a subsequent section.[324]

b. which purchasers are protected

Determining which purchasers are the practical recipients of the protections against claims by entitlement holders involves an examination of the realities of securities markets. The tracing problems in identifying the purchaser of financial assets in securities market transactions protect most purchasers.[325] However, financial assets most likely can be traced to purchasers in unusual or particularly large transactions (such as purchases directly from the securities intermediary) which do not go through a clearing corporation.[326] Thus, the purchasers primarily benefiting from this rule are purchasers who directly negotiated with the securities intermediary, such as its secured parties or repo purchasers.

5. Purchasers of the financial asset

Subsections 8-503(d) and (e) protect purchasers of financial assets from claims asserted by entitlement holders. Section 8-502 protects purchasers of a financial asset that is a security entitlement. If the financial asset is a directly held security, purchasers are protected by the protected purchaser rule. If the financial asset is a negotiable instrument that is not a security under Article 8,[327] then the holder-in-due-course rule of Article 3 governs the claim.[328] For financial assets that do not fit any of the foregoing categories, disputes between claimants and the purchaser are left to common law purchaser rules.

323. This is consistent with the official comments' description of the no-notice-of-adverse-claim standard for protected purchasers. *See* U.C.C. § 8-303 cmt. 2.

324. *See infra* notes 536-564 and accompanying text.

325. *See supra* notes 276-281 and accompanying text.

326. *See id.*

327. *See supra* notes 118-131 and accompanying text.

328. *See* U.C.C. § 3-302.

Purchasers in the indirect holding system receive greater protection than purchasers in the direct holding system who must rely on the protected purchaser rule.[329] Of particular interest is the fact that the primary beneficiaries of these rules will be repo purchasers and secured parties providing credit to the securities industry.[330]

B. *Unique Priority Rules in Indirect Holding*

In addition to the foregoing rules protecting purchasers from adverse claims, there are three priority rules unique to the indirect holding system. One creates priority for securities intermediaries. The other two govern disputes which one would ordinarily expect to be governed by rules protecting purchasers.

1. Priority for securities intermediaries

All but one of the priority rules between secured parties contained in Articles 8 and 9 govern security interests in both directly held securities and security entitlements.[331] The one exception awards priority over any other secured party to a security interest held by the debtor's securities intermediary in a security entitlement or securities account.[332] The rule does not explicitly require that the security interest be perfected.[333] However, a securities intermediary "granted"[334] a security interest in its entitlement holder's security entitlement has control by definition[335]

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329. *See id.* § 8-303.

330. *See supra* notes 294, 311, 326 and accompanying text.

331. The rules in U.C.C. § 9-328 govern most security interests in investment property. U.C.C. § 9-102(a)(49) defines investment property to include a security, a securities account, and a security entitlement. Note that financial assets are not covered unless they are securities or security entitlements.

332. *See* U.C.C. § 9-328(3).

333. *See id.*

334. There are statutory security interests in an entitlement holder's assets in favor of the securities intermediary. Since these are created by statute, rather than "granted" to the securities intermediary, they would not technically qualify as being in the control of the intermediary. The distinction, however, does not appear to be based upon policy and the limitation to "granted" security interests is probably an oversight.

335. The securities intermediary has control under § 8-106(e). Official comment 6 to that section describes margin loans as the common transactions covered by the rule.

and is therefore always perfected. Issues raised by this rule are discussed subsequently.[336]

2. Priority between purchasers

Subsection 8-510(c) is a priority rule governing disputes between two purchasers of a security entitlement who are not secured parties governed by Article 9 priority rules.[337] This rule essentially duplicates the priority rule for disputes between secured parties claiming security entitlements when at least one of them has control. The first to obtain control prevails.[338]

The use of a priority rule virtually identical to an Article 9 priority rule to govern disputes between purchasers raises an obvious question. Who are the intended beneficiaries of the rule? Official comment 4 to section 8-510 says the rule was designed primarily to cover securities repurchase agreement transactions ("repo transactions")[339] that are not covered by other rules.[340] The

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336. *See infra* notes 584-605 and accompanying text.

337. U.C.C. § 8-510(c) (as amended by the conforming amendments to revised Article 9) provides:

> In a case not covered by the priority rules in Article 9, a purchaser for value of a security entitlement, or an interest therein, who obtains control has priority over a purchaser of a security entitlement, or an interest therein, who does not obtain control. Except as otherwise provided in subsection (d), purchasers who have control rank according to priority in time of:
>
> (1) the purchaser's becoming the person for whom the securities account, in which the security entitlement is carried, is maintained, if the purchaser obtained control under Section 8-106(d)(1);
>
> (2) the securities intermediary's agreement to comply with the purchaser's entitlement orders with respect to security entitlements carried or to be carried in the securities account in which the security entitlement is carried, if the purchaser obtained control under Section 8-106(d)(2); or
>
> (3) if the purchaser obtained control through another person under Section 8-106(d)(3), the time on which priority would be based under this subsection if the other person were the secured party.

The exception in subsection (d) gives priority to a securities intermediary over other purchasers with control.

338. *See* U.C.C. § 9-328(1)-(3).

339. Repo transactions are financing devices in which one person sells a security to another person and simultaneously agrees to buy back the same or a similar security at a future date. The relative cost savings of these transactions

subsection 8-510(c) rule ensures that the same priority rule applies to repo transactions that are not disguised security interests governed by Article 9.[341] The problem is that for tax, accounting, and bankruptcy reasons there is significant interest among repo transaction participants that they not be characterized as security interests.[342] The drafters of Article 8 specifically avoided "characterizing [repo purchasers'] interests as Article 9 security interests."[343] There is no explanation for why the drafters and the securities industry wanted the same priority rules to apply to these transactions if they are treated as actual purchases rather than disguised secured

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has made them popular alternative financing devices. *See* Facciolo, *supra* note 6, at 664-65.

340. *See* U.C.C. § 8-510 cmt. 4. (Curiously, the comment first describes secured parties as the most "significant" category of purchasers that would be covered by U.C.C. § 8-510(c), but for the exclusion of disputes governed by Article 9).

341. A classic case of a disguised security interest is represented by a repo transaction that involves a purchase of securities with an obligation to buy back the same securities within a specified period of time for a fixed price. *See* Prefatory Note, *supra* note 3, at Part III.C.10. Professor Schroeder provides a careful analysis of whether repo purchases are disguised security interests. *See* Jeanne L. Schroeder, *Repo Madness: The Characterization of Repurchase Agreements Under the Bankruptcy Code and the U.C.C.*, 46 SYRACUSE L. REV. 999, 1004-25 (1996).

342. *See* Schroeder, *supra* note 341, at 1049. *See generally* William F. Hagerty, IV, *Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos As Separate Purchases and Sales of Securities*, 37 VAND. L. REV. 401 (1984) (proposing a new legal characterization of repos); Deirdre Mullen, *Bankruptcy—Protection of Repurchase Agreements in Bankruptcy—*Bevill, Bresler & Schulman Asset Management Corp. v. Spencer Savings & Loan, 878 F.2d 742 (3d Cir. 1989), 63 TEMP. L. REV. 621 (1990) (analyzing the applicability of the 1984 repo amendments in cases where there are not enough securities to satisfy the competing claims of parties investing in similar repurchase agreements); Elizabeth M. Osenton, Comment, *The Need for a Uniform Classification of Repurchase Agreements: Reconciling Investor Protection with Economic Reality*, 36 AM. U. L. REV. 669 (1987) (evaluating the secured loan versus sale and purchase classification of repurchase agreements); Howard R. Schatz, Note, *The Characterization of Repurchase Agreements in the Context of the Federal Securities Laws*, 61 ST. JOHN'S L. REV. 290 (1987) (considering whether repos are securities within the meaning of securities laws).

343. U.C.C. § 8-510 cmt. 4. While characterization one way or the other may have been beyond the jurisdiction of the Article 8 drafting committee, it certainly was within the scope of the revised Article 9 drafting committee.

transactions.[344] The rule does strengthen the argument that a disguised security interest is not involved. If the goal was merely ensuring identical treatment of all repo transactions for questions of priority, subsection 8-510(c) is an incomplete remedy for the problem because it only covers indirectly held financial assets; repo transactions are not so limited.[345] The rule raises a number of questions that are discussed subsequently.[346]

3. Entitlement holder—secured party priority

Section 8-511 determines priority between an entitlement holder and secured parties of its securities intermediary. These priority rules involve a complex interaction with subsection 8-503(a), which provides that the securities intermediary does not have a property interest in the financial asset that can be acquired by one of its creditors "except as otherwise provided in Section 8-511."[347] Section 8-511 does not delineate which creditors have interests, rather it provides rules governing three different priority contests between entitlement holders and secured parties of the securities intermediary.[348] The apparent purpose of the combination of rules is to defeat the claims of lien creditors and recognize only certain secured creditors of a securities intermediary when it does not have sufficient interests in the financial asset.[349]

The first of the three rules gives priority to entitlement holders if the secured party does not have control.[350] Under the second rule, entitlement holders lose if the securities intermediary's secured party has control.[351] Because having control of investment property

344. *See* Prefatory Note, *supra* note 3, at Part III.C.10.

345. "Delivered-out repos" involve direct holding because they include "handing over" the securities to the repo purchaser. *See id.* Subsection 8-510(c), of course, only applies in the indirect holding system. Purchasers claiming directly held securities are governed by U.C.C. § 9-331 rather than U.C.C. § 9-328. Section 9-331 applies the protected purchaser rule, a rule more closely analogous to U.C.C. § 8-510(a) than U.C.C. § 8-510(c). Of course in the direct holding system, the protected purchaser rule would apply in a dispute between two secured parties if one of them can qualify for it.

346. *See infra* notes 611-616 and accompanying text.

347. U.C.C. § 8-503(a).

348. *See id.* § 8-511 cmt. 1.

349. *See id.*

350. *See id.* § 8-511(a).

351. *See id.* § 8-511(b). This subsection was not adopted by the State of

generally provides the greatest available rights, it is inherent in the indirect holding system for a secured party with control to be awarded priority over the entitlement holder whose interest cannot, by definition, include control of the financial asset.

Under the third rule, entitlement holders lose to secured creditors of a clearing corporation, even if they do not have control.[352] The drafters apparently justify this rule by the difficulties of obtaining control in a timely manner (a clearing corporation often holds directly).[353] The primary, if not the only, entitlement holders who have security entitlements with clearing corporations are securities intermediaries. Clearing corporations have a settlement function in connection with those intermediaries and are thus involved in extending credit and need a ready credit source of their own.[354] This rule facilitates readily available security for that credit, but with the result that securities intermediaries are always at risk that their clearing corporation has encumbered its financial assets to a secured creditor. Priority for secured creditors of a clearing corporation over entitlement holders is less problematic than it would be for secured creditors of other securities intermediaries[355] because clearing corporations are focused on the clearing function and are, at least currently, highly regulated by their members and the SEC.[356]

Section 8-511 creates clear incentives. All secured creditors of securities intermediaries (other than clearing corporations) should obtain control.[357] Otherwise, they lose to the intermediary's entitlement holders.[358] Entitlement holders are obviously at significant risk under these rules because they have no practical way to limit a securities intermediary from creating a security interest perfected by control in the fungible bulk of financial assets to which

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Connecticut. *See* STATE U.C.C. VARIATIONS, U.C.C. REP. SERV. 4 (West Supp. 2001).

352. *See* U.C.C. § 8-511(c).

353. *See id.* § 9-309 cmt. 6; HAWKLAND & ROGERS, *supra* note 138, at 718-19.

354. *See* HAWKLAND & ROGERS, *supra* note 138, at 718-19.

355. *See infra* notes 635-640 and accompanying text.

356. *See* Schroeder, *supra* note 12, at 455.

357. *See* Howard M. Darmstadter, *Revised Article 8 and the Agreement to Pledge*, 28 U.C.C. L.J. 202, 211-12 (1995) (explaining that historic lending practices in the securities industry have not involved secured parties obtaining control, so this incentive is likely to restructure practices).

358. *See* U.C.C. § 8-511(a).

their security entitlement relates.[359] The section 8-511 rules raise a number of issues that are discussed subsequently.[360]

The priority rules unique to the indirect holding system are part of a clear pattern that emerges from Article 8. Secured creditors to the securities industry are provided great protection in the indirect holding system.

C. *Purchaser—Priority Rule Interaction*

Understanding the rights of third persons in the indirect holding system requires exploration of the interaction between its priority rules and its rules protecting purchasers. While the two types of rules are closely related, they are formulated and operate in different ways. Both types of rules resolve disputes to property between competing parties. However, rules protecting purchasers generally permit the qualifying purchaser to defeat competing claims entirely (they are sometimes referred to as cut-off rules).[361] Priority rules, by contrast, generally resolve disputes between secured parties or others with liens or lesser interests in the property. Under a priority rule, the one with priority has its claim satisfied first, with anything left available for the competing party.

These distinctions, however, do not require the application of a rule protecting purchasers when one is claiming complete ownership of the property or of a priority rule when the claim is of a lesser interest. Secured parties claiming less than a full ownership interest can and do qualify for the benefit of purchaser rules.[362] If value is left in the property after the secured party's claim is satisfied, a party defeated by the secured party under the purchaser rule may again pursue his/her claim against that value, like it could under a priority rule. A party whose claim is given priority over a competing claim under a priority rule may consume the property entirely in attempting to satisfy his/her claim, thus leaving nothing for any party with a

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359. *See infra* notes 505-512 and accompanying text (discussing questions raised by a securities intermediary's ability to encumber underlying financial assets).

360. *See infra* notes 617-649 and accompanying text.

361. *See* U.C.C. §§ 8-303(b), 8-502, 8-503(e), 8-510(a).

362. The terms purchase and purchaser are defined in the U.C.C. to include secured parties and others obtaining consensual interests in personal property. *See* U.C.C. § 1-201(32), (33).

lower priority—the same result as obtained under a rule protecting purchasers.

What happens if both types of rules, by their terms, could apply to the same dispute? Several of these situations exist in Article 8 and the Code resolves most, but not all of them. One of those resolutions is counter-intuitive. The unresolved conflicts create significant potential for confusion.

1. Purchaser rules generally prevail

Subsection 9-331(b) of revised Article 9 provides that the priority rules in Article 9 do not limit the rights of a person protected against the assertion of a claim under Article 8. Each of Article 8's rules protecting purchasers in the indirect holding system is structured as a limitation on the assertion of claims.[363] This general resolution in favor of rules protecting purchasers, however, does not apply to all conflicts. First, subsection 8-510(a), by its terms is subordinate to Article 9 priority rules.[364] Second, the general rule from revised Article 9 has no effect when the conflicting rules are both contained in Article 8.

2. Section 8-510's priority rule prevails

As a result of revised Article 9's conforming amendments to Article 8, the subsection 8-510(a) purchaser rule (protecting purchasers of a security entitlement) now applies only if the subsection 8-510(c) priority rule[365] does not. There was no

363. Official comment 4 to U.C.C. § 9-331 specifically lists §§ 8-502, 8-503(e), 8-510, and 8-511 as the provisions in Article 8 protected by this rule.

364. Under Article 8 and its conforming amendments to Article 9, the question of whether the U.C.C. § 8-510(a) claim preclusion rule or Article 9 priority rules were to be applied was present, but not expressly resolved. Although U.C.C. § 9-309 expressly gave the protected purchaser rule of U.C.C. § 8-303 precedence over Article 9 priority rules, there was no similar provision giving precedence to § 8-510(a). Thus, a second secured party who took control without notice of the claim of a first secured party with control could have claimed purchaser protection under U.C.C. § 8-510(a). However, U.C.C. § 9-115(5) expressly provided that priority between conflicting security interests in investment property was governed by its rules. Thus, the first secured party would resist the second secured party's application of the U.C.C. § 8-510(a) rule and seek to rely on U.C.C. § 9-115(5). Subsection 9-115(5)(f) bolstered that argument by providing that U.C.C. § 9-312(5)-(7) would apply to all cases not covered by U.C.C. § 9-115(5)(a)-(e).

365. Section 8-510 was silent on whether subsection (a) or (c) should be

explanation given for this change. Making this rule, protecting purchasers subject to the priority rules in subsection 8-510(c) and Article 9, is inconsistent with all other rules protecting purchasers that could conflict with Article 9 priority rules. The appropriateness of this choice is analyzed subsequently.[366]

3. Entitlement holders vs. secured parties

If an entitlement holder seeks to assert its claim to the underlying financial asset against a secured creditor of the financial intermediary, Article 8 provides both a rule protecting purchasers in subsection 8-503(e) (augmented by the subsection 8-503(d) prerequisites) and a set of priority rules in section 8-511. No provision in Article 8 coordinates the application of these different rules.[367] It is not clear why the drafters used this involved approach to resolve these disputes or why one of the two rules is a claim preclusion rule and the other a priority rule. A close analysis of this matrix of rules is undertaken in a subsequent section.[368]

VI. TRADING, SETTLEMENT, AND CREDIT

The indirect holding system handles most trades occurring in the securities markets.[369] To properly evaluate Article 8 it is necessary to understand the mechanisms used to effect these trades. Whether it occurs on the floor of an exchange or in the over-the-counter market, the legal effect of a securities trade is the creation of a buy-sell contract,[370] but not a contract for immediate performance. Performance, delivery[371] of the financial asset and payment of the price, occurs at settlement. From the investor's perspective the trade establishes the price and, for most practical purposes, who owns the

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used, if both could apply, until it was changed in the conforming amendments to Article 8 promulgated with revised Article 9.

366. *See infra* notes 611-616 and accompanying text.

367. The drafters imply in official comment 1 to U.C.C. § 8-511 that both the claim preclusion rule and the priority rule are to be applied to the dispute. As the subsequent analysis shows, that approach does not work.

368. *See infra* notes 617-649 and accompanying text.

369. *See supra* notes 103-105 and accompanying text.

370. *See* Rogers, *supra* note 4, at 1439-41.

371. Delivery is a term used very broadly in the securities industry and includes making book entries as well as physical delivery of a certificate. *See* U.C.C. § 8-301 cmt. 3. The delivery definitions of Article 8 track this usage. *See id.* § 8-301.

financial asset.[372] Price fluctuations are now the buyer's risk or benefit. It is the settlement function that involves Article 8, the indirect holding system, and securities intermediaries. The time between trade and settlement is where the systemic risk occurs. The steps that need to be taken to complete settlement are dependent on how the seller holds the financial asset and how the buyer will hold the financial asset. There may be more than one tier of intermediaries involved on either side of the trade. There are two separate aspects of these settlement procedures. First, the settlement between the customers and their respective intermediaries, meaning the buyer pays its intermediary and receives the financial asset from its intermediary while the seller delivers the financial asset to its intermediary and receives payment for the financial asset from its intermediary.[373] Second, the settlement involving delivery of the financial asset and payment for it among the intermediaries involved (this is where there may be a multitier aspect of the settlement).[374]

At the end of a trading day, brokers have transacted numerous purchases and sales of various financial assets. Thus, part of the settlement can be efficiently done by the broker, as securities intermediary, netting the sales and purchases of each financial asset it traded that day.[375] Understanding the process is enhanced by considering the simple case where the buyer and seller use the same broker/securities intermediary, so transfer of the financial asset can be effected by the intermediary simply debiting the seller's securities account and crediting the buyer's securities account. Similarly, adjustments for the price can be made to the respective entitlement holder's account. In most cases, however, the netting will result in a broker needing to deliver the financial asset against payment by another intermediary or to pay for the financial asset against delivery by another intermediary. That settlement function is done through a clearing agent or a clearing corporation.[376] Since the 1970s, much of

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372. *See* Prefatory Note, *supra* note 3, at Part III.B.

373. *See* Charles W. Mooney, Jr., *Property, Credit, and Regulation Meet Information Technology: Clearance and Settlement in the Securities Market*, 55 LAW & CONTEMP. PROBS. 131, 137-38 (1992).

374. *See id.* at 136-38.

375. *See* Prefatory Note, *supra* note 3, at Part I.C.; Mooney, *supra* note 18, at 318-19; Schroeder, *supra* note 12, at 324.

376. *See* Mooney, *supra* note 18, at 316-24; Rogers *supra* note 4, at 1442.

this is handled by the National Securities Clearing Corporation in connection with the Depository Trust Company.[377]

The operation of clearing corporations is not regulated by Article 8. Most clearing corporations are regulated by federal securities law. Clearing corporations are also subject to rules they adopt to govern rights and obligations among themselves and their participants. Article 8 expressly recognizes clearing corporation rules, even if they conflict with Article 8[378] or affect a person who does not consent to the rules.[379] Rules regarding finality and reversibility of settlements are examples of clearing corporation rules.[380] Article 8's recognition of these rules is designed to provide flexibility, especially regarding attempts to obtain certainty in clearance and settlement of securities trades.

Prior to June 7, 1995, the norm in the United States for the trade settlement gap was T+5. The settlement date occurred five business days after the trade date.[381] Beginning June 7, 1995, the industry went to a T+3 system for most trades.[382] This change outside Article 8 reduces systemic risk, by reducing the time trades are held open.[383] There is discussion of reducing the time period even further.[384] Reduction of the time period makes direct holding, at least in the current market, more difficult.[385]

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377. *See* Prefatory Note, *supra* note 3, at Part I.C.; Rogers, *supra* note 4, at 1442-44; Schroeder, *supra* note 12, at 324-25.

378. U.C.C. § 8-111.

379. *See id.* Affecting third parties is not grounds for defeating application of the rule, but the rule cannot directly govern the rights and obligations of third persons. *See id.* cmt. 1.

380. *See id.*

381. *See* Rogers, *supra* note 4, at 1440-41.

382. This change was effectuated by SEC Rule 15c6-1. *See* 17 C.F.R. § 240.15c6-1 (2000).

383. *See* Rogers, *supra* note 4, at 1438-41.

384. Same day settlement, T+0, has been suggested as an achievable ideal. *See* Chairman Arthur Leavitt, Speeding Up Settlement: The Next Frontier, Remarks at United States Securities and Exchange Commission Symposium on Risk Reduction in Payments, Clearance and Settlement Systems (Jan. 26, 1996), 1996 WL 29441, at *3-*4.

385. *See id.* at *4-*5.

A. The Credit Risk in Delayed Settlement

During the time period between the trade date and the settlement date, credit is being extended. The securities have to be transferred and the payments have to change hands. To protect against an intervening bankruptcy of a member, clearing corporations often set up guaranty funds to make the payments and fund them by assessing members.[386] The assessments may be by pledge of securities under the control of the clearing corporation.[387] It is also common for upper-tier intermediaries to provide settlement credit by way of taking a security interest in securities in the broker-dealer entitlement holder's clearing account and then moving the securities to the segregation account when paid.[388] Even at the investor level, the securities intermediary is extending credit during the trade settlement gap.[389] Securities intermediaries need a source of funds for credit they have extended and some protection from entitlement holders should the settlement not occur as contemplated.[390]

B. Ensuring Readily Available Credit

Article 9 provides some automatically created and perfected security interests to facilitate the credit necessary in security trades.

1. Credit to entitlement holders

A securities intermediary extending credit in the trade-settlement process is given a statutory security interest in a security entitlement to a financial asset purchased through it to secure payment of the price, if the purchaser is obligated to pay and the financial asset is credited to the purchaser's account before the price is paid.[391] Although Article 9 does not precisely so provide, the official comments state that these security interests are automatically

386. *See* Rogers, *supra* note 4, at 1478-79.
387. *See id.*
388. *See id.* at 1479-80; Schroeder, *supra* note 12, at 331 n.94.
389. *See* Rogers, *supra* note 4, at 1479-81.
390. *See id.* at 1480.
391. *See* U.C.C. § 9-206(a), (b).

perfected.[392] Subsection 9-328(3) awards these security interests priority.

2. Credit to securities intermediaries

To encourage the flow of credit to securities intermediaries so they can extend credit to their entitlement holders, subsection 9-309(10) provides automatic perfection of security interests in investment property granted by brokers or securities intermediaries. In such financing transactions, competing secured parties who have not taken control of the investment property, rank equally for priority purposes.[393] If one of the secured parties obtains control, it has priority over the one without control.[394] If both take control, priority goes to the first to obtain control.[395] If the investment property is a security entitlement or the securities account and the secured party is the securities intermediary with which the account is maintained, that securities intermediary has priority.[396]

3. Credit for deliveries against payment

Subsection 9-206(c) gives a security interest in the delivered financial asset to persons in the business of delivering certificated securities (or other financial assets represented by a writing) against payment[397] to secure the payment if done pursuant to agreement.[398] These security interests are automatically perfected.[399]

392. Official comment 4 to U.C.C. § 9-206 declares that the perfection is accomplished by control and refers to §§ 8-106 and 9-314. Security interests in favor of securities intermediaries are perfected by control under §§ 8-106(e), 9-106(a), and 9-314(a). However, this one is created by statute and § 8-106(e) only provides for control when the security interest is "granted by the entitlement holder." This appears to be an oversight by the revised Article 9 drafting committee in drafting the conforming amendments to Article 8.

393. *See* U.C.C. § 9-328(6).

394. *See id.* § 9-328(1).

395. *See id.* § 9-328(2).

396. *See id.* § 9-328(3).

397. *See id.* § 9-206(d).

398. U.C.C. § 9-206(c)(1)(B) limits this security interest to deliveries made pursuant to "an agreement between persons in the business of dealing with such securities or financial assets." It only applies if the security or financial asset is transferred in the ordinary course of business by delivery and any necessary indorsement. *See id.* § 9-206(c)(1)(A). This is a parallel to the cash sale doctrine found elsewhere in commercial law. *See* Schroeder, *supra* note 12, at 450 n.367.

There is no separate priority rule for this security interest. Because it is only created between persons in the business of making deliveries, it arguably would be covered by the subsection 9-328(6) pro rata priority rule in favor of brokers and securities intermediaries. However, that priority rule expressly refers to being "created by" those parties and this security interest is arguably created statutorily. If that rule does not apply, priority goes to the first party to file or perfect.[400] Both rules, of course, are subject to purchaser rules and the priority rule favoring a secured party with control, so the protection is weaker.

C. *Shifting the Risk*

The inherent risk to entitlement holders in the indirect holding system is the failure of the securities intermediary. Because of the nature of indirect holding and the interaction of priority and purchaser rules in the indirect holding system, priority to financial assets is generally given to a securities intermediary's secured lenders over its entitlement holders.[401] This means that when a securities intermediary fails, its secured creditors may recover at the expense of entitlement holders. Protection for the entitlement holders in these situations is left to the Bankruptcy Code, private insurance,[402] and the program of the federal government to protect investors, the Security Investors Protection Act of 1970.

1. Securities Investor Protection Corporation

In December of 1970, as a result of the financial crisis in the securities industry in 1969-70, which resulted in the failure or instability of numerous brokerage firms,[403] Congress passed the Security Investor Protection Act of 1970.[404] That act established the Security Investor Protection Corporation (SIPC) for the purpose of

399. *See* U.C.C. § 9-309(9) (granting automatic perfection in financial assets delivered against payment).
400. *See id.* § 9-322(a).
401. *See supra* note 330 and accompanying text.
402. While private insurance is quite common, it is less reliable as a means of investor protection. It may lapse, or the insurer may limit its coverage. *See* U.S. GEN. ACCOUNTING OFFICE, SECURITIES INVESTOR PROTECTION: THE REGULATORY FRAMEWORK HAS MINIMIZED SIPC'S LOSSES 51-52 (1992).
403. *See* Handelman v. Weiss, 368 F. Supp. 258, 263 (S.D.N.Y. 1973).
404. *See* 15 U.S.C. §§ 78aaa-78lll (2000).

providing financial relief to customers who had securities or cash with failing brokers or dealers.[405]

SIPC is a nonprofit corporation operating under the laws of the District of Columbia.[406] While it is declared not to be an agency or establishment of the U.S. Government,[407] its seven member board of directors is appointed by the government (one by the secretary of the Treasury, one by the Federal Reserve Board, and the other five by the president with the consent of the Senate),[408] membership is mandatory for brokers or dealers required to register under subsection 15(b) of the Securities Exchange Act of 1934,[409] and it is given limited rule-making authority.[410]

When a financially troubled broker or dealer member is brought to the attention of SIPC,[411] it is empowered (if the member meets certain requirements)[412] to petition for a receiver to be appointed and have the member liquidated under the procedures of SIPC[413] and Chapter 7 of the Bankruptcy Code.[414] The member could be liquidated under either SIPA[415] or the Bankruptcy Code. Reorganization under the Bankruptcy Code is not an option.[416] For

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405. *See* Sec. Investor Prot. Corp. v. Barbour, 421 U.S. 412, 413 (1975).

406. *See* 15 U.S.C. § 78ccc(a) (2000).

407. *See id.*

408. *See id.* § 78ccc(c).

409. *See id.* § 78ccc(a)(2). There are some minor exceptions based on doing business with foreign rather than U.S. customers. In addition, others may become members pursuant to rules promulgated by SIPC. *See id.* § 78ccc(a)(2)(C).

410. *See id.* § 78ccc(b)(4). It can define terms in the SIPA, and prescribe rules for liquidating members, making direct payments and exercising other rights given to it.

411. *See id.* § 78eee(a)(1). Only the Securities and Exchange Commission or the self-regulatory organization of which the member is a part is empowered to initiate this procedure. Only the SEC can force SIPC to act. *See id.* § 78ggg(b). Private rights of action have been foreclosed. *See Barbour*, 421 U.S. at 412.

412. *See* 15 U.S.C. § 78eee(a)(3), (b)(2) (2000).

413. *See* 17 C.F.R. pt. 300 (2000).

414. *See* 15 U.S.C. §§ 78eee(b)(4), 78fff(b) (2000); *In re* Lloyd Sec., Inc., 75 F.3d 853, 857-58 (3d Cir. 1996).

415. *See* Michael E. Don & Josephine Wang, *Stockbroker Liquidations Under the Securities Investor Protection Act and Their Impact on Securities Transfers*, 12 CARDOZO L. REV. 509 (1990) (describing the mechanics of these SIPA proceedings).

416. *See* 11 U.S.C. § 109(b), (d) (1994); Schroeder, *supra* note 12, at 461-64

the ten years preceding its 1996 annual report SIPC had petitioned for receivers for six brokers or dealers on average per year.[417] It commenced proceedings against ten members in 1997, six members in 1998, and nine members in 1999.[418] The largest number in any one year since SIPC was formed was forty in 1972.[419] There have never been fewer than two in a year.[420] There were 7,315 member firms at the end of 1999.[421]

Once SIPC's petition against a member firm has been granted, it has the responsibility of notifying the member's customers about the proceeding.[422] In addition, the SIPC is obligated as promptly as possible after the petition is granted to deliver to each customer any "customer name securities" held by the member (securities held directly by the customer).[423] If the customer owes the member money, payment can be required before the delivery is made.[424]

Customers must make a written statement of claim within six months after receiving the notice from SIPC.[425] Promptly[426] after receipt of claims (which are appropriately established),[427] SIPC is to

(giving a brief overview of these options).

417. *See* SECURITIES INVESTOR PROTECTION CORPORATION, 1996 ANNUAL REPORT 3 (1997).

418. *See* SECURITIES INVESTOR PROTECTION CORPORATION, 1999 ANNUAL REPORT 3, 6-7 (2000).

419. *See id.* at 6.

420. *See id.*

421. *See id.*

422. *See* 15 U.S.C. § 78fff-2(a) (2000).

423. *See id.* § 78fff(a)(1)(A). SIPA requires that "customer name securities" be delivered. Customer name securities are defined as

> securities which were held for the account of a customer on the filing date by or on behalf of the debtor and which on the filing date were registered in the name of the customer, or were in the process of being so registered pursuant to instructions from the debtor, but does not include securities registered in the name of the customer which, by indorsement or otherwise, were in negotiable form.

Id. § 78lll(3). These are securities directly held by the customer. *See* U.C.C. § 8-501 cmt. 4.

424. *See* 15 U.S.C. § 78fff-2(c)(2) (2000).

425. *See id.* If the customer is too closely associated with the member, a formal proof of claim is required.

426. Promptness does not necessarily have the meaning nonlawyers would ascribe. Only a few customers' net equity claims had been paid thirteen months after customers were asked to submit claims in the case of *In re* Lloyd Sec., Inc., 75 F.3d at 855.

427. *See* 15 U.S.C. § 78fff-2(b) (2000).

pay the customer its "net equity." This is the amount the member would have owed the customer for "customer property" if it liquidated all the customer's holdings at the time SIPC filed for a protective decree less any debt the customer owed to the member.[428] Customer property encompasses securities held indirectly.[429] To the extent it can practically do so (including purchasing them), SIPC is to satisfy the claims for these indirectly owned securities with delivery of such securities.[430] The funds are to be advanced by SIPC for these purposes even before the assets of the member are fully known.[431] These customer protections have a $500,000 limit per customer (which includes up to $100,000 for claims to cash in the member's hands).[432]

SIPC uses, to the extent possible, assets of the member firm to meet the obligations to customers.[433] SIPC is empowered to use the avoiding powers of a trustee in bankruptcy to recover customer property that is recoverable by such means.[434] While it has no general power to recover from third persons responsible for the member's losses,[435] it is subrogated to the claims of customers it has paid.[436] Note that Article 8's rules will play a significant role in

428. *See id.* § 78fff(a)(1)(B). "Net equity" is defined as "customer property" less debts to the member arising out of securities transactions. *See id.* § 78lll(11). Customer property is defined as

> cash and securities (except customer name securities delivered to the customer) at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted.

Id. § 78111(4).

429. *See* U.C.C. § 8-501 cmt. 4. *But cf.* Facciolo, *supra* note 7, at 692-94 (arguing that the new structure of Article 8 weakens this characterization).

430. *See* 15 U.S.C. §§ 78fff-1(b)(1), 78fff-2(b)(2), (d) (2000).

431. *See id.* § 78fff-2(b)(1).

432. *See id.* § 78fff-3(a). Such advances from SIPC are not made to affiliates of the member or to banks, brokers or dealers (unless their claims are established to be on behalf of customers otherwise entitled to protection).

433. *See id.* § 78fff-2(c)(1).

434. *See id.* §§ 78fff-1(a), 78fff-2(c)(3).

435. *See* Sec. Investors Prot. Corp. v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 649-54 (S.D.N.Y. 1999).

436. *See* 15 U.S.C. § 78fff-3(a) (2000); Appleton v. First Nat'l Bank of Ohio, 62 F.3d 791, 799-800 (6th Cir. 1995); Redington v. Touche Ross & Co., 592 F.2d 617, 624 (2d Cir. 1978), *rev'd on other grounds*, 442 U.S. 560 (1979); SEC v. Albert & Maguire Sec. Co., 560 F.2d 569, 574 (3d Cir. 1977).

SIPC's obtaining of assets of the member firm. Article 8 contains the property rules applied in bankruptcy proceedings. To the extent secured creditors have been favored, the claims of customers will be less successful and SIPC will recover fewer assets.

Additional funds to meet these obligations (including advances while the trustee is collecting the firm's assets) come from the capital SIPC maintains by assessing member firms.[437] That capital, by statute, is to be maintained at a level of $150,000,000[438] but SIPC has set and met a goal of $1 billion in its fund.[439] Relying on that capital spreads the customer losses of one member firm among the other member firms. In the twenty-nine years of its operations, SIPC has advanced a total of $380,763,000 (of this $146,478,000 was recovered).[440] Its greatest one year net payout was $63,238,000 in 1981.[441]

If its capital is inadequate, the Securities and Exchange Commission (SEC) can loan SIPC money obtained by the issuance of up to one billion dollars worth of treasury notes.[442] Repayment of that loan would come from member assessments. However, it can be accomplished by the SEC levying on each sale of securities on an exchange with a value of $5,000 or more a charge of 1/50 of a percent of the price of the securities.[443] An SEC levy spreads the loss of customers of a member firm to all participants in the market except small trades. SIPC has also obtained from a consortium of lenders credit facilities totaling one billion dollars.[444]

But cf. Mishkin v. Peat, Marwick, Mitchell & Co., 744 F. Supp. 531, 555-58 (S.D.N.Y. 1990) (stating that SIPC becomes subrogated to claims of customers against the estate).

437. *See id.* § 78ddd(a), (c).

438. *See id.* § 78ddd(d).

439. *See* SECURITIES INVESTOR PROTECTION CORPORATION, 1996 ANNUAL REPORT 3 (1997); SECURITIES INVESTOR PROTECTION CORPORATION, 1999 ANNUAL REPORT 3 (2000).

440. *See* SECURITIES INVESTOR PROTECTION CORPORATION, 1999 ANNUAL REPORT 17 (2000).

441. *See id.*

442. *See* 15 U.S.C. § 78ddd(g), (h) (2000).

443. *See id.* § 78ddd(g).

444. *See* SECURITIES INVESTOR PROTECTION CORPORATION, 1999 ANNUAL REPORT 3 (2000).

investors, it is inadequate for many retirement funds or institutional or other large investors that are customers of brokers and dealers. Fourth, the protection is limited to "securities." While securities are very broadly defined in SIPA,[455] Part 5 of Article 8 covers "financial assets." "Financial asset" is a concept that includes other investment media.[456]

The most interesting and troubling question is: what if a member's failure, or the failure of multiple members, results in claims on SIPC in excess of its capital or the one billion dollar federal loan? While one hopes never to learn the answer to that question, there are important factors in the securities markets that demand that we address it. First, the evidence shows that most broker-dealer insolvencies are a result of fraud.[457] This means that

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300.101(a), 300.103, 300.105.

455. 15 U.S.C. § 78lll(14) (2000) defines "security" as:

> any note, stock, treasury stock, bond, debenture, evidence of indebtedness, any collateral trust certificate, preorganization certificate or subscription, transferable share, voting trust certificate, certificate of deposit, certificate of deposit for a security, . . . any investment contract or certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or mineral royalty or lease (if such investment contract or interest is the subject of a registration statement with the Commission pursuant to the provisions of the Securities Act of 1933), . . . any put, call, straddle, option, or privilege on any security, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase or sell any of the foregoing, and any other instrument commonly known as a security. Except as specifically provided above, the term "security" does not include any currency, or any commodity or related contract or futures contract, or any warrant or right to subscribe to or purchase or sell any of the foregoing.

456. Letters of credit and certificates of deposit purchased through a broker dealer could qualify as financial assets under Article 8. *See* U.C.C. § 8-102(a)(9)(iii). *Cf.* SEC v. C.H. Wagner & Co., 373 F. Supp. 1214, 1216-20 (D. Mass. 1974) (holding that investments in letters of credit and certificates of deposit purchased through the broker-dealer were not securities includible in net equity).

457. *See* U.S. GEN. ACCOUNTING OFFICE, SECURITIES INVESTOR PROTECTION: THE REGULATORY FRAMEWORK HAS MINIMIZED SIPC'S LOSSES 5, 29-31 (1992); Schroeder, *supra* note 12, at 300 n.16, 431.

2. Gaps in SIPC protections

Several gaps exist in the protections provided by SIPC. First, not all securities intermediaries are members of SIPC (most notably banks).[445] Banks are also not covered by the Bankruptcy Code,[446] so that the rules governing distribution of assets would come from the Article 8 priority rules and rules protecting purchasers.[447] Second, not all entitlement holders are customers protected by SIPA:[448] The term customer does not include secured parties who are entitlement holders.[449] A trustee is a single customer even if the trust has multiple beneficiaries.[450] Repo purchasers are generally not customers.[451] Third, each customer is limited to $500,000 ($100,000 for cash delivered to the broker or dealer).[452] Note that the dollar limit is not to the size of the account, but to the shortfall coverage by SIPA after distribution of assets.[453] SIPA does not aggregate certain customer accounts, thus giving some customers more protection than the $500,000 limit.[454] While this is certainly adequate for small

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445. *See* Schroeder, *supra* note 12, at 464.

446. *See* 11 U.S.C. § 109(b) (1994).

447. *See* Schroeder, *supra* note 12, at 463-65.

448. Customer is defined as:

> any person (including any person with whom the debtor deals as principal or agent) who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer.

15 U.S.C. § 78lll(2) (1994).

449. *See* Don & Wang, *supra* note 415, at 537; Schroeder, *supra* note 12, at 467.

450. *See* Sec. Investor Prot. Corp. v. Morgan, Kennedy & Co., 533 F.2d 1314, 1318 (2d Cir. 1976), *cert. denied sub nom* Tr. of Reading Body Works, Inc. v. Sec. Investor Prot. Corp., 426 U.S. 936 (1976).

451. The SIPC takes the position that they are not customers. *See* Don & Wang, *supra* note 415, at 537-40. However, some courts have disagreed. *See* Schroeder, *supra* note 341, at 1043-46.

452. "Cash" has been interpreted to include investments made by check. *See* Appleton v. First Nat'l Bank of Ohio, 62 F.3d 791, 800-01 (6th Cir. 1995).

453. *See* Rogers, *supra* note 4, at 1538 n.161.

454. *See* 17 C.F.R. § 300.100 (1981). For example, an account held by an individual, an account held by a corporation of which the individual was the sole shareholder, and an account of an individual held jointly with a spouse would be accounts held by three separate customers. *See id.* §§ 300.100(b),

regulations cannot be completely effective in preventing the failures. Second, new investment media are regularly developed and the risks associated with these investments take time to fully assess.[458] If member assessments are inadequate for the obligations to be covered by SIPC capital, there is no guarantee that the SEC will authorize the loan. Neither is there a guarantee that once the loan is authorized the SEC will authorize the charge on large trades to fund repayment. In short, there is no mechanism that avoids a financial crisis that could result in a federal taxpayer funded bailout analogous to that accomplished by the FSLIC in the savings and loan crisis in the late 1980s.[459]

VII. Analysis and Proposed Changes

A. Revised Concept of Adverse Claim

Article 8's narrower definition of an adverse claim, which affects both the direct and indirect holding systems, raises several concerns about whether it is appropriate.

1. Adverse claims limited to property interests

The drafters, in requiring adverse claims to be property interests, expressed concern that the definition in the 1977 version could include any wrongful action concerning a security, even "a simple breach of contract."[460] They specifically rejected two cases, *Fallon v. Wall Street Clearing Co.*[461] and *Pentech Int'l, Inc. v. Wall Street Clearing Co.*,[462] to the extent the holdings in those cases were based upon the view that a contract breach created an adverse claim. These cases were not popular with the securities industry.[463] Unfortunately, the cases were decided without expressly deciding whether adverse

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458. *See, e.g.*, Schroeder, *supra* note 12, at 450-51 (discussing the recent proliferation of derivatives and the financial problems that became associated with them).

459. *See id.* at 349.

460. U.C.C. § 8-102 cmt. 1.

461. 586 N.Y.S.2d 953 (N.Y. App. Div. 1992).

462. 983 F.2d 441 (2d Cir. 1993).

463. One commentator describes *Pentech Int'l* as "the most extreme anti-secured party case." Schroeder, *supra* note 12, at 347-48.

claims based on equitable interests arising under contracts were, or needed to be, property interests.[464]

Both cases arose out of the same broker-dealer insolvency. The clearinghouse lender for the securities broker-dealer had taken a pledge of an underwriter's warrant which was subject to a two-year transfer restriction (except for transfers to its officers) required by the National Association of Securities Dealers.[465] The clearinghouse had *actual knowledge* that the broker had agreed in shareholder and employment agreements that a certain percentage of the warrant belonged to each shareholder or principal employee, but refused to reduce to writing a promise to honor those commitments.[466] The shareholders and employees asserting adverse claims won. Neither court concerned itself with whether the rights to the warrants were property interests. The drafters, however, considered the interests mere contract rights that should not have been recognized in an action against the secured creditor.[467]

There are no facts in the cases that lead one to believe that justice was not served or that an undue burden was placed on the clearinghouse secured party who had actual knowledge of the claims. In fact, there were allegations that the clearinghouse knowingly helped the broker-dealer violate Securities and Exchange Commission rules in connection with the pledging of securities.[468] The rejection of these cases by the drafters appears to evidence too great an influence by the securities industry in trying to ensure that lenders always win.

Conceptually, only property interests can be adverse claims because ultimately, the issue with adverse claims is whether the claimant can enforce its claim against property in the hands of a person with whom the claimant has had no dealings.[469] Although the

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464. *See* Pentech Int'l v. Wall St. Clearing Co., 983 F.2d 441, 445-46 (2d Cir. 1993); Fallon v. Wall St. Clearing Co., 586 N.Y.S.2d 953, 956 (N.Y. App. Div. 1992).

465. *See Pentech Int'l*, 983 F.2d at 442-44; *Fallon*, 586 N.Y.S.2d at 954-57.

466. *See Pentech Int'l*, 983 F.2d at 442-44; *Fallon*, 586 N.Y.S.2d at 956.

467. *See* U.C.C. § 8-102 cmt. 1.

468. *See Fallon*, 586 N.Y.S.2d at 955-56.

469. At least one court has held a contractual claim to a security was not an adequate ownership interest to justify suit for conversion, wrongful transfer, and tortious interference with contract against an issuer that redeemed the stock with knowledge of the contractual claim. *See* Beck v. American

question of when a contractual right to property arises to the level of a property interest is an interesting legal question, it is not necessarily a good basis for making a legal distinction. There are no clear rules to resolve the question. Furthermore, it is not clear that this new requirement will result in the development of such rules. For example, if the owner of a security grants an option to a third party to purchase the security, should the option holder be deemed to have a property interest in the security or a mere contract right?

One of the few cases discussing whether an adverse claim had to be a property interest rather than a breach of contract claim was *McMillan, Ltd. v. Warrior Drilling & Engineering Co.*[470] This case involved an option and the trial court resolved the issue contrary to the resolution taken by the drafters of Article 8. In *McMillan*, a letter was delivered to the purchaser of closely held stock before the purchase.[471] The letter spelled out the terms of an option which had been given by one of the sellers to a lender.[472] The trial court held that the option did not need to be a property interest, but upheld the lender's adverse claim under the option to purchase the stock.[473] Again, nothing in the facts of that case suggests the outcome was either unjust or unduly burdensome on securities transfers because the purchaser had actual knowledge.[474] If a property interest had been required, would the court have been wrong in finding the option to be a property interest?

The example of a breach of contract claim not rising to the level of a property right given by the drafters in the official comments to Article 8 is a breached contract to sell a security.[475] The drafters, however, qualify that example with the assertion that unusual

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Sharecom, Inc., 514 N.W.2d 584 (Minn. Ct. App. 1994). Note, however, that Article 8 standards for recovery of a wrongfully transferred security have always been stricter, requiring the person to be entitled to a transfer as an owner—a mere "adverse claim" would not be sufficient. *See* U.C.C. § 8-404; U.C.C. § 8-315 (1977).

470. 512 So. 2d 14, 20 (Ala. 1986) (describing the trial court's holding).

471. *See id.* at 17-18.

472. *See id.* at 17-19.

473. *See id.* at 19-21.

474. The option holder, however, was later equitably estopped from exercising the option because of the delay in notice to the purchaser. *See* McMillan, Ltd. v. Warrior Drilling & Eng'g Co., Inc., 507 So. 2d 151 (Ala. 1992) (affirming the trial court's finding of equitable estoppel).

475. *See* U.C.C. § 8-102 cmt. 1.

circumstances could permit it to rise to the level of a property interest and recognize that equitable remedies may give rise to property claims. The drafters' example distinguishes fraud permitting the remedy of rescission of the transaction (a property interest) from a simple breach of contract where the only recovery would be damages for breach.[476] If the question could be resolved simply by determining what remedy would be available, the distinction might be easier to make. But would we look at the remedy when the financial assets are in the hands of the one making the contract (specific performance) or in the hands of a third person (replevin, constructive trust)?

Similarly, if an attempt to transfer an indorsed security certificate fails for want of delivery, does the purported transferee have a contract right or a property interest? The drafters seem to support this as a property interest.[477] In contrast, in the view of the drafters and the securities industry, a securities lending transaction (used to complete a short sale) does not involve a retained property interest in the party lending the securities, despite the semantic argument.[478]

In fact, the security entitlement which the drafters of Article 9 explicitly refer to as a property interest in the underlying financial asset can be conceived of as merely a set of contractual and statutory rights against the securities intermediary. It is not clear what aspect of the security entitlement, since it involves a pro rata claim to a fungible bulk, raises it from the level of contractual right to property interest.[479] This difficulty further illustrates the problems inherent in expressly requiring adverse claims to be property interests.

Thus, the requirement that an adverse claim be a property interest accomplishes little because courts may find a property interest, or finesse the issue to achieve a just result. For example, the *In Re SRJ Enterprises, Inc.*[480] court finessed the issue in a case under Article 9 of the Uniform Commercial Code. The court found that a

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476. *See id.*

477. *See id.* § 8-304 cmt. 3 (drawing an inference of a property interest from the drafters' omission of references to a promise to transfer and application of the law of contracts).

478. *See* Prefatory Note, *supra* note 3, at Part III.C.11.

479. *See supra* notes 140-149 and accompanying text.

480. 150 B.R. 933 (Bankr. N.D. Ill. 1993).

prohibition on transfer of rights under a franchise agreement was enforceable, thereby effectively precluding a grant of a security interest in the franchise.[481] However, the court upheld as enforceable, a security interest in the value of the franchise based upon the fact that the franchisee had to terminate its franchise before a purchaser of its assets could acquire a new franchise from the franchiser.[482] Because a security interest is an interest in the debtor's personal property,[483] the ultimate outcome on the facts of that case was the same as if the court had held that the franchisee could transfer an interest in the franchise contract. In effect, the franchisee had a property interest in the franchise.

2. Adverse claims limited to violations

A different concern is raised by the requirement that an adverse claimant must establish that its interest was violated by "hold[ing], transfer[ring] or deal[ing] with the financial asset."[484] The "transfer" alternative of this requirement seems perfectly logical. If it was not a violation of a claimant's right to "transfer" a financial asset, why should the claimant be able to assert an adverse claim against the transferee? Law, however, is never so simple. If the transfer was permitted only if made subject to the claimant's right, the claimant certainly should be able to assert a claim against the transferee. There is less certainty of the requirement's meaning or logic when one considers the "holding" or "dealing with" the financial asset alternatives of the requirement. Both those terms have uncertain legal meanings. There is also no guidance on how to determine when "holding" or "dealing with" violates the claimant's interest.

Arguably, security interests are not adverse claims because subsection 9-401(b) permits the debtor to transfer or further encumber the property despite a contractual prohibition, i.e. the secured party's rights were not violated. This conclusion apparently can be reversed by the terms of a security agreement, because other provisions in the Uniform Commercial Code contemplate transfer or retention of collateral violating security interests.[485] Thus, there is

481. *See id.* at 937-41.
482. *See id.*
483. *See* U.C.C. § 1-201(37).
484. U.C.C. § 8-102(a)(1).
485. *See, e.g.*, U.C.C. §§ 1-209(9), 9-320(a), 9-332, 9-615(g).

arguably no notice of the adverse claim without notice of the terms of the security agreement. What other types of property interests may lose their status as adverse claims because holding, transferring, and dealing with the financial asset is permitted?

3. Effect of the adverse claim limitation

The effects of changing the definition of adverse claim may be counterproductive to the goals of Article 8. The best face that can be put on the new definition is that it increases the negotiability of financial assets by making it easier for purchasers to be protected, because notice of claims that are not adverse claims will not preclude protection.[486] The concept of adverse claim in Article 8, however, is two-edged. While notice of an adverse claim precludes protection,[487] being protected means that one takes free of adverse claims.[488] Thus, a narrower definition of adverse claim may make protected purchaser status less valuable if the protected purchaser takes free of fewer claims. Conversely, a broader definition of adverse claim permits a protected purchaser to take free of more claims.

An instructive contrast can be drawn with the description of adverse claims in Article 3 which includes property or possessory rights as adverse claims.[489] That broader description explicitly recognizes that property interests are not the only interests from which holders in due course need protection. Conversely, having notice of either property interests or possessory interests would defeat holders in due course status.[490]

It is certainly not clear that because the claim is not an adverse claim, a purchaser of a financial asset would be subject to it. In fact, the drafters of Article 8 would argue vehemently against such a

486. *See id.* §§ 8-303, 8-502, 8-510(a).
487. *See id.*
488. *See id.*
489. U.C.C. § 3-306 provides in pertinent part: "A person taking an instrument, other than a person having rights of a holder in due course, is subject to a claim of a property or possessory right in the instrument or its proceeds, including a claim to rescind a negotiation and to recover the instrument or its proceeds." The prior version of Article 3 simply referred to "claims" with no limitation as to the character of the claim. *See* U.C.C. §§ 3-305(1), 3-306(a) (1962). Thus, recent amendments to the U.C.C. have all tended to limit the definition of claim.
490. *See* U.C.C. § 3-302(a)(2)(v).

construction. There are, however, three significant arguments that could subject a purchaser protected from adverse claims to such non-adverse claims. First, if the claim is a property interest, but not an adverse claim due to the "hold, transfer or deal with" violation requirement, it should still be enforceable. A security interest is an excellent example of such a claim.[491] Second, unlike Article 3 which specifically describes the claims and defenses to which one not qualifying as a "holder in due course" is subject,[492] Article 8 has no such provision for those who are not "protected purchasers" or purchasers against whom adverse claims may not be asserted. In fact, the closest analog in the 1977 version, section 8-315,[493] was unceremoniously deleted with the cryptic explanation that its function was "not entirely clear" so the issue was left to "other law."[494] The question has thus arguably been left to the courts.

491. *See* Schroeder, *supra* note 12, at 442-43.

492. U.C.C. § 3-306 provides in pertinent part: "A person taking an instrument, other than a person having rights of a holder in due course, is subject to a claim of a property or possessory right in the instrument or its proceeds, including a claim to rescind a negotiation and to recover the instrument or its proceeds." Likewise, § 3-305(a) provides in pertinent part: "Except as stated in subsection (b) [rights of a holder in due course], the right to enforce the obligation of a party to pay an instrument is subject to the following:
(1) [real defenses]. . .;
(2) [ordinary defenses]. . .; and
(3) [claims in recoupment]. . . ."

493. U.C.C. § 8-315 (1977) provided:

> (1) Any person against whom the transfer of a security is wrongful for any reason . . . as against anyone except a bona fide purchaser, may:
>
> (a) reclaim possession of the certificated security wrongfully transferred;
>
> (b) obtain possession of any new certificated security representing all or part of the same rights;
>
> (c) compel the origination of an instruction to transfer to him or a person designated by him an uncertificated security constituting all or part of the same rights; or
>
> (d) have damages.

Note that this section gave rights to those with ownership interests, not all "adverse claimants."

494. Prefatory Note, *supra* note 3, at Part IV.B.8. Interestingly, the drafters of the 1977 version had no difficulty explaining its purpose. It gave owners of securities "a remedy for wrongful transfer." U.C.C. § 8-315 cmt. 1 (1977). The remedy, importantly, was against the purchaser, not the issuer or transfer agent. *See id.*

Third, in a situation where the court is inclined to protect the adverse claimant, such an argument may be an appealing way to reach an equitable result without directly conflicting with the language of Article 8.

The drafters were properly concerned that the marketability of securities should not be impeded by concerns with being subject to claims to the securities. The appropriate protection, however, is in the awareness provisions, not the definition of adverse claims. The cases which impeded the market were overruled by revised notice provisions.[495] If there are legitimate concerns that some claims to financial assets should not be enforceable against the financial asset, the concerns should have been addressed directly, similarly to the way they were addressed in Article 3.[496]

The probable effect of the limited definition of adverse claim will be an increase in unnecessary and unproductive litigation over issues of little import. Perhaps the securities industry, when it had the chance to shape the law, hoped to achieve an extra benefit. In reality, it accomplished little if anything for holders of financial assets, but instead created a number of legal issues that would have been best left where they stood.

B. Right to Modify by Contract

In the indirect holding system, the rights and property interest of an entitlement holder are completely focused on the relationship with the securities intermediary. That contractual relationship involves a number of duties of the securities intermediary and correlative rights of the entitlement holder created by Article 8.[497] Most of those rights are expressly subject to contractual variation.[498] Because of the nature of the contracting process in this context, the contractual flexibility raises important concerns.

1. Contractual lowering of standards

Under our freedom of contract notions for property rights, the ability to modify by contract is essential. However, the contracting

495. *See infra* notes 525-529 and accompanying text.
496. *See supra* note 492 and accompanying text.
497. *See* U.C.C. §§ 8-504(a)-(b), 8-505(a)-(b), 8-506(1)-(2), 8-507(a)-(b), 8-508(1)-(2), 8-509.
498. *See supra* notes 193-196 and accompanying text.

realities in this context require closer analysis. It is a foregone conclusion that at least in the consumer context the agreements will be prepared by the securities intermediary and will not be subject to negotiation.[499] Even in nonconsumer contexts, experience teaches us that only the economically powerful entitlement holders will be able to negotiate these agreements in meaningful ways. It will be surprising (shocking is probably a more accurate term) if securities intermediaries include higher standards for performance in the contracts. In contrast, the likelihood that many agreements will set forth lower standards is high.

This provision in Article 8 creates one of the more significant risks to those holding securities indirectly. Subsection 8-509(b) requires the securities intermediary to perform its duties in a commercially reasonable manner. That requirement, however, is subject to the agreement of the parties. This limitation is statutory, not contractual, so it is valid despite the fact that duties of due care cannot be disclaimed by "agreement" under subsection 1-102(3).[500]

Article 8's reporter, Professor Rogers, has attempted to justify the rule,[501] but none of his justifications go beyond merely establishing the need for a right to modify Article 8 by contract. The drafters attempt to justify this with an example of a securities intermediary having custody of certain foreign financial assets which create significant risks. The intermediary, therefore, contracts to disclaim responsibility for custodial risk with these financial assets.[502] The problem with the justification is that if those facts justify the statute, they also establish that it is a commercially reasonable disclaimer.

Moreover, the drafters point out that compliance with the contractual standards is still subject to the good faith requirements of

499. For consumers, these contracts are contracts of adhesion. The author's personal experience when attempting to negotiate a provision in a brokerage agreement is that he was told it was a "take it or leave it" provision. The author then asked, "Does that mean you will refuse to open an account with me unless I accept the provision as written?" The answer was "yes!" Perhaps some brokers may have a different approach. If the consumer has a particularly large account, negotiation may be possible.

500. *See* U.C.C. § 8-504 cmt. 4.

501. *See* Rogers, *supra* note 4, at 1503-11.

502. *See id.*

section 1-203 and subsection 8-102(a)(10).[503] Thus, the securities intermediary already has similar "uncertain" limitations on its functioning under the contract. While there is certainly a difference between evaluating whether a contractual duty is commercially reasonable and whether the performance of that contractual duty was done in good faith, the argument is still available that good faith was not exercised in putting the provision in the contract.[504]

The preference of agreement over commercial reasonableness in Article 8 is simply backwards. Requiring standards set by agreement to be commercially reasonable is not too great a burden. Simply imagine trying to convince a court that, although it was not commercially reasonable, your client complied with the terms of the agreement it prepared for its entitlement holder to sign. In contrast, what serious limitations does it place on a securities intermediary to have to perform in a commercially reasonable manner? The lawyer's response that "I cannot define for my clients what that means" is accurate, but irrelevant. There are many business risks that cannot be clearly described and delineated beforehand. Clients should have little concern with a given practice being determined not to be commercially reasonable. It does not happen very often. When it does, the practice is rarely defensible.

2. Contractual authority to encumber

One of the more troubling contexts in which Article 8's contractual override can expressly be used is the prohibition on granting a security interest in financial assets necessary to meet obligations to its entitlement holders.[505] The ability to encumber the

503. *See id.* The decision to incorporate the broader definition of good faith into Article 8 was part of a package that included the contractual modification provisions in U.C.C. §§ 8-504 to 8-509. *See* Rogers, *supra* note 4, at 1505 n.104.

504. In fact, the drafter's example of a lack of "good faith performance" is a contractual provision "purport[ing] to establish" a usual relationship while disclaiming a basic element that defines the relationship. U.C.C. § 8-504 cmt. 4. That is, including a contractual provision so one-sided that it would not be consistent with the good faith performance of duty. *See id.*; Guttman, *supra* note 66, at 26-33 (arguing for courts to rely on good faith to protect investors).

505. U.C.C. § 8-504(b) provides as follows: "Except to the extent otherwise agreed by its entitlement holder, a securities intermediary may not grant any security interests in a financial asset it is obligated to maintain pursuant to subsection (a)."

financial assets is important to protect securities intermediaries between the trade date and the settlement date, when they are creating a security entitlement on margin and when they are loaning money against the security entitlement because it permits them to re-pledge the financial assets and thereby obtain the financing they need to extend such credit.[506] Because these contracts will be prepared by the securities intermediary, they are virtually certain to contain authorizations to encumber. It will be surprising, however, if the securities intermediary includes anything but a blanket authorization to encumber. With this authorization, unnecessary encumbrance does not breach any Article 8 duty. Although it violates federal securities laws for a broker to pledge a customer's securities, other than to fund loans to the customer,[507] violation of that duty would not violate an Article 8 duty. Moreover, these federal rules only apply to "securities" under federal securities laws and only to those securities intermediaries that are subject to the SEC Rules.[508] Thus, a securities intermediary in financial need can completely undercut its entitlement holders in favor of its secured creditors.

In the indirect holding system, elimination of this entitlement holder risk cannot be accomplished without significantly impairing financing of securities intermediaries. Even though subsection 8-504(a)[509] requires a securities intermediary to maintain sufficient financial assets to meet its obligations to entitlement holders, there is no meaningful way to know if the obligation has been breached until it is too late. The risk can, however, be reduced. The most logical protection from the entitlement holder's standpoint would be to limit contractual changes to those necessary to permit repledging of financial assets securing credit extended to entitlement holders,[510]

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506. *See* U.C.C. § 8-504 cmt. 2.

507. *See* 17 C.F.R. §§ 240.8c-1, 240.15c2-1 (2001). These regulations require the customer's consent before a broker can rehypothecate the customer's securities and limit brokers to rehypothecating 110% of the aggregate amount of customer indebtedness.

508. *See id.*

509. *See supra* note 176.

510. This could be accomplished by changing U.C.C. § 8-504(b) to read as follows: "Except to the extent [otherwise agreed by] *it has a security interest in the security entitlement of* its entitlement holder, a securities intermediary may not grant any security interests in a financial asset it is obligated to maintain pursuant to subsection (a)."

similar to the limitations imposed by federal securities laws. An entitlement holder has no other conceivable justification for giving such consent. The two possible remedies for a securities intermediary breaching this duty would be to either (1) consider the securities intermediary not to have power to encumber those financial assets necessary to meet obligations to entitlement holders,[511] or (2) simply treat such encumbrance as a violation of the securities intermediary's duties.

The first of these remedies would add an unacceptable risk to secured creditors with no easy way to assess or avoid it. This makes financing more risky and therefore less readily available. That remedy would increase systemic risk. The second remedy, while not as protective of entitlement holders, would enable them to meet one of the requirements in subsection 9-503(d) (transfer was a violation of the intermediary's duty) that could not have been met absent the limitation. The second remedy does not create a serious risk to the intermediary's secured party, because there is no duty of inquiry.[512] Financing is only impaired to the extent the secured party knows that the intermediary is breaching its duty. Financing under that circumstance does not need to be facilitated.

C. Structure of Claim Preclusion Rules

The differences between the rules protecting purchasers in the indirect holding system[513] and the protected purchaser rule[514] in the direct holding system raise the questions: Do the structural differences between the two systems justify the rule differences? If not, which type of rule is preferable?

Each rule protecting purchasers in the indirect holding system is structured as a preclusion of the claimant's action in contrast to the protected purchaser rule which sets forth the requirements a purchaser must meet to be free from adverse claims.[515] The official comments to section 8-502 explain that the protected purchaser rule's language of "takes free from adverse claims" was not used because the entitlement holder's claim to the financial asset is

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511. *See infra* notes 624-629 and accompanying text.
512. *See infra* notes 536-564 and accompanying text.
513. *See* U.C.C. §§ 8-502, 8-503(e), 8-510(a).
514. *See id.* § 8-303.
515. *See id.* §§ 8-303, 8-502, 8-503(e), 8-510(a).

necessarily subject to other claims.[516] The preclusion of the claimant's action structure solves that problem for the section 8-502 rule. That explanation also justifies the subsection 8-510(a) rule protecting purchasers of security entitlements. The justification breaks down, however, for the rule in subsection 8-503(e) because the purchasers being protected are purchasing financial assets which can be, but are not necessarily, security entitlements. In fact, other than secured parties and repo purchasers, it is unlikely that such purchasers would be acquiring security entitlements.

The preclusion of an action structure was not the only way to solve the structural problem in the indirect holding system. Simply excluding the rights of the securities intermediary and other entitlement holders and using the protected purchaser rule structure would solve the problem for the section 8-502 and subsection 8-510(a) rules and, to the extent the problem exists, for the subsection 8-503 (e) rule.

In the official comments to one of the indirect holding system rules protecting purchasers, the drafters describe as a fundamental policy of "investor protection" reliance on a "forward-looking" perspective in assessing the rule's impact on the "vast number of transactions" without wrongful conduct rather than the "*post hoc* perspective of what rule might be most advantageous" to a class of claimants after someone acted wrongfully.[517] The statement implies that the ideal rule would not benefit one engaged in wrongful conduct while not impeding the action of one not engaged in wrongful conduct. In other words, innocently facilitating wrongful conduct by another would be overlooked, because it met the forward-looking standard of making the markets function smoothly. Thus, the ideal rule under that standard is one without a duty of inquiry and without implied notice or knowledge. If that is true, the neutrality principle suggests that the type of rule protecting purchasers in the indirect holding system should also be used for the direct holding system because the differences are not driven by the structure of the systems. Closer analysis, however, reveals significant deficiencies in the type of rule used in the indirect holding system.

516. *See id.* § 8-502 cmt. 1.
517. *Id.* § 8-503 cmt. 3.

1. Allocating the burden of proof

The preclusion of an action structure does more than simply eliminate the problem highlighted by the drafters. It shifts the burden of proof to the adverse claimant in the indirect holding system whereas in the direct holding system, the burden is on the purchaser seeking protection.[518]

The drafters of Article 8 do not discuss the burden of proof.[519] We are left with the following question: Does the structure shift the burden of persuasion, or the burden of going forward with evidence? Article 1 defines "burden of establishing" as the burden of persuading the trier of fact,[520] but the drafters of Article 8 did not use that language. On the other hand, the burden of going forward with evidence generally applies in connection with meeting the requirements for a presumption. A presumption is not present in this context. Thus, it appears the burden of persuasion was shifted. To recover, the adverse claimant will need successful discovery. The only evidence necessarily in the claimant's possession would relate to the mere possibility that the purchaser could have notice. Whether the purchaser actually had notice (or colluded), had obtained control, or had given value would involve facts known to the purchaser and perhaps to no one else. That procedure is cumbersome and inefficient. Shifting the burden of proof makes claims more difficult to assert against a purchaser who qualifies for protection, thus providing increased purchaser protection in the indirect holding system.

If shifting the burden of proof facilitates security markets, the neutrality principle would require that the same structure be established in the direct holding system. Before concluding that this structure should be used in the direct holding system, however, the operation of the structure in the indirect holding system needs to be more fully understood. These rules only benefit the entitlement holder when an adverse claim is asserted against the entitlement holder. Such assertions are rare.[521] The parties most benefited by

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518. *See supra* note 289 and accompanying text.

519. The second paragraph of official comment 3 to § 8-503 recognizes the shifted burden in that rule, but does not discuss its practical implications or the manner in which it will function.

520. *See* U.C.C. § 1-201(8).

521. *See supra* notes 276-281 and accompanying text.

the rules are secured creditors in the indirect holding system.[522] Thus, the preclusion of an action structure is not as relevant to the securities markets per se as it is to financing securities intermediaries in those markets.

A better solution would be a procedure similar to that explicitly set forth for holders and holders in due course in Article 3. Under subsection 3-308(b), the holder of the negotiable instrument is entitled to enforce it, unless the obligor establishes a defense.[523] At that point, the holder of the instrument has the burden of establishing holder-in-due-course status to defeat the defense. The analogous procedure for adverse claims to financial assets would be for the adverse claimant to have the burden of establishing its claim. When that burden is met, the purchaser could defeat the claim by establishing its protected status. This is the way the protected purchaser rule in the direct holding system operates. This scheme is logical and puts the burden on the party in possession of the evidence. Note that the purchaser-holder has the burden of proving a negative, lack of notice, but the purchaser's mere assertion of lack of notice should adequately meet the burden unless the adverse claimant can prove otherwise. Such proof on that issue is similar to what is required by the preclusion of action rules protecting purchasers in the indirect holding system.[524]

2. The awareness standard

Historically, the benefits of a purchaser rule were dependent on the purchaser not having notice of an adverse claim to the asset being purchased. The reason for the no-notice requirement was that a purchaser rule cuts off legitimate claims to the asset and it was against public policy to cut off such claims to benefit someone who was not sufficiently innocent when purchasing the asset. One of the significant issues that arose was the extent to which notice was imputed to a purchaser who did not have actual knowledge of the claim.

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522. *See supra* notes 294, 311, 326 and accompanying text.

523. U.C.C. § 3-308(a) presumes the authenticity of and authority to make signatures, unless a party expressly puts it in issue. Thus, the holder of the instrument is entitled to enforce it simply by establishing status as a holder.

524. *See* U.C.C. §§ 8-502, 8-503(e), 8-510(a).

This imputation of knowledge is facilitated under most of the Uniform Commercial Code's purchaser rules by including in the definition of notice in subparagraph 1-201(25) both actual knowledge and a clear objective component, "reason to know." It is also facilitated by the good faith requirement, particularly good faith defined to require the exercise of reasonable commercial standards of fair dealing. The drafters of Article 8 specifically rejected that general notice definition in its rules protecting purchasers in favor of a narrower definition of "notice of adverse claim,"[525] and eliminated the good-faith requirement from rules protecting purchasers.

Article 8, however, does not simply use the "no notice of adverse claim" standard. In one rule, notice of any adverse claim is the operative standard.[526] In others, the standard is increased to notice of the specific adverse claim being asserted.[527] In still another context, actual knowledge is required.[528] Finally, some rules require collusion.[529]

a. notice of specific claim

Using the "notice of the adverse claim" awareness standard for two rules in the indirect holding system is a significant change from using the "notice of any adverse claim," awareness standard for the protected purchaser rule in the direct holding system. Using this awareness standard for section 8-502 and subsection 8-510(a) was one method of solving a problem inherent in the indirect holding system.[530] A security entitlement is expressly a pro rata claim, along with other entitlement holders and the securities intermediary to a fungible bulk of the financial asset.[531] Thus, using the notice-of-any-adverse claim structure for this protection would have an inherent conflict: the entitlement holder would have notice of those claims but that notice should not subject it to assertion of other claims. Another method of resolving the problem would have been to use the

525. *See supra* notes 73-80 and accompanying text.
526. U.C.C. § 8-303.
527. *See id.* §§ 8-502, 8-503(e), 8-510(a).
528. *See id.* § 8-115(1).
529. *See id.* §§ 8-115(2), 8-404(b), 8-503(e).
530. A similar problem relating to "takes free from adverse claims" was discussed in the text accompanying *supra* note 516.
531. *See* text accompanying *supra* note 147.

no-notice-of-adverse-claim standard and except there from notice of the claims of the securities intermediary and its other entitlement holders.

By opting to draft the rules in terms of notice of the specific adverse claim, the drafters apparently had additional, unarticulated goals in mind.[532] The historical rationale for purchaser rules was that the deserving attributes (bona fides) of the purchaser justified depriving a claimant of its property rights. An important effect of the awareness standard chosen for the indirect holding system is to protect purchasers who may have purchased with notice of some problems. The standard significantly reduces the focus on the purchaser's deserving attributes. Rather it rewards a claimant who made its claim more widely known. The different standard represents a sea change in purchaser rules. The focus is not on the innocence of the entitlement holder, but on the diligence of the claimant.

The drafters do not provide adequate insight into the reasons for taking this course.[533] Their stated policy of focusing on the forward-looking perspective of the rule's impact on the majority of transactions without wrongful conduct rather than "*post hoc*" perspective of using rules advantageous to claimants after someone wrongfully acts,[534] provides no guidance on this issue. To focus on the deserving attributes of the purchaser is precisely consistent with that policy. The question is did the purchaser act wrongfully? The drafters' choice, however, appears to be simply a method of limiting the number of claims that can be asserted.[535]

532. Professor Facciolo has traced the drafting history and concluded that the change was initially inadvertent. *See* Facciolo, *supra* note 7, at 654 n.218. Note that it was not changed after the inadvertence was discovered.

533. This change cannot be explained as a counterbalance to having shifted the burden to the claimant on the theory that the claimant would likely only have evidence regarding knowledge of its claim. If the protection was defeated by notice of any claim, the burden on the adverse claimant would not be increased, it would be eased. The claimant would have the option of proving notice of either its claim or any other claim.

534. *See* U.C.C. § 8-503 cmt. 3.

535. *See supra* note 532.

b. the collusion standard

The rule protecting purchasers of financial assets against claims from entitlement holders uses a no-collusion standard, rather than the no-notice-of-adverse-claim standard used in section 8-502 and subsection 8-510(a). Because collusion is different from the increasing levels of awareness, it deserves closer analysis.

When the drafters adopted the no-collusion standard, their intent was to establish a higher standard of participation in the wrongdoing,[536] or, as described in another official comment, "complicity in the wrongdoing," acting "as an aider or abettor for the tortious conduct," or "affirmative misconduct."[537] The no-collusion standard appears to require both knowledge and action (or perhaps willful inaction if aiding and abetting can include inaction).[538] Professor Rogers suggests that the key role of the standard will be to focus the inquiry toward blameworthy conduct.[539]

Professor Rogers explains that the no-collusion standard in section 8-503 was chosen to track the no-collusion standard used in sections 8-115 and 8-404.[540] The contexts, however, are very different. In section 8-115, securities intermediaries, brokers and agents are protected from liability for complying with a wrongdoer's effective direction or order unless they were in collusion with the wrongdoer.[541] Similarly, in section 8-404 issuers are protected from liability for complying with a wrongdoer's effective request to register or transfer securities unless they were in collusion with the wrongdoer.[542] Lack of collusion is a new standard to Article 8, but may be an appropriate standard to protect innocent persons performing ministerial acts from liability for wrongful actions of another.[543] In contrast, subsection 8-503(e) is a rule allocating the

536. *See* U.C.C. § 8-503 cmt. 2.

537. *See id.* § 8-115 cmt. 5.

538. *See id.*

539. *See* Rogers, *supra* note 4, at 1536-37.

540. *See id.* The justification can also be implied from official comment 10 to § 8-102.

541. *See* U.C.C. § 8-115(2).

542. *See id.* § 8-404(a)(4).

543. The drafters borrowed the standard from RESTATEMENT (SECOND) OF TORTS § 876 (1979) which governs liability of an aider and abettor in the tortious conduct of another. *See* U.C.C. § 8-115 cmt. 5.

risk of property loss between two wronged parties.[544] For an entitlement holder to have the claim, the securities intermediary must have acted wrongfully[545] but the purchaser is not acting as its agent, rather as an independent third party. The purchaser was not carrying out a duty, it was making an investment with its attendant risks. Why should the section 8-503 rule protecting purchasers and limiting an entitlement holder's rights track the section 8-115 and 8-404 standard designed to protect those acting innocently on behalf of others who acted wrongfully?

A more provocative justification is proffered in official comment 10 to section 8-102 where the drafters elaborate on the role of good faith under Article 8. The comment asserts that if subsection 8-503(e) depended on notice of adverse claims, "a sound and efficient securities clearance and settlement system" would be impaired rather than advanced, because intermediaries would be required "to investigate the propriety of the transactions. . . ." Similar assertions are made in official comment 3 to section 8-503.[546] Those assertions are surprising on two levels. First, the assertion that a notice of adverse claim standard creates a duty to investigate seems inconsistent with efforts made elsewhere in Article 8. The duty of inquiry was virtually eliminated by the drafters in their construction of the protected purchaser rule.[547] They also eliminated good faith as a separate requirement[548] and defined "notice of adverse claim" to eliminate some cases that imposed a duty to inquire.[549] Moreover, the duty of inquiry example given in that official comment is problematic. It involves securities issuers avoiding liability for transfers that were in breach of fiduciary duty. And transfer by a fiduciary may require certain inquiries.[550]

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544. U.C.C. § 8-503(e) resolves the dispute between the entitlement holder and a purchaser. The entitlement holder's securities intermediary who sold to the purchaser is the wrongdoer.

545. *See* U.C.C. § 8-503(d)(3).

546. U.C.C. § 8-503 cmt. 3 refers to the "sound and efficient operation of the securities *holding* and settlement system" and to the duty to "investigate *whether their sellers may be acting wrongfully*" (emphasis added). The minor wording differences, do not appear to evidence separate policies.

547. *See supra* note 65 and accompanying text.

548. *See supra* notes 66-69 and accompanying text.

549. *See supra* notes 73-80 and accompanying text.

550. *See* U.C.C. §§ 8-401(a)(3), 8-402(a)(1)-(5), 8-403(a).

More surprising is the fact that the two other rules protecting purchasers in the indirect holding system,[551] in which the highly liquid securities markets operate, each use a "no notice of the adverse claim" standard. If the standard is not problematic for those rules to make the clearance and settlement system more sound, why is a no-collusion standard necessary in subsection 8-503(e)?[552] There is no readily apparent answer.

The use of the no-collusion standard only for this rule is particularly puzzling because most adverse claims that could be asserted in the indirect holding system are not by entitlement holders. Those claims are severely limited.[553] Before an entitlement holder can assert a claim to the financial asset, it must satisfy the threshold requirements in subsection 8-503(d). The rationale of promoting the "safe and efficient operation of the clearance and settlement system"[554] justifies this first level of protection. It reinforces the indirect holding system's scheme of giving virtually complete responsibility to the securities intermediary for claims by the entitlement holder.[555] Thus, it offers protection for purchasers of financial assets by simplifying the system so long as the securities intermediary is either solvent or has sufficient quantities of the particular financial asset to satisfy all claimants. It keeps the losses with those dealing with the insolvent intermediary, rather than passing them on more widely through the system.[556] If that fails, deference is appropriately given to the liquidation schemes that have been established by giving the rights to the trustee or liquidator to assert the claim in a collective action.[557]

551. *See id.* §§ 8-502, 8-510(a).

552. Professor Rogers indicates there was consideration of using the standard in these rules and the protected purchaser rule, but the change would have been too great. *See* Rogers, *supra* note 4, at 1535. That fact makes the choice in the U.C.C. § 8-503 context even more provocative.

553. *See supra* notes 315-325 and accompanying text.

554. U.C.C. § 8-503 cmt. 3.

555. This policy is articulated by the drafters. *See id.*

556. *See id.* Because there are often two or more tiers of holding, other rules would simply shift losses from one group of entitlement holders to another based upon the acts and knowledge of their securities intermediary. Even though such shifting is a rational means of loss allocation when the second tier intermediary is a clearing corporation—the loss is spread to participants through the market—that structure is not always present.

557. *See id.* § 8-503(d).

The problem is that the purchaser is further protected by a claim preclusion rule limited by the no-collusion standard.[558] After the indirect nature of an entitlement holder's claim has been taken into account by the subsection 8-503(d) rule, why should it be treated more harshly than other claimants? Here the justification of furthering "the sound and efficient operation of the securities holding and settlement system,"[559] becomes much more attenuated.

If the real concern justifying the no-collusion standard is complete elimination of a duty of inquiry, a knowledge standard accomplishes the task more cleanly. Collusion, unlike knowledge, is not a bright line standard. It is a legal conclusion, not an objectively verifiable fact. In that respect, it is similar to imputed notice. Protecting a purchaser who acts in the face of knowledge of an adverse claim just because the purchaser was not additionally affirmatively involved with any wrongdoing does not further any important interest.

With the no-collusion standard, the question simply becomes what will courts require before concluding that collusion was involved?[560] This author has been unable to formulate a set of circumstances by which it can confidently be asserted that a court would find there was "knowledge of the adverse claim for breach of duty" but would not find collusion.[561] If one knows that the transaction violates another's duty, can that fact alone not readily be held to constitute collusion in violating that duty? If courts construe collusion to include functionally the same thing as knowledge that the adverse claim breaches the securities intermediary's duty, then

558. *See id.* § 8-503(e).

559. *See id.* § 8-503 cmt. 3.

560. Professor Rogers suggests courts can use cases under sections of Article 9 referring to collusion. *See* HAWKLAND & ROGERS, *supra* note 138, at 627. *But see* Facciolo, *supra* note 7, at 656 n.230 (pointing out that the case law under those sections does not address collusion).

561. Professor Rogers expresses the same difficulty with the "lower standard" of notice of adverse claim. *See* Rogers, *supra* note 4, at 1536. The drafters, however, state in official comment 5 to § 8-115 that knowledge is a necessary, but not a sufficient, condition to finding collusion.

The New York legislature, however, expressed the intent that collusion included actual knowledge of the securities intermediary's violation. N.Y. U.C.C. LAW art. 8 pmbl (McKinney Supp. 2001-02). The first court to address the issue seems to have followed the legislature's expressed intent. *See* Nathan W. Drage, P.C. v. First Concord Sec., Ltd., 707 N.Y.S. 2d 782 (Sup. Ct. 2000).

Article 8 will have created a confusion of legal standards. Raising the historical legal standard from bona fide purchaser for value without notice to a standard of lack of knowledge would be a far more consistent and meaningful approach in the context of these rules. And if it is that important, then why not use that standard in sections 8-303, 8-502 and subsection 8-510(a) as well?

The difficulty in justifying the no-collusion standard is further illuminated by contrasting a claim to the financial asset in the hands of a purchaser asserted by the entitlement holder with one asserted by a secured party of the securities intermediary. To defeat a secured party, the purchaser must satisfy the protected purchaser rule (if the financial asset is a directly held security), the indirect holding system's rule in section 8-502 (if the financial asset is a security entitlement), or some similar rule (for other types of financial assets).[562] Why should entitlement holders be given a higher hurdle than secured parties of the securities intermediary?

The explanation probably lies in the fact that claims by entitlement holders against purchasers of a financial asset are not likely due to the tracing problems[563] unless the purchaser against whom the claim is made was a secured party of the securities intermediary.[564] Thus, secured parties are given the benefit both ways. If they are the claimant, they must satisfy a lower standard. If they are the party against whom the claim is being asserted, the entitlement holder has to meet a higher standard.

The no-collusion standard creates greater risks for entitlement holders than are necessary. This rule demonstrates a pervasive preference for secured parties over entitlement holders in the indirect holding system which is unique to it, but not inherent in it.

D. Priority Rules and Awareness

In contrast to rules protecting purchasers, the drafters of Article 8 did not include an awareness element in any of its priority rules. A few revised Article 9 priority rules, in contrast, permit notice or knowledge of a prior security interest to explicitly defeat priority.[565]

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562. *See supra* notes 327-328 and accompanying text.

563. *See supra* notes 276-280 and accompanying text.

564. Note that official comment 3 to § 8-503 unceremoniously states that the rules apply to pledgees as well as other transferees.

565. Article 9 defers to purchaser rules in other articles of the U.C.C. which

In two additional revised Article 9 priority rules, the drafters took the likelihood of knowledge (or lack thereof) into account in structuring the rules.[566] It is noteworthy that in most of those instances the rules benefit purchasers and either are, or contain the traditional elements of, purchaser rules.

Three aspects of the Article 8 and revised Article 9 priority rules suggest they be given special attention. First, knowledge or awareness by purchasers in security markets is not very meaningful because the trades are completely impersonal.[567] Whereas, security interests are obtained in direct negotiation contexts where knowledge could be meaningful. Second, the parties governed by some of the Article 8 priority rules are (at least nominally) purchasers, not just secured parties. Third, there is a more complicated relationship between perfection and priority in the Article 8 and revised Article 9 priority rules for investment securities. The drafters' choices reflect policy decisions that need to be explored and evaluated.

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have "no notice" requirements. *See* U.C.C. § 9-331. Two of the priority rules for purchasers of chattel paper or instruments require a lack of knowledge to prevail. *See* U.C.C. § 9-330(b), (d). Priority for future advances over lien creditors or buyers or lessees of goods can be limited by knowledge. *See id.* § 9-323(b), (d)-(g). Finally, certain priority to goods covered by a newly issued certificate of title is dependent upon a lack of knowledge of a prior security interest perfected under another state's laws. *See id.* § 9-337 cmt. 2.

Only in rare circumstances have courts gone beyond these express rules in Article 9 to subordinate later security interests that qualified for priority, but had knowledge of a prior security interest. *See* Gen. Ins. Co. of America v. Lowry, 570 F.2d 120 (6th Cir. 1978) (holding that the debtor's attorney who negotiated an unperfected security interest with the creditor had his perfected security interest subordinated due to knowledge); Thompson v. United States, 408 F.2d 1075 (8th Cir. 1969) (holding that the perfected security interest in favor of an affiliated corporation was subordinated to an unperfected security interest of which it had knowledge). Several other courts have approved the concept of egregious circumstances without applying it to the particular facts. *See* Berga v. Amit Int'l Trade, Ltd., 511 F. Supp. 432 (E.D. Pa. 1981); State v. Fowler, 611 P.2d 58 (Alaska 1980); Shallcross v. Cmty. State Bank & Trust Co., 434 A.2d 671 (N.J. Super. Ct. Law Div. 1981); Bloom v. Hilty, 234 A.2d 860 (Pa. 1967); Grossmann v. Saunders, 376 S.E.2d 66 (Va. 1989).

566. One priority rule for purchasers of chattel paper depends on the absence of a legend or other indication of a security interest on the collateral. *See* U.C.C. § 9-330(a). A security interest perfected by filing a financing statement that contains incorrect information is subordinate to a perfected security interest in favor of a secured party who relied on the information. *See id.* § 9-338.

567. *See* Schroeder, *supra* note 12, at 353-54.

The differential treatment of awareness in purchaser rules and priority rules is fascinating because priority rules, like purchaser rules, can cut off legitimate claims.[568] What justifies treating Article 8's secured parties more favorably than other purchasers?[569] Two apparent justifications are: first, to place a very high value on perfection of security interests because it gives the public notice (in many cases) of the security interest, and second, to avoid litigation over questions of awareness. The first is not very compelling because the incentive is not diminished in any meaningful way by limiting priority when there is awareness of a prior interest. Perfection is still needed to beat subsequent interests, including a lien creditor's (primarily a trustee in bankruptcy). The second justification is more meaningful, but raises the question of why some priority rules nevertheless have awareness elements.

Even after the notice function of perfection has been met, a subsequent secured party can perfect or obtain a security interest in a "preferred" way and defeat the prior interest even with actual knowledge of that prior interest.[570] Specifically, a secured party with a previously perfected security interest (or the purchaser of a security entitlement) can lose priority to: 1) a subsequent secured party who perfected by (or a subsequent purchaser of a security entitlement who obtained) control, if the prior party did not have control;[571] 2) a subsequent secured party with a security interest in a certificated

568. *See* text accompanying *supra* note 362.

569. Professor Rogers attempts to justify the distinction by explaining that for purchaser rules to work, the adverse claimant has to establish its property interest under other law and then rely on the purchaser rule, whereas for the security interest, both the property interest and priority are governed by Article 9. *See* Rogers, *supra* note 4, at 1490 n.88. The argument either begs the question or confuses two concepts. His argument may simply be that the two dispute resolution rules are different and do not necessarily have to be consistent—thus begging the question. On the other hand, he may be confusing attachment and perfection of a security interest. A secured party's property interest is obtained when the security interest attaches, whereas secured party priority rules are closely related to perfection, which has nothing to do with creation of the property interest.

Ironically, in his argument for rules protecting secured parties, Professor Rogers poses the question, "Should the Finality Rules Differ for Transferees Who Take Securities as Collateral, Rather than as Outright Buyers?" *Id.* at 1523. His answer is no! *Id.*

570. *See id.* at 1481-83.

571. *See* U.C.C. §§ 8-510(c), 9-328(1).

security in registered form perfected by delivery, if the prior party did not have control;[572] 3) a secured party (or purchaser of a security entitlement) who is a securities intermediary, even if the prior party had control;[573] or 4) a secured party of a broker or securities intermediary, if neither party has control.[574] At one level, the issue may resolve itself into this question: Are the Article 8 priority rules basic Article 9 type priority rules to encourage perfection or do they parallel more general purchaser rules for investment property?[575]

1. Priority and control or delivery

Perfecting by filing a financing statement is not a particularly valuable method of giving notice of a security interest in financial assets.[576] Thus, encouraging secured parties to perfect by control or delivery is a laudable goal, because such perfection provides notice that is more effective in these markets. The incentive for the first party to perfect by control or delivery, however, is not diminished in any meaningful way by including an awareness requirement because control or delivery offers clear priority advantages.

The drafters of Article 9 rejected an "awareness" requirement out of concern for the uncertainty it would create, thereby ostensibly impairing the ability of those in security markets to obtain financing.[577] Eliminating the difficult factual question of awareness is one aspect of this justification. The drafters, while asserting that the absence of an awareness requirement is evidence that common law and equitable principles on the issue have been displaced,[578]

572. *See id.* § 9-328(5).
573. *See id.* §§ 8-510(d), 9-328(3).
574. *See id.* § 9-328(6).
575. Professor Schroeder suggests that perfection by control is tantamount to reducing the supernegotiability of investment property by making it harder for a subsequent party to qualify for protection as a purchaser. *See* Schroeder, *supra* note 12, at 434-35. Her suggestion clearly implies that control priority rules are virtually like purchaser rules for secured parties.
576. Article 9 expressly limits the notice effect of a financing statement in regard to the application of purchaser rules from other articles of the U.C.C. *See* U.C.C. § 9-331(c).
577. Official comment 8 to § 9-328 makes this point in connection with a discussion of whether principles of law and equity could be used to read in an awareness requirement.
578. Displacement is the standard established by U.C.C. § 1-103 for determining whether principles of common law or equity apply when a statutory provision addresses the issue.

concede that such knowledge "may, in some circumstances, appropriately be treated as a factor in determining whether the control party's action is the kind of egregious conduct for which resort to other law is appropriate."[579] Thus, there is already limited uncertainty over the same issue. What would make the subsequent secured party's conduct egregious? Lack of a no-knowledge requirement permits that secured party to knowingly deprive a prior perfected secured party of the benefit of its security interest.[580] Is that egregious? Probably not because the prior creditor could have easily protected itself by obtaining control. Lack of a no-knowledge requirement also creates an opportunity for collusion between the debtor and a potential secured party to defeat a prior perfected interest. Such collusion is more likely to be considered egregious.

The uncertainty argument is greatly diminished if the awareness requirement is lack of knowledge as opposed to lack of notice. A no-knowledge standard would avoid imputing knowledge or claiming reason to know or a duty to inquire. For example, a secured creditor providing financing is at risk if there is a prior creditor with control and would be likely to inquire whether such a creditor existed. If knowledge of a prior perfected creditor without control were obtained, why should the subsequent secured party be able to prime that creditor?

The question comes down to whether perfection by filing a financing statement and automatic perfection are simply means to defeat a trustee in bankruptcy, leaving perfection by control or delivery as the "real" perfection, or if perfection by control or delivery is a close relative of being a protected purchaser or its equivalent. If the first proposition is true, the rules are acceptable without a no-knowledge requirement. If the second proposition is true, the priority benefits that accompany control or delivery should be limited to those who obtain control without knowledge of the other secured party's perfected security interest to parallel those rules. In fact, the validity of the second proposition is effectively affirmed by Article 8's reporter, Professor Rogers.[581]

579. U.C.C. § 9-328 cmt. 8. This comment was included as a result of issues raised by the American Law Institute concerning the lack of an awareness standard. *See* Rogers, *supra* note 4, at 1489-90.

580. *See* U.C.C. § 9-328 cmt. 3.

581. *See* Rogers, *supra* note 4, at 1481-83.

Adding a no-knowledge requirement is not as radical as the drafters make it appear. Due to the protected purchaser rule, a second secured party taking control of directly held securities without notice already obtains priority by relying on that rule.[582] Thus, in the direct holding system, adding a no-knowledge requirement only limits the rights of a second secured party who obtained control with knowledge but otherwise could have qualified as a protected purchaser. A no-knowledge requirement would have a greater effect in the indirect holding system simply because the claim preclusion rules do not always trump the priority rules. A no-knowledge requirement could be added simply by limiting the priority benefits of control or delivery in subsections 8-510(c), 9-328(1) and 9-328(5)[583] to those obtaining it without knowledge of the perfected security interest of another.

2. Priority for intermediaries

A more troubling question related to the lack of an awareness requirement arises with the subsection 9-328(3) rule granting priority to a securities intermediary with a security interest in its entitlement holder's security entitlement or securities account over any other secured party. The parallel subsection 8-510(d) rule favoring securities intermediaries over purchasers of security entitlements who obtain control is also troubling. Note that a securities intermediary automatically has control when its entitlement holder grants it a security interest.[584] These priority rules permit the securities intermediary to obtain priority over all earlier secured parties or purchasers of security entitlements, even those with control. Moreover, because the prior secured party or purchaser

582. *See* U.C.C. § 8-303.

583. A provision such as the following could be added to U.C.C. § 9-328(1): "provided, however, if a secured party obtained control with knowledge of a prior perfected security interest in the investment property, its security interest shall be subordinate to that prior security interest." The same provision could be added to U.C.C. § 9-328(5) by substituting "took delivery" for "control" and "certificated security in registered form" for "investment property." A provision such as the following could be added to § 8-510(c): "provided, however, if a purchaser obtained control with knowledge of a prior purchaser of a security entitlement or interest therein it shall be subordinate to that prior purchaser."

584. *See* U.C.C. § 8-106(e).

cannot obtain control without the involvement of the securities intermediary,[585] the securities intermediary will always have knowledge of a prior secured party or purchaser with control. Why should the securities intermediary be awarded priority especially when it has actual knowledge of the earlier interest?

This priority rule for indirectly held financial assets facilitates a credit monopoly for securities intermediaries.[586] Statutes that facilitate monopolies always raise a significant concern. The justification for this rule was not directly disclosed by the drafters. One possible justification is that many security interests in favor of securities intermediaries are the equivalent of purchase money security interests which are historically given priority.[587] If the entitlement holder is buying on margin,[588] the securities intermediary will take a security interest in the financial asset to secure the margin loan. The purchase money justification is bolstered by the fact that purchase money priority rules of Article 9 do not apply to investment securities.[589] The justification is weakened by the fact that a

585. To obtain control, the securities intermediary must either enter into an agreement with the secured party or the secured party must become the entitlement holder—an action that would require the involvement of the securities intermediary. *See id.* § 8-106(d)(1), (e).

586. *See* Note, *Super-Priority of Securities Intermediaries Under the New Section 9-115(5)(c) of the Uniform Commercial Code*, 108 HARV. L. REV. 1937, 1940-54 (1995) (listing some unfair advantages and setting forth arguments to defeat the priority).

587. *See* Russell A. Hakes, *According Purchase Money Status Proper Priority*, 72 OR. L. REV. 323, 328-61 (1993).

588. Not all margin lending is of the purchase money type. Any borrowing against securities is known as borrowing on margin and is regulated by Regulations G, T, U and X.

589. Article 8's conforming amendments to Article 9 specifically excluded purchase money priority. *See* U.C.C. § 9-115(5)(f) (1994). The official comments indicated that purchase money rules were excluded because the control priority rule of § 9-115(5)(a) adequately covered it. *See id.* § 9-115 cmt. 5. That explanation, however, was not adequate. Under that version of Article 9, a broker with control lending on margin would have shared pro rata if another secured party had control. *See id.* § 9-115(5)(b). However, under § 9-115(5)(c) a securities intermediary extending margin credit to its customer holding indirectly had priority, eliminating the need for purchase money priority in that situation.

Revised Article 9 replaced § 9-115, and purchase money security interests were defined to be available only when the collateral was goods (or software acquired with the goods). *See* U.C.C. § 9-103(a)(1).

securities intermediary financing acquisition of a security entitlement can easily ensure that it is the first to obtain control and therefore win under the regular priority rule.[590] A second justification for the priority rule favoring securities intermediaries is the need to provide security for the credit risk during the gap between the trade date and the settlement date.[591] A security interest to secure that obligation is created[592] by statute and considered perfected by control.[593] This priority rule complements that scheme.

Under the neutrality principle, priority rules for secured parties in the indirect holding system should parallel those in the direct holding system unless different rules have some compelling justification. There is not an equivalent priority rule for a securities intermediary dealing with directly held securities.[594] If the justification is to be equivalent to purchase money security interests with directly held securities, then it is also easy for a purchase money lender to be the first to obtain control.[595] If the rationale is protection during the trade-settlement gap, a parallel rule is not as important for

590. The securities intermediary has control by definition. *See* U.C.C. § 8-106(e). The general priority rule for investment property awards priority to the first to obtain control. *See id.* § 9-328(b). If another secured party had control of the securities account, the securities intermediary and the entitlement holder could simply open a new "margin account." *See id.*

591. *See supra* notes 391-392 and accompanying text.

592. *See* U.C.C. § 9-206(a), (b).

593. *See id.* § 9-206 cmt. 4. This statutory security interest is a codification of the "broker's lien" recognized at common law. *See id.* cmt. 2. The broader rights of setoff, to which duties of the securities intermediary to its entitlement holder may be subject as described in § 8-509(c)(2), are not secured by a lien, and thus, do not provide a basis for this priority.

594. If a broker or dealer perfects its security interest in a directly held security by delivery and the security has been indorsed to or is registered in the name of the broker or dealer, it is treated as a security entitlement and the indirect holding system's priority rule would apply. *See id.* § 8-501(d). Perfection in directly held securities by other means would not result in application of this rule.

595. The secured party simply has the security delivered to it (this can be through a third person acknowledging that it holds for the secured party), *see id.* § 8-301, and ensures that it is indorsed in blank or to the secured party, *see id.* § 8-106(a), (b), (c). Note that if the secured party is the securities intermediary, this will often result in the creation of a security entitlement under § 8-501(d).

the direct holding system because virtually all trades in the securities markets are made in the indirect holding system.[596]

Because these priority rules were not limited to priority for credit given during the trade-settlement gap and for credit given to purchase financial assets on margin, another justification is necessary. One possibility is that it is simply codification of the practical result of other rules in Article 8.[597] Secured parties with control have priority;[598] control of indirectly held securities requires participation of the securities intermediary[599] and the securities intermediary is not required to give control.[600] This justification overlooks the effect of the priority rule in subordinating a security interest previously perfected by control.

The rationale appears to have been to provide an advantage to key players in the securities markets when they extend credit. Superficially, this rule fits into a pattern that emerges in Article 8 of preferring those who provide financing to participants in the securities markets. Generally, a justification for that preference is to minimize the systemic risk by ensuring easy priority; thus reducing barriers to providing financing. This rule, however, is a disincentive for outsiders wanting to finance entitlement holders because they must obtain a subordination agreement from the securities intermediary in order to ensure they will not be primed.[601] Since most securities intermediaries are also entitlement holders and would

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596. *See supra* notes 103-105 and accompanying text.

597. Professor Rogers, the reporter for Article 8, makes essentially the same argument in defense of the rule. *See* Rogers, *supra* note 4, at 1476-77, 1486-88.

598. *See* U.C.C. § 9-328(1).

599. *See id.* § 8-106(d). While control via a third party with control under § 8-106(d)(3) would not directly involve the securities intermediary, it would have been involved when the third party obtained control by one of the other two methods. *See id.*

600. *See id.* § 8-106(g).

601. The reporter, Professor Rogers, asserts that the rule was a default rule providing what the parties would normally agree to. His examples, which are all convincing, however, are limited to the purchase money and credit settlement situations. *See* Rogers, *supra* note 4, at 1486-88. The approach taken, however, requires a secured party that is not an intermediary to work out a tri-party priority agreement or forego making the loan. If the basic agreement would be as Professor Rogers suggests, then the limitation of the priority to the situations suggested is more efficient. It may preclude the necessity of an agreement.

benefit by the rule as borrowers more than they would be burdened by it as lenders, the rule is particularly perplexing.

To avoid undercutting secured parties or purchasers of security entitlements who have obtained control, the priority benefits in favor of securities intermediaries[602] should be limited to the trade-settlement gap and the purchase-money situations.[603] Other priority disputes involving the securities intermediary as a secured party should be resolved with the same rules that govern other secured parties. Because obtaining control of a security entitlement involves the securities intermediary, it is virtually impossible for a competing secured party or purchaser of a security entitlement not to obtain notice of a security intermediary's prior security interest.[604] Thus, such a change together with the change proposed above to subsection 9-328(1)[605] would simply help level the playing field for securities intermediaries as secured creditors and other secured parties. The change should enhance the availability of credit for the securities industry.

3. Pro rata priority

If more than one secured party of a broker or securities intermediary has a perfected security interest in investment property, but neither obtained control, they share pro rata.[606] This means that a subsequent secured party obtains equal priority with a prior secured party, even if it knows of its existence. Knowledge of the existence of the security interest is knowledge of its perfected status because

602. *See supra* notes 332-335 and accompanying text.

603. Subsection 9-328(3) could be rewritten as follows to solve this problem:

> A security interest *created under Section 9-206 or* held by a securities intermediary in a security entitlement *to secure payment of the purchase price of the security entitlement* [or a securities account] maintained with the securities intermediary has priority over a conflicting security interest held by another secured party.

Italicized words are to be added to the subsection and words in brackets deleted. A parallel change would need to be made to the § 8-510(d) rule.

604. This could only happen if the securities intermediary permitted the creditor to obtain control without informing them of the securities intermediary's security interest.

605. *See supra* note 583.

606. *See* U.C.C. § 9-328(6).

secured parties of brokers or securities intermediaries are automatically perfected.[607]

The aim of a secured party in the event it needs to resort to its collateral is to have first priority. Among automatically perfected secured parties of brokers or securities intermediaries who have not obtained control, the pro rata priority of subsection 9-328(6) can be overcome by either party obtaining control, so the priority rule in subsection 9-328(1) will govern. Thus, relying on automatic perfection will probably rarely result in pro rata priority. Shortly before the issue arises, one of the secured parties can obtain control if it obtains the cooperation of the debtor.[608] As currently written, knowledge of the other security interest would not defeat this priority.

Because a subsequent secured party of a broker or securities intermediary will not trump a prior secured party and because the prior secured party can avoid losing priority by obtaining control, this rule does not create the potential for abuse.[609] The pro rata priority rule simply creates an incentive for secured parties of brokers and securities intermediaries to perfect by control. This, however, is a break with traditional lending practices in the securities industry.[610]

E. Resolving Purchaser-Priority Rule Conflicts

Determining whether the applicable claim preclusion rule or the applicable priority rule should apply to a dispute raises a number of issues, including the appropriate awareness standard.

607. *See id.* § 9-309(10).

608. *See id.* § 9-328 cmt. 3.

609. The rule does facilitate a maneuver not available under prior law. A secured creditor of the broker or securities intermediary with significant influence over it who learns of serious financial problems can obtain control, and thereby priority over others, on the eve of bankruptcy—the "midnight grab." Previously, bankruptcy preference law would have defeated this creditor. *See* 11 U.S.C. § 547(b) (1994). Under revised Article 9, however, automatic perfection will preclude the preference attack—thereby making the midnight grab viable.

610. *See supra* note 357.

1. Subsection 8-510(a) versus priority rules

Revised Article 9's conforming amendments to Article 8 limited the application of the subsection 8-510(a) claim preclusion rule to situations not governed by the priority rules in either subsection 8-510(c) or Article 9. This change eliminated the argument that subsection 8-510(c) operated merely as a threshold to a claim, with the claim being resolved by application of the priority rule.[611]

The question of whether the claim preclusion rule or the priority rule should prevail is interesting only when the two rules provide different outcomes in the same dispute. The awareness requirement difference between the rules produces a different outcome in some disputes. For example, the first purchaser to obtain control always wins under the subsection 8-510(c) priority rule regardless of whether it has notice of the other purchaser. However, if the second purchaser obtains control without notice of the first purchaser's claim, it would win under the subsection 8-510(a) claim preclusion rule even if the first purchaser had control. The other basic difference between the section 8-510 claim preclusion and priority rules[612] places the burden of proof on the party asserting priority (the party benefiting from the rule) in subsections 9-328(1)-(3) and 8-510(c)-(d), but on the one asserting the adverse claim (the one not

611. The claim preclusion rule simply describes the persons against whom "[a]n action based on an adverse claim to a financial asset" may not be asserted. U.C.C. § 8-510(a). Under the rule's operation, a qualifying person defeats an adverse claim because the claimant cannot proceed against such a person. The rule does not address the converse situation—whether the person who can assert an action will prevail. This opened the way to argue that the priority rule would then apply to resolve the dispute.

612. There are two other notable differences. First, U.C.C. § 8-510(a) applies to both claims to financial assets and claims to security entitlements, while § 8-510(c) is limited to priority between purchasers of security entitlements. This difference, however, means there is no conflict when the adverse claims are to the financial asset itself asserted against a purchaser of a security entitlement—only § 8-510(a) could apply. Second, § 8-510(a) has no limitation on the type of claim asserted against the purchaser, while § 8-510(c) is expressly limited to disputes between two purchasers.

There is also a wording difference that is probably nonsubstantive. Subsection 8-510(a) requires that the purchase be from an entitlement holder, while § 8-510(c) includes no such requirement. Because it does not appear that one can purchase a security entitlement from anyone but an entitlement holder, this difference is not relevant.

benefiting from the rule) in subsection 8-510(a).[613] Shifting the burden of proof makes the claim preclusion rule harder to rely on, but will not otherwise necessarily yield predictable differences in who wins the dispute.

The drafters do not explain why they preferred the priority rule over the claim preclusion rule.[614] The rationale cannot be found in the fact that the primary role of the subsection 8-510(c) priority rule is to govern disputes between repo purchasers and that the drafters wanted the applicable Article 8 rules to be independent from the characterization of the transaction.[615] That goal is equally well served if the claim preclusion rule takes precedence in both situations. Thus, another explanation must be found.

Here, the reason for the preference appears to be elimination of any effect of awareness of adverse claims. Because the parties primarily affected by these rules are secured parties (or repo purchasers), the drafters have chosen to benefit the first creditor. That choice makes financing more readily available in the indirect holding system only from the point of view of a second secured party or repo purchaser who is the first to obtain control, yet was aware of a prior interest. A first secured party or repo purchaser to obtain control is only given an advantage to the extent its control is not discovered by a later person gaining control or the rule eliminated a duty to inquire. But why should a qualifying second secured party or repo purchaser not be able to benefit from a claim preclusion rule? Such a benefit would seem to facilitate financing by protecting an "innocent" secured party or repo purchaser.

The appropriate outcome in these disputes appears to be obtained by using a no-knowledge awareness standard to eliminate any duty of inquiry and then giving precedence to the claim preclusion rule rather than the priority rule. These changes would improve the indirect holding system and bring it into harmony with the direct holding system.[616]

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613. *See supra* notes 518-522 and accompanying text.

614. The official comments simply describe § 8-510(c) as tracking the Article 9 priority rule, giving primacy to control and having multiple parties in control share according to a temporal priority rule if they have not agreed otherwise. *See* U.C.C. § 8-510 cmt. 4.

615. *See supra* notes 339-346 and accompanying text.

616. To accomplish that result, U.C.C.§ 8-510(a) would need to be amended by deleting the bracketed material and adding the italicized material so it

2. Priority or claim preclusion rules and entitlement holders

The question of whether the priority rules in section 8-511 or the claim preclusion rule in subsections 8-503(d) and (e) should govern in a dispute between an entitlement holder and a secured party of a securities intermediary is not directly answered by Article 8. This is one place Article 8 fails in its goal to eliminate legal uncertainty, thus increasing systemic risk. Resolving the conflict between these rules is complex. The analysis must start with an understanding of the circumstances under which the priority and claim preclusion rules lead to conflicting resolutions. Each of the three priority rules in section 8-511 will conflict with the subsection 8-503(d) and (e) claim preclusion rule in different situations.

a. the subsection 8-511(a) conflict

Subsection 8-511(a) awards priority to the entitlement holder, if the securities intermediary is not a clearing corporation[617] and does not have control.[618] However, in such a priority contest if the entitlement holder does not meet the requirements in subsections 8-503(d)(1)-(3) for asserting a claim,[619] the secured party would argue

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would read as follows (much like the Article 8 version before the conforming amendment):

> [In a case not covered by the priority rules in Article 9, or the rules stated in subsection (c)] An action based on an adverse claim . . . if the purchaser gives value, does not have [notice] *knowledge* of the adverse claim . . . .

In addition, the italicized material would then be added to § 8-510(c) so it would read as follows:

> In a case not covered by the priority rules in Article 9 *or the rules stated in subsection (a)*, a purchaser for value of a security entitlement . . . .

Note that if a knowledge element is included in the provisions of § 9-328, *see supra* note 583, one should also be added to § 8-510(c) to keep it consistent with Article 9 priority rules. Such a change would minimize the difference between § 8-510(c) and the claim preclusion rule in § 8-510(a).

617. If the securities intermediary is a clearing corporation, § 8-511(c) applies and gives it priority. This situation is discussed in the next section.

618. If the secured party has control, § 8-511(b) gives it priority. This situation is discussed in the next section.

619. If the entitlement holder meets all the requirements in § 8-503(d)(1)-(3), no conflict arises. The entitlement holder wins under § 8-511(a) and can assert its claim under § 8-503(d), because the secured party is not entitled to § 8-503(e) protection.

that the entitlement holder is unable to assert its claim and therefore the secured party would win, despite the priority rule. That argument is based on one of two statutory constructions. First, apply both rules to the dispute with the claim preclusion rule functioning as a threshold to the claim and the priority rule governing if the claim is permitted. Second, give the claim preclusion rule precedence over the priority rule—the typical resolution of a purchaser rule versus priority rule question.

In ascertaining the appropriate interaction between the subsection 8-511(a) priority rule and the subsection 8-503(d) and (e) claim preclusion rule, it is necessary to determine the meaning of subsection 8-503(a). This subsection describes the property interest of an entitlement holder in the fungible bulk of the financial asset held by the securities intermediary and that description's interrelationship with section 8-511. Subsection 8-503(a) states that all interests in a particular financial asset held by a securities intermediary, "to the extent necessary" to satisfy the claims of all entitlement holders "are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary, except as otherwise provided in Section 8-511."[620]

There are at least three ways to interpret the interrelationship between subsection 8-503(a) and section 8-511. First, despite the language about the financial assets not being the property of the securities intermediary, the existence of subsection 8-511(a) implies that the securities intermediary has the "power" under subsection 8-503(a) to grant a security interest to a secured party which does not have control, even if that security interest will not prevail over entitlement holders.[621] The drafters expressly take this position in

620. U.C.C. § 8-503(a).

621. Section 8-116 declares the securities intermediary to be a purchaser for value of a financial asset it receives, if it establishes a security entitlement in favor of an entitlement holder in that financial asset. A purchaser for value generally has full power to further transfer the asset. This is implicit for securities (note that financial asset is broader) in § 8-104(a)(1), which provides that a person acquires a security if that person is a purchaser to whom it is delivered. Subsection 8-302(a) states that a purchaser has all rights that the transferor had power to transfer. It is this power to transfer that is not explicitly described for a securities intermediary when the financial asset is subject to a security entitlement.

official comment 3 to section 8-503.[622] This reading gives precedence to the claim preclusion rule.

Second, there is an interpretation consistent with giving precedence to the priority rule but the drafters attempt to negate it in official comment 3 to section 8-503.[623] That interpretation focuses on the "not property of the securities intermediary" language in subsection 8-503(a). This language facilitates an argument that the securities intermediary only has a property interest in the financial asset to the extent it creates a security interest in favor of secured creditors who are described as having priority rights under section 8-511.[624] Read this way, subsection 8-503(a) would preclude a purchaser (or creditor) from obtaining an interest in the fungible bulk of the particular financial asset because the securities intermediary did not have a property interest in it.[625] That would not be true if:

622. *See* U.C.C. § 8-503 cmt. 3. In official comment 1 to § 8-503 the drafters explain the reason for choosing the particular language in § 8-503(a). Securities intermediaries in practice commingle customer securities with their own. Thus, the language is intended to defeat claims of creditors of the securities intermediary when necessary to protect entitlement holders. Thus, while the statutory language leaves the question of power to transfer less than clear, its intent is to be a priority rule of sorts when the securities intermediary is insolvent. That intent, however, is also at odds with other language in those official comments about the rule not necessarily determining how the financial assets will be distributed in an insolvency proceeding. *See id.* § 8-503 cmt. 1. The drafters are trying to walk a fairly fine line on these questions.

623. *See* U.C.C. § 8-503 cmt. 3.

624. *See id.* § 8-511(a).

625. The argument would be that a securities intermediary attempting to create security interests in financial assets necessary to satisfy claims of entitlement holders did not have sufficient rights in the financial asset. The debtor is required to have "rights in the collateral" before a security interest can be created. *See id.* § 9-203. The U.C.C. does not elaborate on what rights are sufficient, and court holdings have not necessarily clarified the concept. Subsection 8-503(a) would be used to support this argument, because it declares that the securities intermediary does not have an interest in the financial asset sufficient for its general creditors to attach, if there is not a sufficient quantity of the financial asset to satisfy entitlement holders. *See id.* § 8-503(a).

The fact that the securities intermediary does not have a property interest does not mean that it does not have the power to transfer a property interest. In fact, although it is not explicit in the section, the drafters clearly would have intended the power to exist. The question, not directly answered by Article 8, is under what circumstances does the securities intermediary have that power. In this present dispute, the argument would be that the reference to § 8-511 and the rules contained therein would negate any inference that the

(1) the amount of the financial asset exceeds that necessary to satisfy entitlement holders,[626] (2) the securities intermediary is a clearing corporation[627] or (3) the secured creditor has obtained control.[628] Under this interpretation, the secured party who does not have control and is not a clearing corporation (those covered by subsection 8-511(a)) would not have a valid claim to the financial asset.[629]

In essence, this interpretation treats section 8-511 and subsection 8-503(a) together as a gatekeeper for secured party claims to the financial asset, a role similar to the one subsection 8-503(d) plays as a gatekeeper for entitlement holder claims against purchasers. Each party would thus be claiming that the other party cannot make a claim, because it cannot meet the gatekeeper's requirements. The entitlement holder would win this battle because its threshold relates to making a claim against the purchaser (secured party), while the secured party's threshold relates to making a claim to the financial asset (the security entitlement itself provides the entitlement holder its claim to the financial asset).[630] In other words, because the secured party is precluded from making a claim to the financial asset, the entitlement holder does not need to assert a claim against the secured party. If this interpretation were correct, subsection 8-511(a) would be unnecessary and the result could have been achieved more directly by simply eliminating it.

The third interpretation of the interplay between subsections 8-511(a) and 8-503(a) would give subsection 8-511(a) a role to play while giving precedence to the priority rule. Subsection 8-503(a) would be interpreted as set forth above, to preclude the creation of the security interest if the securities intermediary did not have sufficient financial assets at the time of creation. In contrast,

power existed in this context.

626. This situation is of no interest, because entitlement holders are made whole and would not need to assert competing claims.

627. *See* U.C.C. § 8-511(c).

628. *See id.* § 8-511(b).

629. This reading limits the application of § 8-503(d) and (e) to situations in which the entitlement holder asserted a claim against a purchaser (other than a secured party) from the securities intermediary. However, such purchasers would not have an interest in the financial asset (unless there were enough to satisfy entitlement holders) because the securities intermediary did not have an interest in the financial asset that it could transfer to a purchaser. Of course, if there were enough to satisfy entitlement holders, then no dispute would arise.

630. *See* U.C.C. § 8-503(a), (b).

subsection 8-511(a) would apply to resolve the priority dispute if the securities intermediary had sufficient assets to satisfy both the secured party and entitlement holder at the time the security interest was created, but not at the time of the dispute.

The ultimate question is: should the priority rule have precedence, providing the protection for entitlement holders subsection 8-503(a) seems to intend? Resort to the priority or purchaser rules will only be necessary when the securities intermediary has failed and thus the first two requirements of subsection 8-503(d) will have been met.[631] The fourth requirement is satisfied in the situation we are examining, because the secured party does not have control. It is the third requirement, that the securities intermediary violated its obligation by transferring the financial asset to the secured party, which creates the conflict.

If both rules apply or if the claim preclusion rule is given precedence, the entitlement holder will have the difficult burden of proving that the creation of a security interest in favor of the secured party violated the securities intermediary's duty to maintain sufficient interests in the financial asset.[632] Thus, both of these readings dramatically undermine the priority for entitlement holders in subsection 8-511(a). Consequently, Article 8 as drafted, gives entitlement holders a significantly greater risk because these two readings are the most readily supportable by the text.

b. the subsections 8-511(b) and (c) conflicts

The subsection 8-503(a) question regarding the securities intermediary's power to encumber is not raised by the conflicts between the priority rules of subsections 8-511(b) or (c)[633] and the claim preclusion rules of subsections 8-503(d) and (e). Those rules only conflict when the entitlement holder can meet the prerequisites

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631. Two of the four requirements under § 8-503(d) are that the securities intermediary be in insolvency proceedings and that it does not have sufficient financial assets to meet the needs of all entitlement holders. There is no need to assert conflicting rights under other circumstances.

632. *See* U.C.C. § 8-503(d)(3).

633. Because under any interpretation of §§ 8-503(a) and 8-511, a securities intermediary has a property interest in the financial assets transferred to secured parties with control or secured parties of clearing corporations, the questions addressed in the preceding paragraphs raise no issues in these conflicts.

for asserting a claim in subsections 8-503(d) and (e). Thus, the securities intermediary must have failed, thereby satisfying the first two requirements of subsection 8-503(d),[634] and the entitlement holder must be able to establish that the securities intermediary violated its obligation by transferring the financial asset to that secured party, thereby satisfying the third requirement. It is the fourth requirement, that the secured party not be protected by subsection 8-503(e), that creates the issues in the conflict between the subsection 8-511(b) or (c) priority rules and the subsection 8-503(d) and (e) claim preclusion rule.

Subsection 8-511(b) awards priority over the entitlement holder to a secured party who has control. Control is one of the elements the secured party must meet to be protected by subsection 8-503(e). Thus, the claim preclusion rule will conflict with the secured party's claim of priority under subsection 8-511(b) only if the secured party was in collusion[635] with the securities intermediary. If the secured party was in collusion, the entitlement holder will argue that it is entitled to assert its claim under subsection 8-503(d) and is entitled to prevail. This is because unlike the other claim preclusion rules for the indirect holding system, subsection 8-503(d) expressly provides for the entitlement holder to "recover" the financial asset.[636] In such a dispute, equity and the official comments favor the entitlement holder's position, due to the collusion.[637]

Subsection 8-511(c) awards priority over the entitlement holder to the secured party, even if it does not have control, if the securities intermediary is a clearing corporation. An entitlement holder entitled to assert its claim under subsection 8-503(d), however, will argue

634. These requirements under § 8-503(d) are that the securities intermediary must be in insolvency proceedings and that it must lack sufficient financial assets to meet the needs of all entitlement holders.

635. If a secured party with control was not in collusion with the securities intermediary, the secured party wins under § 8-511(b) and the entitlement holder will have no claim due to the secured party's protected status under § 8-503(e). All secured parties that are owed an obligation have given value, the other requirement for protection under U.C.C. § 8-503(e). *See* U.C.C. § 1-201(44).

636. U.C.C. § 8-503(d) provides in pertinent part: "The trustee or other liquidator . . . may recover the financial asset . . . . If the trustee or other liquidator elects not to pursue that right, an entitlement holder . . . has the right to recover its interest in the financial asset from the purchaser."

637. *See* U.C.C. § 8-511 cmt. 1.

that it prevails under subsection 8-503(d) and can recover the financial asset.[638] These secured parties are not protected by subsection 8-503(e) because control is necessary to be protected by that rule.[639] However, only when the secured party was in collusion with the clearing corporation, does equity clearly favor the entitlement holder. Absent collusion, failure to give precedence to the subsection 8-511(c) priority rule would limit it when needed. That is, upon the insolvency of the securities intermediary if the entitlement holder can establish that the securities intermediary violated its duty when it granted the security interest.[640]

c. resolving the conflicts

The appropriate outcome in the conflict between subsection 8-511(a) and subsections 8-503(d) and (e) is to give the priority rule precedence and avoid its virtual obsolescence. The drafters appear to agree. Example one in official comment 1 to section 8-511 simply gives the priority rule precedence in an insolvency situation. Moreover, in official comment 3 to section 8-503, the drafters refer to section 8-511 as governing whether the secured party takes subject to the entitlement holder's claim. In that comment they state that the priority rules are "an application to secured transactions of the general principles expressed in subsections (d) and (e) of this section."[641] That statement strongly implies that subsections (d) and (e) are not necessary to the dispute because their principles were taken into consideration when the priority rules were drafted. Moreover, it appears to be an appropriate policy choice for entitlement holders not to lose to secured parties who have not qualified for subsection 8-511(b) or (c) priority.

As Article 8 is currently written, however, that result can be obtained only by reading subsection 8-511(a) as a limitation on the power to create a security interest. That is, by resorting to one of the strained interpretations of subsection 8-503(a). A better approach

638. *See supra* note 636.

639. Although a secured party of a clearing corporation with control could rely on this rule as well as the § 8-511(b) rule, for analysis purposes this rule is of interest only when the secured party does not have control.

640. *See* U.C.C. § 8-503(d)(3).

641. *Id.* § 8-503 cmt. 3.

would be to amend one of the sections to simply give the priority rule precedence.

Subsections 8-511(b) and (c) award priority to secured creditors with no express limitation if a secured creditor obtained its interest either with knowledge of the entitlement holder's adverse claim or by acting in collusion with the securities intermediary to defraud entitlement holders. Official comment 1 to section 8-511 belies this conclusion.[642] The drafters considered the collusion requirement from subsection 8-503(e) to apply, at least as far as the subsection 8-511(b) priority rule is concerned, even though it is not explicitly included. If official comment 1 to section 8-511 simply means that the no-collusion requirement is engrafted into the subsection 8-511(b) priority rule, the statutes and the official comment conflict.[643] Interpreting that comment to mean that when both the priority rule and the claim preclusion rule could apply the claim preclusion rule takes precedence, significantly undermines both the subsection 8-511(a) and 8-511(c) priority rules because collusion is not necessary for the claim preclusion rule to conflict with those priority rules. Although the official comments do not expressly address these situations, it is apparent that the drafters would not agree with those outcomes.[644]

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642. U.C.C. § 8-511, comment 1 states:

> Under subsection (b) the claim of a secured creditor of a securities intermediary has priority over the claims of entitlement holders if the secured creditor has obtained control. If, however, the secured creditor acted in collusion with the intermediary in violating the intermediary's obligation to its entitlement holders, then under subsection 8-503(e), the entitlement holders, through their representative in insolvency proceedings, could recover the interest from the secured creditor, that is, set aside the security interest.

643. Official comment 1 to § 8-503 seems to downplay any role of § 8-503 in resolving disputes by stating that § 8-503 "does not necessarily determine how property held by a failed intermediary will be distributed in insolvency proceedings." *See also* U.C.C. § 8-503 cmt. 2 (which seems to have a similar implication). That statement is primarily intended to recognize the supremacy of federal law in the form of the Securities Investor Protection Act and the Bankruptcy Code. It suggests, however, that other rules governing insolvency would also trump Article 8. Thus, the statement potentially has greater ramifications, because the claim preclusion rule in § 8-503(d) and (e) only applies if there is an insolvency proceeding.

644. *See id.* § 8-503 cmt. 3; *see id.* § 8-511 cmts. 1-2.

Thus, we are left with confusion between the text of Article 8 and the apparent intent of the drafters. If the claim preclusion rule preempts the priority rules, then the priority of secured parties of clearing corporations[645] and of entitlement holders[646] would be dramatically limited. On the other hand, if the priority rules are given precedence, subsection 8-503(e) would have a small role and secured creditors colluding with the securities intermediaries would be rewarded.

One way to avoid both of those outcomes and to resolve the uncertainty in the application of the provisions would be to amend both rules. The priority rules in section 8-511 could be given precedence over the rules in subsections 8-503(d) and (e). This change would solve the problem with the subsection 8-511(a) priority rule conflict[647] and part of the problem with the subsection 8-511(c) priority rule conflict. Subsections 8-511(b) and (c) could then be amended to include the no-collusion requirement. Better still, a no-knowledge requirement should replace the no-collusion standard as previously discussed with reference to subsection 8-503(e).[648] The lack of knowledge should apply both to the time a secured party obtains control and at the time a secured party of a clearing corporation obtains its security interest.[649]

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645. *See supra* notes 638-640 and accompanying text.

646. *See supra* notes 617-632 and accompanying text.

647. *See supra* notes 617-632 and accompanying text.

648. *See supra* text accompanying notes 536-564.

649. These changes to § 8-511(b) and (c) all could be accomplished by adding the italicized text and deleting the bracketed text so it would read as follows:

> (b) A claim of a creditor of a securities intermediary who has a security interest in a financial asset held by a securities intermediary has priority over claims of the securities intermediary's entitlement holders who have security entitlements with respect to that financial asset [if] *to the extent* the creditor [has] *obtained its security interest and* control over the financial asset *without knowledge of the entitlement holder's claim based upon breach of the securities intermediary's duties under Section 8-504.*
>
> (c) If a clearing corporation does not have sufficient financial assets to satisfy both its obligations to entitlement holders who have security entitlements with respect to a financial asset and its obligation to a creditor of the clearing corporation who has a security interest in that financial asset, the claim of the creditor has priority over the claims of entitlement holders, *to the extent the creditor obtained its security*

VII. CONCLUSION

Whether securities would be best held directly or indirectly is a question that defies an easy answer. Institutional investors holding indirectly resolve the question by using brokers who are not their securities intermediary and by taking advantage of other institutional benefits not available to smaller investors.[650] Of the many factors that influence determining how to hold securities, risk to the participant is one of the most critical. The differences in risk would make the inquiry of how to hold securities easy. However, this is tempered by the fact that trading of securities is currently much easier in the indirect system. Thus, the inquiry is converted to whether the securities are being held long term, in which case direct holding is clearly superior, or whether a trade in the short term is possible, where the expense and inconvenience of direct holding weigh against it.

Development of clearing and settlement systems that would permit trading in uncertificated securities in the direct holding system would significantly change the playing field. With that development, the current structure of Article 8 would lead investors out of indirect holding due to the unnecessary risks. It may well be, however, that the indirect holding system provides a more efficient system for trading.

To accommodate the current and increasing volume of securities trading, systems for holding securities that are compatible with such trading volume are essential. Closely related to that need are transfer and registration rules that minimize, to the extent reasonably practical, the "systemic risk" inherent in the securities markets. Two types of rules important to this goal are negotiability vis-à-vis adverse claimants and certainty of priority for lenders making loans to cover settlement risks. Both types of rules involve allocating risks among participants in the market.

The direct holding system in Article 8 does not allocate the risks in the same manner as the indirect holding system. The indirect holding system's priority and claim preclusion rules favor secured

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interest without knowledge of the entitlement holder's claim based upon breach of the clearing corporation's obligations under Section 8-504.

650. *See* Facciolo, *supra* note 7, at 674.

lenders to the securities industry in virtually every instance. While many of these preferences facilitate much-needed credit to the securities industry, they do so by shifting the risk of intermediary misbehavior almost entirely onto entitlement holders. Although lender safety is essential to reducing systemic risk, the protections in the indirect holding system go further than necessary. The source of the unnecessary risk appears to be best characterized as the result of over-zealousness on the part of the securities industry in establishing a legal scheme to protect its lenders. The sections providing that protection also happen to be the most confusing provisions in Article 8.

The argument has been made that shifting the risk to entitlement holders is appropriate for efficiently functioning markets because SIPC, private insurance, and federal regulation mitigate the risk of securities intermediary misbehavior.[651] The argument, however, overlooks the fact that the direct holding system allocates significantly more risks to secured lenders. Neither system's allocation appears to be ideal. The question is: "What risk of intermediary misbehavior can be placed on secured parties without significantly reducing secured credit to the securities industry or significantly increasing its cost?" There are no empirical studies that answer this question nor can any such study be expected to definitively answer it.

Wisdom counsels refining the legal rules governing both the direct and indirect holding system based upon the neutrality principle so that the choice of how to hold financial assets is not skewed by disparate rules in the different systems. If the differences are limited to those inherent in a particular type of holding, better systems will result and market adjustments will be facilitated. The changes suggested in this article would give lenders in the indirect holding system the necessary certainty limited only to the extent they were knowingly facilitating a breach of duty by the securities intermediary to the investor. These changes will not have a chilling effect on the availability of credit to the market. The small reduction in certainty to lenders in the indirect holding system would be accompanied by a concomitant increase in certainty in the direct holding system. They would also provide significant help to entitlement holders, including

651. *See* Schroeder, *supra* note 12, at 493-502.

members of the securities industry, in reducing risks. The suggested changes may also facilitate a market-based clearance and settlement system for directly held uncertificated securities.