Revised UCC Article 8: Why It's Needed, What It Does

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REVISED UCC ARTICLE 8:
WHY IT'S NEEDED, WHAT IT DOES

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WHAT IS ARTICLE 8?

Article 8 of the Uniform Commercial Code ("UCC") deals with the transfer of investment securities (primarily stocks and bonds). It's one part of the mosaic of laws under which securities are bought, sold, and pledged. State corporate and contract laws establish the rights that owners of equity and debt securities have against issuers. Federal and state securities laws govern disclosure of financial information about issuers of securities and regulate the activities of broker-dealers and other participants in the securities markets. Article 8 is different. It sets the ground rules for implementing transfers and resolves disputes that may arise when different people claim conflicting interests.

By way of a rough analogy, one might think of Article 8 as playing the role for securities that the recording acts play for real estate. Real estate recording acts tell you how to transfer interests in real estate, but they don't tell you what it means to own real estate nor do they regulate the conduct of parties to real estate transactions.

WHY IS REVISION NEEDED?

The commercial law rules of the securities holding and transfer system are a bit like the utility systems of a building. When they're working right, no one notices them. As they age, it takes more and more effort to keep them working and they may break down altogether under a heavy load. At some point prudence demands that they be replaced with modern systems, even though they are still "working." Today, an inordinate amount of legal time which, of course, means cost, is required to fit modern securities transactions into the conceptual scheme of a prior era. Moreover, the poor fit
between law and practice means that legal advisors are unlikely to be able to provide quick and certain answers when they are most needed.

A key concern in the modern securities clearance and settlement system is the control of systemic risk, that is, the risk that a failure of one securities firm might cause others to fail. Participants in the securities markets and government agencies that oversee the markets are engaged in various initiatives to control systemic risk. The revision of Article 8 is one part of that effort. Studies of the October 1987 stock market break indicated that uncertainty concerning the application of the old Article 8 rules to modern securities transactions adversely affected liquidity and placed significant stress on the securities clearance and settlement system. As one knowledgeable observer remarked, "That's an interesting question" is not an acceptable answer to questions about the legal rights of securities firms and their lenders in times when the prospect of the collapse of the financial system is a matter of more than theoretical concern.

Revised Article 8 establishes clear legal rules designed specifically for modern securities holding practices. It does not so much change the law as recognize the changes that have already occurred as a result of developments in the marketplace. It establishes simple rules on the use of securities as collateral for loans in order to ensure that financial institutions can be assured of their legal rights in providing the financing to securities firms that may be necessary to maintain liquidity in times of stress.

Another key element of Revised Article 8's rules that ensure finality in securities transactions. If securities settlements are not final, there is a risk that the failure of one firm could affect others because persons harmed by the failure might try to undo transactions to get back securities that the firm transferred.

THE INDIRECT HOLDING SYSTEM

When Article 8 was first written, delivery of physical certificates was the key to the securities transfer process. In 1978 provisions for uncertificated securities were added, in contemplation of a system in which some issuers of securities, instead of issuing certificated, would keep electronic records of the holdings of the beneficial owners. Although such systems continue to develop, the development of the market has been different. Securities continue to be issued mostly in certificated form, but the owners elect to leave them in depositories. The depositories hold the securities on behalf of brokers and banks, who in turn hold them on behalf of their customers.

**DIRECT HOLDING**

Issuer

Investor  Investor

**INDIRECT HOLDING**

Issuer

Intermediary  Intermediary

Investor  Investor  Investor  Investor

The relationship between depositories, other securities intermediaries, and their customers is central to part of the modern securities holding system. Present Article 8, however, deals with this relationship only tangentially. Revised Article 8 adds a new set of commercial law rules specifically tailored for the modern indirect holding system.

The difference between the "direct" and "indirect" holding systems can be seen in a simple example of two pension funds, PF1 and PF2, each of which owns 100,000 shares of Acme, Inc., a publicly traded company. PF1 elected to hold a certificate representing its...
100,000 shares and is registered on the books maintained by Acme's transfer agent as the holder of record of those 100,000 shares. PF1 has a direct claim against the issuer, so it receives dividends and proxy materials directly from the issuer. PF2 elected to hold its securities through an account with a custodian bank. PF2 doesn't have a certificate and isn't registered on Acme's books as a holder of record. It enjoys the economic and corporate benefits of ownership but does so through its custodian bank and any other intermediaries in the chain back to the issuer.

Institutional investors, such as the pension funds in the above example, almost invariably use the indirect holding system. By holding their securities through custodians, they obtain expert safekeeping services rather than running the risk of keeping physical possession of their own certificates, assure themselves of the ability to transfer securities rapidly in settlement of trades, and obtain professional services in the complex record keeping involved in tracking their investments, distributions, calls, and the like. Today, ordinary people's stake in the securities markets, particularly for persons of modest means, is in large measure as beneficiaries of institutional investors, such as pension funds, insurance companies, and mutual funds. They have a real interest in seeing that the legal rules for the indirect holding system are sufficiently clear and modern so that the managers of their pension funds and other institutional investors can work with the rules easily. Individuals who manage their own investments also have a real stake in the law governing securities holding systems. Although many individual investors still hold their securities directly, it is more and more common for individuals to hold through the indirect holding system, for example, by leaving their securities in accounts with their brokers. The reasons are largely the same as for institutional investors: convenience in record keeping, rapid access to trading facilities, and professional safekeeping.

CONTROL OF HOLDING SYSTEM RISK

There is, of course, an inevitable measure of risk in any securities holding system. Just as investors who hold security certificates directly risk loss of the certificates, investors who hold through intermediaries face the risk that the intermediary might fail and not have the securities that they were supposed to be holding on behalf of their customers. Investors are protected against that risk by the regulatory regimes under which securities intermediaries operate. Intermediaries are required to maintain custody through clearing corporation accounts or in other approved locations of their customers' securities and are prohibited from using customers' securities in their own business activities. Even if a failed brokerage has violated the customer protection regulations and doesn't have sufficient securities to satisfy customers' claims, the customers are protected against loss from a shortfall by the Securities Investor Protection Corporation ("SIPC").

A recent report by the U.S. General Accounting Office, prompted in part by concerns about the bank deposit insurance system, assessed the adequacy of the SIPC fund as part of the total legal regime for protection of investors in the indirect holding system. The GAO Report noted that the SIPC system is quite different from bank deposit insurance. The Report pointed out that "the regulatory framework including the net capital and customer protection rules serves as the primary means of customer protection," and concluded that "the regulatory framework within which SIPC operates has thus far been successful in protecting customers while at the same time limiting SIPC's losses."

Revision of Article 8 is not prompted by any concern that other laws are inadequate to provide protections to investors who held through failed intermediaries. Those issues are dealt with prospectively by regulatory law and, in the event that failures occur, by SIPC and bankruptcy law. Even if there were inadequacies in the other laws that protect investors in the indirect holding system, there is nothing that commercial law rules can do about the risk that an intermediary might not have the securities. What led to revision of Article 8 is not intermediary risk itself, that is, the risk that customers of a failed intermediary might suffer loss, but systemic risk, that is, the risk that a failure of one securities firm might cause others to fail. Article 8 can't protect against the failure of one's own intermediary, but it can help protect against the risk that an investor will suffer as a result of the failure of someone else's intermediary.

DIFFERENCE FROM CURRENT LAW

Article 8 deals with complex and technical matters, yet it has been drafted to be as "user friendly" as possible. A Prefatory Note gives an
overview of the modern securities holding system, summarizes the key features of Revised Article 8, and explains the application of the rules of Revised Articles 8 and 9 to various common investments and investment arrangements. In addition, extensive Official Comments accompany each section of the statute.

One major change from present law is that Revised Article 8 deals separately with the "direct" and "indirect" holding systems. For the direct holding system, Revised Article 8 retains the basic conceptual structure and rules of present law in Parts 2, 3, and 4. A new Part 5 deals with the indirect holding system. The new Part 5 rules are based on the concept of "security entitlement," the term used to describe the property interest of a person who holds a security through a securities intermediary. A security entitlement is a special form of property interest, not merely a contractual claim against the intermediary. Part 5 sets baseline rules on such matters as the duty of the securities intermediary to pass through to entitlement holders the economic and legal rights of ownership of the security, including the right to receive payments and distributions and the right to exercise any voting rights.

The other major change is that the rules on creation and perfection of security interests have been taken out of Article 8 and placed in Article 9, thus returning to the structure used prior to the 1978 amendments. The Article 9 amendments set out new rules for security interests in all forms of "investment property," a new term that includes securities, whether held directly or indirectly, and also commodity futures positions. The security interest rules are based on the concept of "control." In rough form, "control" means that the secured party has taken whatever steps are necessary, given the way that the investment property is held, to ensure that the collateral can be liquidated without further action by the debtor. Control is not the exclusive means of perfecting a security interest, but a secured party with control has priority over a secured party who did not take control.

CONCLUSION

The primary objective of Revised Article 8 is to establish clear and certain legal rules that benefit all participants by lessening costs, risks, and delays. Certain aspects may, of course, be of special concern to particular groups. Some of the key benefits are summarized below.

**Systemic benefits:**
Modernizes commercial law of securities holding, basing the rules on current practices, not on those of an earlier era.
Enables lawyers to give quick and certain answers about the rights of purchasers, sellers, lenders, borrowers, and intermediaries. This is particularly important in times of stress in the securities and financial markets.
Protects finality of settled transactions, thereby reducing systemic risk.
Provides flexibility to adapt to changing practices by agreements and clearing corporation rules.
Accommodates globalization of securities markets by establishing clear choice of law rules to facilitate planning of international custody and clearing arrangements.

**Benefits for investors (institutional and individual):**
Creates neutrality among securities holding systems. Provides clear rules for both direct and indirect systems, so that investor choice and market forces can determine the evolution of the holding system.
Clarifies the property rights of investors who hold securities through intermediaries.
Provides protection against adverse claims for investors in the indirect holding system.
Establishes baseline duties of securities intermediaries to their customers. Agreements can specify how these duties are to be performed, subject to good faith requirement.

**Benefits for securities firms:**
Clarification of indirect holding system rules facilitates transfer and pledge of firms' own proprietary securities.
Clarifies the law governing firms' activities as securities intermediaries, e.g., establishes the basic principle that the duties of a securities intermediary run only to its own customers, not to third parties.
Protects intermediaries who act on their customers' instructions against liability to third party adverse claimants.
 Allows intermediaries to specify by agreement how they will perform basic duties, subject to good faith requirement.
Coordinates state commercial law and federal regulation to ensure that Article 8 rules on duties of intermediaries are consistent with regulations on safekeeping of customer securities, distribution of proxy materials, etc.
Benefits for issuers:
Protects issuers who transfer securities on effective indorsements or instructions against liability to third party adverse claimants.
Provides flexibility in account reporting for issuers of uncertificated securities by eliminating detailed statutory requirements for transaction statements.
Enables issuers of uncertificated securities to provide pledge facilities for their security holders by "control" agreements without imposing statutorily mandated registered pledge requirements.

Benefits for lenders and borrowers:
Facilitates use of investments held through intermediaries as collateral for loans. Eliminates uncertainties about methods of perfecting security interests, thereby reducing costs and delays in documenting secured loans.
Facilitates financing arrangements for securities firms. Eliminates legalistic formalities, such as 21-day "roll-over" requirement of current law.
Enables intermediaries to provide pledge facilities for their account holders by "control" agreements without imposing statutorily mandated requirements. Intermediaries are not required to enter into control agreements and have no obligations to secured parties absent agreement.

Comment: Revised Article 8 was discussed and approved by the membership of the American Law Institute in May and was read and approved by the National Conference of Commissioners on Uniform State Laws at the end of July. Revised Article 8 thus will be ready for consideration by the legislatures of the several states in 1995.

"ABSOLUTE BAR" v. "REBUTTABLE PREJUSMPTION": NY LAW STILL UNSETTLED

[See UCC Case Digest ¶12102.6, 2302.4(1), 2302.5, 2719.3, 2719.4(1), 2719.7(1), 2719.7(2), 2719.7(5), 2719.7(6), 2719.10(1), 2719.11(1), 9102.2, 9206.1, 9504.21, 9504.28, 9504.36, 9507.3, 9507.6]

The New York courts are all over the map (figuratively speaking) on the question, not directly addressed by the UCC, of what the appropriate remedy is for a secured party's failure to notify the debtor prior to selling repossessed collateral. The Appellate Division, Second Department, has imposed an "absolute bar" to recovery of a deficiency judgement in this context (an approach adopted by some 11 other states). In contrast, the First and Fourth Departments, and Judge Easterbrook of the Seventh Circuit in an opinion applying New York law, have held that a failure to give notice merely results in a "rebuttable presumption" that the amount recovered was equal to the debt (a view adopted by some 26 other states.) Still another approach known as the "setoff" rule has been applied by the Appellate Division, Third Department. The setoff rule (in effect in only three other U.S. jurisdictions) reduces the deficiency by the amount of any damages that the debtor can prove he sustained as a result of the lack of notice. An example of where a non-notified debtor suffers harm that may be deducted from the deficiency under the setoff rule is where the asset is worth more to the debtor than to other potential buyers.

Now, United States District Judge Michael B. Mukasey of the Southern District of New York weighs in on this question. Siemens Credit Corp. v. Marvik Colour, Inc., 24 UCC Rep Serv 2d 705 (US Dist Ct SD NY, decided July 21, 1994). He "predicts" that, in cases where the debtor has been given no prior notice of the foreclosure sale, the New York Court of Appeals would reject the approach of imposing an "absolute bar" to recovery of a deficiency judgment as disproportionately harsh, in that it deprives the secured party of money to which it is entitled, often as punishment for a relatively minor oversight. Instead, based on his own independent policy analysis, he predicts that New York's highest court would adopt a combination "rebuttable presumption" and "setoff" approach. This combination approach means that (1) the secured party is entitled to a deficiency judgment only to the extent that he proves the amount of the deficiency ("rebuttable presumption" rule), and (2) damages suffered by the debtor due to the failure of notice are deducted from any resulting deficiency judgment ("setoff" rule). This combination approach "best balances the interests at stake," Judge Mukasey says. Accordingly, he denies the debtor's summary judgment motion and sends the case to trial to give the secured party the opportunity to prove the amount of any deficiency, and allow the