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## Practitioners' Guide to Revised Articles 5 and 8 of the Uniform Commercial Code, A

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# **Uniform Commercial Code**

## **A Practitioners' Guide to Revised Articles 5 and 8 of the Uniform Commercial Code**

### **I. INTRODUCTION**

On July 1, 1997, Missouri Governor Mel Carnahan signed Senate Bill 6 adopting Revised Articles 5 and 8 of the Uniform Commercial Code (UCC) and incorporating the revisions into Missouri law. Revised Articles 5 and 8 were promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI) in order to provide a "modern legal structure" to current securities holding practices.<sup>1</sup> Missouri is following a national trend by adopting these massive revisions,<sup>2</sup> which garnered unanimous support in the Missouri General Assembly.<sup>3</sup>

Part II of this Law Summary will discuss Revised Article 8, which deals with investment securities, and its impact on Article 9's governance of secured transactions. Part III will analyze the effect of Revised Article 5 on Missouri law regulating letters of credit.

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1. For a general explanation of this new "modern legal structure," see the prefatory note preceding U.C.C. § 5 [hereinafter Prefatory Note 5], and the prefatory note preceding U.C.C. § 8 [hereinafter Prefatory Note 8].

2. As of November 1, 1997, the following states have enacted Revised Article 5: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Maryland, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, Utah, Virginia, Washington, West Virginia, Wyoming and the District of Columbia.

As of November 1, 1997, the following states have enacted Revised Article 8: Alaska, Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Puerto Rico, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wyoming and the District of Columbia. Telephone Interview with John McCabe, Uniform Law Commissioner (Oct. 13, 1997).

3. Senator Harry Wiggins, a Missouri representative on the National Conference of Commissioners on Uniform State Laws [hereinafter NCCUSL], introduced Senate Bill 6, and was instrumental in the passage of these revisions. Letter from Harry Wiggins, Senator, Missouri Senate, to Tim Heinz, Dean, University of Missouri-Columbia School of Law (May 5, 1997) (on file with author).

## II. REVISED ARTICLE 8 AND ITS IMPACT ON ARTICLE 9

## A. Introduction

Drafted in the 1940s, the original version of Article 8 was premised on the assumption that physical possession and delivery of tangible certificates were the key elements consummating a transfer of ownership in the securities holding system.<sup>4</sup> In the direct holding system on which Article 8 was based, possession of the physical certificate evidenced ownership of a particular security, while subsequent delivery of that certificate signaled a change in ownership.<sup>5</sup> This traditional *modus operandi* reflected commercial reality in the public securities market at the time Article 8 was drafted, but, as the market developed and the volume of securities trading dramatically increased, certificate-based securities transactions resulted in an insurmountable “paper crunch” on Wall Street.<sup>6</sup> Consequently, in the face of an evolving market, the direct holding system, which required actual delivery of certificates and related paperwork for every trade, proved too slow and labor-intensive to remain the dominant mechanism for clearing and settlement of securities trades.<sup>7</sup>

In anticipation of market developments that would eliminate the use of paper certificates in the securities holding system and thereby alleviate the paper crunch, the NCCUSL and ALI revised Article 8 in 1978.<sup>8</sup> The 1978 revisions sought to regulate transactions involving “uncertified securities,” where registration of ownership interests on the records of the issuer provided evidence of beneficial ownership of the security.<sup>9</sup> The drafters anticipated an environment in which physical certificates would no longer be needed to show ownership. Thus, the essence of the 1978 amendments was the addition of parallel provisions dealing with uncertified securities. Substantively, Article 8 was left unchanged.<sup>10</sup> Because the system which actually developed in the marketplace

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4. Prefatory Note 8, *supra* note 1. See Bryn R. Vaaler, *Revised Article 8 of the Mississippi UCC: Dealing Directly with Indirect Holding*, 66 MISS. L.J. 249, 254 (1996). The Authors believe that Professor Vaaler’s article represents the clearest exposition on Revised Article 8. The Authors have adopted the general structure of Professor Vaaler’s article in an effort to emulate his clarity on this difficult subject.

5. Prefatory Note 8, *supra* note 1. See generally Vaaler, *supra* note 4, at 254.

6. Vaaler, *supra* note 4, at 254.

7. Prefatory Note 8, *supra* note 1; Vaaler, *supra* note 4, at 255.

8. Prefatory Note 8, *supra* note 1.

9. Prefatory Note 8, *supra* note 1.

10. Prefatory Note 8, *supra* note 1.

differed substantially from what the drafters envisioned,<sup>11</sup> the 1978 amendments proved inadequate.<sup>12</sup>

A monumental expansion in trading volume pushed the market toward a system that not only eliminated the formality of moving paper certificates, as contemplated by the 1978 system premised on uncertificated securities, but also removed the need to deal with the issuer or its transfer agent in order to effectuate a securities trade.<sup>13</sup> In the market scheme that actually developed, individual investors still could obtain and hold physical certificates, but most beneficial owners instead chose to hold their shares through clearing corporations.<sup>14</sup> Public securities still were issued in certified form, but settlement occurred predominantly by computer entries in the records of clearing corporations and securities intermediaries, not by delivery of certificates or registration on the records of the issuer. Consequently, Article 8 was not equipped to govern the complex issues arising under the newly-developed "indirect holding system."<sup>15</sup>

Rather than perpetuating the inefficiencies of direct registration of uncertificated securities, the securities market evolved to create the indirect holding system. In this arrangement, paper certificates exist, but instead of being registered with the issuer in the name of the beneficial owner, brokerage firms, banks, or other depositories hold securities on the investor's behalf.<sup>16</sup> The owner's beneficial interest is evidenced in the customer's account records with the applicable intermediary, and transfer is indirectly accomplished through relevant bookkeeping entries.<sup>17</sup> At the end of the trading day, the entries for all transactions by customers at each intermediary are totaled, and the net buy-sell obligations of the intermediary to other brokers can be determined for each specific security traded.<sup>18</sup> Corresponding adjustments on the books of

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11. For an historical perspective on the indirect holding system, see James S. Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 UCLA L. REV. 1431, 1441-49 (1996).

12. Vaaler, *supra* note 4, at 256.

13. Vaaler, *supra* note 4, at 256.

14. Prefatory Note 8, *supra* note 1.

15. *See infra* notes 23-36 and accompanying text.

16. Vaaler, *supra* note 4, at 257.

17. Vaaler, *supra* note 4, at 257-58.

18. Vaaler, *supra* note 4, at 258. For example, if customer A wishes to sell 100 shares of XYZ corporation, the securities would be taken off the account that A's intermediary, the Brokerage Firm (BF), maintains with Deposit Trust Company (DTC). The applicable records would show a reduction in BF's account at DTC, and A's account with BF would reflect a corresponding adjustment. When customer B purchases 100 shares of XYZ that same day, DTC credits the shares to B's intermediary, Depository, in the account maintained by D at the DTC. Similarly, B's account at D shows B's increase in beneficial ownership of XYZ. At the end of the trading day, the transactions of A and B are evidenced by changes in the securities accounts of their intermediaries.

participant intermediaries accomplish clearing of securities trades and reflect the net change in quantity for each security traded by individual investors.<sup>19</sup> Today, the vast majority of publicly traded securities are held indirectly in a multi-tiered system of securities intermediaries, eliminating physical handling and delivery of certificates and accomplishing clearance and settlement through computer-automated bookkeeping processes.<sup>20</sup> Consequently, “[a]s technology has advanced, the efficiencies afforded by this predominant system of immobilized certificates and netted bookkeeping entries has permitted the clearance and settlement process to keep up with the enormous trading volume of the 1980s and 1990s.”<sup>21</sup> Because the original version of Article 8 and the 1978 revisions were based on the direct holding of certificated and uncertificated securities, the drafters of Revised Article 8 recognized the need to adapt the law of investment securities to effectively govern the indirect holding system.

### *B. Overview of the Indirect Holding System*

As previously mentioned in this Law Summary,<sup>22</sup> evolution in the U.S. securities market has led to the dominance of the indirect holding system, with its highly efficient mechanisms for transfer, delivery, and settlement of security interests. The indirect holding system is best described as a multi-tiered pyramid of securities intermediaries.<sup>23</sup> At the top of this pyramid is the Depository Trust Company (DTC), which performs custodial services for numerous securities brokers and banks that maintain accounts with the company.<sup>24</sup> DTC holds securities primarily under its nominee designation “Cede & Co.,” but utilizes smaller common depositories created to hold securities on behalf of participant intermediaries.<sup>25</sup> At the bottom of the pyramid are the beneficial owners of securities, the individual investors. Between the DTC and individual investors are the various securities intermediaries, beginning at the bottom with the dealer who maintains a customer relationship with the beneficial owner, and progressing upward through the other participants with which the customer-level intermediary has a clearing agency relationship.<sup>26</sup>

The primary mission of the DTC is to reduce transaction costs for the various actors in the indirect holding system, which is achieved in two primary

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Because there are no changes in the volume of securities held by DTC and because transfer of beneficial ownership is reflected by applicable bookkeeping entries, the certificates remain immobilized at DTC.

19. Vaaler, *supra* note 4, at 258.

20. Vaaler, *supra* note 4, at 258.

21. Vaaler, *supra* note 4, at 258.

22. See *supra* notes 15-20 and accompanying text.

23. Prefatory Note 8, *supra* note 1. See Vaaler, *supra* note 4, at 262.

24. Vaaler, *supra* note 4, at 263.

25. Vaaler, *supra* note 4, at 262.

26. Vaaler, *supra* note 4, at 262-63.

fashions: 1) by immobilizing certificates, and 2) by netting transactional book entries at each level of the indirect holding system.<sup>27</sup> The DTC holds certificates representing securities owned by the customers of participant intermediaries.<sup>28</sup> When a beneficial owner decides to trade securities, changes in ownership are reflected in DTC bookkeeping entries that adjust the amount of a particular security credited to the account of the intermediary serving the trading customer.<sup>29</sup> Thus, despite “constant fluidity of beneficial ownership,” certificates are immobilized, because the DTC remains the registered owner of the traded security so long as the quantity of certificates remains sufficiently high to cover overall indirect ownership.<sup>30</sup> Consequently, no need exists to physically deliver or indorse certificates, submit them to the issuer’s agent for cancellation, reissue them in the transferee’s name, change registered ownership on the issuer’s records, or mail out new certificates, as might be required in the direct holding system.<sup>31</sup> Immobilization of securities results in convenience and maximum efficiency in the securities market.

The second key aspect of the indirect holding system is the netting of transactional book entries at each level of the pyramid.<sup>32</sup> The system “nets” all transactions that occur each trading day among participants, and a net receive or deliver obligation is determined for each depository participant.<sup>33</sup> The DTC then executes corresponding adjustments to reflect the change in each respective participant’s DTC account.<sup>34</sup> A separate corporation, the National Securities Clearing Corporation, actually performs the netting function, providing centralized clearance and settlement services for participants in the indirect holding system.<sup>35</sup> As a result, the need for costly and time-consuming deliveries and the execution of an unworkable number of book entries, which would be required if every trade had to be recorded in the books of the depository, are eliminated.<sup>36</sup>

### C. Basic Objectives and Policies of Revised Article 8

Revised Article 8 does not attempt through legal mandates to dictate changes in current securities holding practices,<sup>37</sup> but rather the revisions seek to

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27. Vaaler, *supra* note 4, at 263.

28. Vaaler, *supra* note 4, at 263-64.

29. Vaaler, *supra* note 4, at 265.

30. Vaaler, *supra* note 4, at 265.

31. Vaaler, *supra* note 4, at 265.

32. Vaaler, *supra* note 4, at 269.

33. Vaaler, *supra* note 4, at 270.

34. Vaaler, *supra* note 4, at 270.

35. Vaaler, *supra* note 4, at 270.

36. Vaaler, *supra* note 4, at 269-70.

37. Vaaler, *supra* note 4, at 270.

provide the flexibility which enables the law to respond to market changes.<sup>38</sup> In addition, the drafters sought to ensure that the “clearance and settlement system has adequate capacity to handle ever-increasing trading volumes.”<sup>39</sup>

In allowing the market to influence the evolution of securities holding practices, the drafters dealt with the direct holding system and the indirect holding system separately under the “neutrality principle.”<sup>40</sup> By treating the securities holding systems in a neutral fashion, the UCC drafters believed they could accomplish their goal of allowing the market, not the revisions, to shape the future of securities holding practices.<sup>41</sup> In light of this distinction and the drafters’ goal of allowing the market to evolve, the drafters authored provisions with sufficient clarity and predictability so as not to “operate as a constraint on market developments,”<sup>42</sup> while attempting to identify and eliminate any proposed revisions that might act as an impediment to foreseeable market evolution.<sup>43</sup> The market obviously did not respond to the 1978 revisions, which attempted to dictate securities holding practices to the market. The 1997 revisions codify a refreshing change in philosophy by conforming and providing flexibility for the future. Consequently, the drafters’ successful balance of clarity and flexibility should operate to allow the market to evolve on its own.

#### D. Terminology and Scope

To understand the scope and application of Revised Article 8 and the related security interest rules of Article 9, one must begin by comprehending the key terms and concepts which underlie the revisions.<sup>44</sup>

#### 1. Security

A security is generally defined under Section 8-102(a)(15) as “an obligation of an issuer.”<sup>45</sup> Furthermore, as with the prior version of Article 8,<sup>46</sup> three requirements or conditions must be present for an interest to qualify as a security: transferability,<sup>47</sup> divisibility,<sup>48</sup> and a functional requirement<sup>49</sup> that turns

38. Prefatory Note 8, *supra* note 1.

39. Rogers, *supra* note 11, at 1441.

40. Vaaler, *supra* note 4, at 276.

41. Vaaler, *supra* note 4, at 276.

42. Vaaler, *supra* note 4, at 258.

43. Prefatory Note 8, *supra* note 1.

44. Prefatory Note 8, *supra* note 1.

45. A “security,” except as otherwise provided in Section 8-103, means an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer. U.C.C. § 8-102(a)(15).

46. Prefatory Note 8, *supra* note 1.

47. To satisfy the transferability requirement, the security must be “represented by a security certificate in bearer or registered form, or the transfer of which may be

on whether the security is dealt on, or traded in, the market.<sup>50</sup> An “opt-in” provision in subparagraph (iii) also allows the issuer to specify that it intends the obligation to be a security governed by Article 8.<sup>51</sup>

Section 8-103 contains rules that supplement Section 8-102 and clarify the meaning of “security” under Revised Article 8.<sup>52</sup> Section 8-103 stipulates that corporate stocks and bonds,<sup>53</sup> treasury securities, and investment company securities fall within the definition of security.<sup>54</sup> On the other hand, insurance products, partnership interests,<sup>55</sup> shares of a limited liability company, money market instruments, options,<sup>56</sup> and commodity positions<sup>57</sup> are not considered “securities” under Revised Article 8 unless they are traded on the securities exchanges.<sup>58</sup> The rules in Revised Article 8 were intended to “foreclose interpretive issues” regarding those investment products not included within the revisions.<sup>59</sup> The drafters specifically state in the Official Comments to Section

registered upon books maintained for that purpose by or on behalf of the issuer.” U.C.C. § 8-102(a)(15)(i).

48. To be considered divisible, the security must be “one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.” U.C.C. § 8-102(a)(15)(ii).

49. A security satisfies the functionality requirement when the security “is, or is of a type, dealt in or traded on securities exchanges or securities markets; or is a medium for investment and by its terms expressly provides that it is a security governed by this Article.” U.C.C. § 8-102(a)(15)(iii)(A)(B).

50. U.C.C. § 8-102 cmt. 15.

51. U.C.C. § 8-102 cmt. 15.

52. U.C.C. § 8-103 cmt. 1.

53. U.C.C. § 8-103 cmt. 2. “Subsection (a) establishes an unconditional rule that ordinary corporate stock is a security. That is so whether or not the particular issue is dealt in or traded on securities exchanges or in securities markets. Thus, shares of closely held corporations are Article 8 securities.” *Id.*

54. U.C.C. § 8-103 cmt. 3.

55. U.C.C. § 8-103 cmt. 4. “[P]artnership interests or shares of limited liability companies are not Article 8 securities *unless* they are in fact dealt in or traded on securities exchanges or in securities markets.” *Id.* “Partnership interests or shares of limited liability companies are included in the broader term ‘financial asset.’ Thus, if they are held through a securities account, the indirect holding system rules of Part 5 apply, and the interest of a person who holds them through such an account is a security entitlement.” *Id.*

56. U.C.C. § 8-103 cmt. 6. Options are treated as “financial assets,” but not “securities.” “Thus, the indirect holding system rules of Part 5 apply, but the direct holding system rules of Part 2, 3, and 4 do not.” *Id.*

57. U.C.C. § 8-103 cmt. 7. Subsection (f) of this Article excludes commodity contracts. “However, the Article 9 rules on security interests in investment property do apply to security interests in commodity positions.” *Id.*

58. U.C.C. § 8-103 cmt. 4.

59. U.C.C. § 8-103 cmt. 1.



8-103 that no implication should be made concerning investment products provided for in the revisions, showing that the drafters intended to leave the door open to evolution of new investment products.<sup>60</sup>

## 2. Financial Asset

As defined in Revised Article 8, a “financial asset”<sup>61</sup> includes obligations, shares, participations, and interests, in addition to securities.<sup>62</sup> However, the fact that an interest might be considered a financial asset does not necessarily mean the interest is governed by the revisions. Remember that the revisions were developed primarily to accommodate the indirect holding system; thus, to trigger Article 8 coverage, the financial asset must be a security entitlement which is indirectly held in a securities account.<sup>63</sup> Therefore, one must analyze whether the relationship between an institution and the beneficial owner of the security results in a customer holding a securities entitlement in a securities account at an intermediary. If this relationship is established, Part 5 of Revised Article 8, which sets forth the basic duties a securities intermediary owes an entitlement holder, applies.<sup>64</sup>

In addition to plainly referring to the asset itself, “financial asset” is defined broadly to include the particular means by which ownership of that asset is evidenced.<sup>65</sup> For example, with a certified security, a financial asset may refer to the interest or obligation of the issuer or the security certificate representing that interest or obligation. Furthermore, if a financial asset is held through a securities account, the term may refer either to the underlying asset or to the person’s security entitlement.<sup>66</sup>

60. U.C.C. § 8-103 cmt. 1.

61. U.C.C. § 8-102(a)(9) provides that the term “financial asset” includes:

(i) a security;

(ii) 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 financial markets, or which is recognized in any area in which it is issued or dealt in as a medium for investment; or

(iii) 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.

As context requires, the term means either the interest itself or the means by which a person’s claim to it is evidenced, including a certificated or uncertificated security, a security certificate, or a security entitlement.

62. U.C.C. § 8-102(a)(9). *See also* U.C.C. § 8-102 cmt. 9.

63. U.C.C. § 8-102 cmt. 9.

64. U.C.C. § 8-102 cmt. 9.

65. U.C.C. § 8-102 cmt. 9.

66. U.C.C. § 8-102 cmt. 9.

### 3. Securities Intermediary; Security Entitlement; Entitlement Holder; Securities Account

As defined in Revised Article 8, “securities intermediary” is the term used for those institutions which hold securities for others in the indirect holding system.<sup>67</sup> Common examples of securities intermediaries include “clearing corporations holding securities for their participants, banks acting as securities custodians, and brokers holding securities on behalf of their customers.”<sup>68</sup> The term securities intermediary must be distinguished from a broker, the latter being a person engaged in the business of buying and selling securities, while the former is one maintaining security accounts for others.<sup>69</sup>

“Security entitlement”, a term created by Revised Article 8 specifically to accommodate the indirect holding system, is defined as the rights and property interest of a person who holds a security or other financial asset through a securities intermediary.<sup>70</sup> A security entitlement is the backbone of the indirect holding system, comprising both a package of personal rights against the securities intermediary and an interest in the specific property held by the securities intermediary.<sup>71</sup> Part 5 of Revised Article 8 provides rules specifying the various rights and duties which accompany a security entitlement.<sup>72</sup>

The person identified as having a security entitlement against the securities intermediary is referred to as the “entitlement holder.”<sup>73</sup> The term encompasses those who hold financial assets through intermediaries in the indirect holding system, and, in most cases, is limited to the person specifically designated on the records of the intermediary.<sup>74</sup>

A securities account emanates from a consensual arrangement between the securities intermediary and the entitlement holder that creates the security

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67. U.C.C. § 8-102(a)(14) provides: “Security intermediary means: (i) a clearing corporation; or (ii) a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity.”

68. U.C.C. § 8-102 cmt. 14.

69. U.C.C. § 8-102 cmt. 14.

70. U.C.C. § 8-102(a)(17) provides: “‘Security entitlement’ means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5.”

71. U.C.C. § 8-102 cmt. 17.

72. See *infra* Section II.F. and accompanying text for an explanation of the inherent rights of an entitlement holder against a securities intermediary. The provisions of Part 5 are considered the basic rules of the indirect holding system.

73. U.C.C. § 8-103(a)(7) provides: “‘Entitlement holder’ means a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary.” If a person acquires a security entitlement by virtue of Section 8-501(b)(2) or (3), that person is the entitlement holder.

74. U.C.C. § 8-103 cmt. 7.

entitlement.<sup>75</sup> The definition of securities account also plays a key role in setting the scope for the rules in Part 5 of Revised Article 8. Essentially, a person has a security entitlement when a financial asset has been credited to her securities account, and if a securities account is established, it means that the intermediary has agreed to treat the customer as entitled to exercise all the rights that accompany the financial asset.<sup>76</sup> Thus, the basic test of whether an arrangement creates a securities account is whether the firm has undertaken to treat the customer as being empowered to exercise the rights that comprise the financial asset in question.<sup>77</sup> Another key issue is whether application of the Part 5 rules is consistent with the expectations of the parties to the relationship.<sup>78</sup>

#### 4. Investment Property

The adoption of Revised Article 8 necessitated a corresponding set of amendments to Article 9. "Investment property," defined in Section 9-115(1)(f),<sup>79</sup> is the cornerstone to the new Article 9 rules for secured transactions.<sup>80</sup> The term "investment property" encompasses "securities," "security entitlement," and "securities account," and allows a creditor to take a

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75. U.C.C. § 8-501(a) provides: "Securities account" means 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 whom the account is maintained as entitled to exercise the rights that comprise the financial asset."

76. U.C.C. § 8-501 cmt. 1.

77. U.C.C. § 8-501 cmt. 1.

78. U.C.C. § 8-501 cmt. 1 provides in part:

The effect of concluding that an arrangement is a securities account is that the rules of Part 5 apply. Accordingly, the definition of "securities account" must be interpreted in light of the substantive provisions in Part 5, which describe the core features of the type of relationship for which the commercial law rules of Revised Article 8 concerning security entitlements were designed. There are many arrangements between institutions and other persons concerning securities or other financial assets which do not fall within the definition of "securities account" because the institutions have not undertaken to treat the other persons as entitled to exercise the ordinary rights of an entitlement holder specified in the Part 5 rules. For example, the term securities account does not cover the relationship between a bank and its depositors or the relationship between a trustee and the beneficiary of an ordinary trust, because those are not relationships in which the holder of a financial asset has undertaken to treat the other as entitled to exercise the rights that comprise the financial asset in the fashion contemplated by the Part 5 rules.

79. "Investment property" means: (i) a security, whether certificated or uncertificated; (ii) a security entitlement; (iii) a securities account; (iv) a commodity contract; or (v) a commodity account. U.C.C. § 9-115(1)(f).

80. Prefatory Note 8, *supra* note 1. See U.C.C. § 9-115 cmt. 1.

security interest in an entire account, an interest in particular securities entitlements within an account, an interest in securities held directly by the debtor, or an interest in all the above.<sup>81</sup> Another difference between the coverage of Article 8 and Article 9 is that “investment property” under Article 9 includes commodity futures contracts, which are excluded from Article 8.<sup>82</sup> “Thus, the new Article 9 rules apply to security interests in commodity futures positions as well as security interests in securities positions.”<sup>83</sup>

### *E. The Direct Holding System*

With respect to the direct holding system, Article 8 essentially retains the same rules and conceptual structure.<sup>84</sup> The 1978 revision of Article 8 provided one set of regulations for certificated and uncertificated securities, all of which were included in Article 8. The drafters eliminated the parallel rules concerning certificated and uncertificated securities<sup>85</sup> and introduced the new Section 5 for the indirect holding system, while moving the rules on secured transactions to Article 9.<sup>86</sup> Although the basic concepts of Article 8 were not altered by the amendments, the following Section attempts to introduce some of the significant changes to the laws governing the direct holding system.

#### 1. Transaction Statements

The 1978 revision on uncertificated securities anticipated a system with no definitive certificates as reifications of the underlying interests or obligations.<sup>87</sup> Under this system, the 1978 revision required issuers of uncertificated securities to annually send paper “transaction statements” upon registration of transfer and at the security holder’s request.<sup>88</sup> While imposing reporting requirements on issuers of uncertificated securities, Article 8 has never stipulated reporting imperatives on securities intermediaries.<sup>89</sup> Accordingly, Revised Article 8 eliminates these requirements for transaction statements and leaves governance

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81. U.C.C. § 9-115 cmt. 4.

82. U.C.C. § 9-115(1)(f)(iv), (v). *See* Prefatory Note 8, *supra* note 1.

83. Prefatory Note 8, *supra* note 1.

84. Prefatory Note 8, *supra* note 1.

85. Prefatory Note 8, *supra* note 1. The contrast between certificated and uncertificated securities has been minimized or eliminated as much as possible in the substantive provisions. Prefatory Note 8, *supra* note 1.

86. Prefatory Note 8, *supra* note 1.

87. Prefatory Note 8, *supra* note 1.

88. Prefatory Note 8, *supra* note 1.

89. Prefatory Note 8, *supra* note 1.

of reporting obligations to agreements between the parties or to other areas of the law.<sup>90</sup>

## 2. Deletion of Provisions on Registered Pledges

The registered pledge was a common mechanism for perfecting a security interest under prior versions of Article 8.<sup>91</sup> The 1978 revision to Article 8 required an issuer of uncertificated securities to offer a registered pledge program, which was created as a substitute for the pledge in the absence of a certificate.<sup>92</sup> Presumably, the purpose of the registered pledge program was to allow the debtor to retain the uncertificated security in his name in order to maintain voting rights and dividend privileges.<sup>93</sup> Market participants and legal commentators found the registered pledge provision troublesome, which provided an impetus for change.<sup>94</sup> Consequently, Revised Article 8 eliminates the provisions concerning registered pledges of uncertificated securities.<sup>95</sup>

Under Revised Articles 8 and 9, the drafters allowed the issue of perfection to be resolved by the market.<sup>96</sup> Under these provisions, a security interest in uncertificated securities may be perfected by various means. First, a debtor can always transfer securities to its lender.<sup>97</sup> Second, filing remains a permissible method of perfection for debtors other than security firms.<sup>98</sup> Third, the parties may create their own arrangement, similar to the registered pledge, which permits the debtor to remain the registered owner entitled to vote and receive dividends, but grants the lender power to order disposition.<sup>99</sup> The deletion of the provisions on registered pledges for uncertificated securities accomplishes the drafters' goal of providing a uniform system of rules for certificated and uncertificated securities.<sup>100</sup>

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90. Prefatory Note 8, *supra* note 1. These reporting requirements will be governed by whatever law or agreement specifies these matters, paralleling other business entities, such as partnerships. *Id.* See generally James S. Rogers, *Revised Article 8: Why It's Needed, What It Does*, C965 ALI-ABA 285, 291 (1994).

91. Prefatory Note 8, *supra* note 1.

92. Prefatory Note 8, *supra* note 1.

93. Prefatory Note 8, *supra* note 1.

94. Prefatory Note 8, *supra* note 1.

95. Prefatory Note 8, *supra* note 1.

96. Prefatory Note 8, *supra* note 1. This follows the drafters neutrality policy. *Id.* See also *infra* notes 246-59 and accompanying text for a discussion of perfection under Article 9.

97. Prefatory Note 8, *supra* note 1.

98. Prefatory Note 8, *supra* note 1.

99. Prefatory Note 8, *supra* note 1.

100. Prefatory Note 8, *supra* note 1.

### 3. Rejection of the *Lowry* Principle

Under Revised Article 8, an issuer no longer is liable for failing to investigate adverse claims even if it has notice of such claims before executing a requested transfer.<sup>101</sup> The 1978 Amendment to Section 8-403 dealt with the obligations and duties of issuers to adverse claimants.<sup>102</sup> The leading case addressing issuers' liability for wrongful transfers is *Lowry v. Commercial & Farmers Bank*,<sup>103</sup> decided in 1848. The *Lowry* principle stated that issuers could be held liable for registering a transfer at the direction of a registered owner who was acting wrongfully against a third party in making the transfer.<sup>104</sup> This principle imposed onerous liability on issuers, who required extensive documentation to complete transfers to assure themselves that the third party was acting rightfully.<sup>105</sup> Throughout the last century, American law has slowly moved away from the *Lowry* principle.<sup>106</sup> Revised Article 8 rejects the *Lowry* principle altogether.<sup>107</sup> *Revised Article 8* provides that "an issuer is not liable for wrongful registration if it acts on an effective endorsement or instruction, even though the issuer may have notice of adverse claims, so long as the issuer has not been served with legal process and is not acting in collusion with the wrongdoer in registering the transfer."<sup>108</sup> In addition, the duty to investigate adverse claims

101. Prefatory Note 8, *supra* note 1.

102. The 1978 version of U.C.C. § 8-403 reads in part:

(1) An issuer to whom a certificated security is presented for registration shall inquire into adverse claims if:

(a) a written notification of an adverse claim is received at a time and in a manner affording the issuer a reasonable opportunity to act on it prior to the issuance of a new, reissued, or re-registered certificated security, and the notification identifies the claimant, the registered owner, and the issue of which the security is a part, and provides an address for communications directed to the claimant; or

(b) the issuer is charged with notice of an adverse claim from a controlling instrument it has elected to require under Section 8-402(4).

103. 15 F. Cas. 1040 (C.D. Md. 1848) (No. 8581).

104. *Id.* See Prefatory Note 8, *supra* note 1.

105. Prefatory Note 8, *supra* note 1. This process proved to be cumbersome and time consuming for the issuers. Prefatory Note 8, *supra* note 1.

106. Prefatory Note 8, *supra* note 1. Statutes such as the Uniform Fiduciaries Act, the Model Fiduciary Stock Transfer Act, and the Uniform Act for the Simplification sought to avoid delays in stock transfers by limiting the issuer's liability for transfers in breach of the registered owner's duty to others. Although these statutes provided that issuers had no duty of inquiry to determine whether a third party was acting rightfully, they all provided that an issuer could still be liable if they acted with notice to third party claims. Prefatory Note 8, *supra* note 1.

107. Prefatory Note 8, *supra* note 1.

108. *Id.* See U.C.C. § 8-404.

has been deleted from Article 8.<sup>109</sup> The drafters of the amendments believed that “a third party should not be able to interfere with the relationship between an issuer and its registered shareholders unless the claimant obtains legal process.”<sup>110</sup> In rejecting the *Lowry* principle, the drafters were able to streamline the transfer process without imposing excessive liability on issuers.

#### 4. Statute of Frauds Inapplicable

Revised Article 8 deletes the special Statute of Frauds for securities contracts formerly covered in Section 8-319.<sup>111</sup> Most litigation involving the former Statute of Frauds rule involved informal transactions,<sup>112</sup> rather than those on the organized securities market.<sup>113</sup> In an effort to eliminate any roadblocks to continued development of electronic communication, and because “the Statute of Frauds is unsuited to the realities of the securities business,”<sup>114</sup> the drafters eliminated the Statute of Frauds section. To emphasize their point, the drafters stated, “For securities transactions, whatever benefits a Statute of Frauds may play in filtering out fraudulent claims are outweighed by the obstacles it places in the development of modern commercial practices in the securities business.”<sup>115</sup>

#### F. Securities Entitlements

Part 5 defines the basic package of rights and duties which accompany a “security entitlement,” a new form of property included in Revised Article 8. A security entitlement is created when a securities intermediary credits a financial asset to the entitlement holder’s securities account, and the intermediary permits the entitlement holder to exercise all rights which comprise the credited financial asset.<sup>116</sup> For example, suppose A has a securities account with Merrill Lynch,

109. Prefatory Note 8, *supra* note 1.

110. Prefatory Note 8, *supra* note 1.

111. Prefatory Note 8, *supra* note 1. See U.C.C. § 8-113.

112. Prefatory Note 8, *supra* note 1. The typical case involved an employee or former employee of a small enterprise who sued to enforce an alleged promise that he or she would receive an equity interest in the business. Prefatory Note 8, *supra* note 1. “The usual commercial policies relating to writings in contracts for the sale of personal property are at most tangentially implicated in such cases.” Prefatory Note 8, *supra* note 1. There was a large and complex body of case law dealing with the applicability of the Statute of Frauds to cases of this sort. Prefatory Note 8, *supra* note 1. The Prefatory Note continues to say that it seems doubtful that the cost of litigating these issues was warranted by whatever protection the Statute of Frauds offered against fraudulent claims. Prefatory Note 8, *supra* note 1.

113. Prefatory Note 8, *supra* note 1.

114. U.C.C. § 8-113 cmt..

115. U.C.C. § 8-113 cmt..

116. U.C.C. Section 8-102(a)(17) provides: “‘Security entitlement’ means the

through which she owns one thousand shares of IBM and one thousand shares of Microsoft. A's one thousand shares of IBM constitute a securities entitlement, as do the shares of Microsoft, and A, the entitlement holder, may exercise any ownership rights inherent in the shares which comprise the securities entitlement. When the individual entitlements are combined, they comprise A's securities account with the securities intermediary, Merrill Lynch.

The relationship between the securities intermediary and the entitlement holder, defined in the context of the parties' rights and duties toward one another, is at the core of a security entitlement under Revised Article 8. Rather than adopting traditional property law concepts, such as the bailment, to govern the relationship between a securities intermediary and an entitlement holder, the drafters of Revised Article 8 adopted rules based on the parties' functional rights and duties as defined within the revisions.<sup>117</sup> In specifying the rights and duties inherent in a security entitlement, Revised Article 8 does not attempt to comprehensively govern all aspects of the relationship between an entitlement holder and a securities intermediary, nor did the drafters intend to usurp rules of contract law, agency law, federal securities law, or other areas of the law which might define the relationship in certain contexts.<sup>118</sup> Part 5 intends only to regulate those aspects of the commercial and property relationship necessary for the efficient, effective operation of the various rules of Revised Articles 8 and 9.<sup>119</sup>

The basic package of rights and duties governing the relationship between a securities intermediary and an entitlement holder under Revised Article 8 are as follows:

### 1. Property Interest of Entitlement Holder in Financial Asset Held by Securities Intermediary: Section 8-503

In specifying the nature of the entitlement holder's property interest in the financial assets credited to its securities account, Section 8-503(a) provides as follows:

To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests

rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5." See *supra* notes 70-78 and accompanying text. See also Vaaler, *supra* note 4, at 295.

117. Vaaler, *supra* note 4, at 295. For a thorough analysis and comparison of the common law of bailment, the property law concept which governed the relationship between a securities intermediary and its customers prior to Revised Article 8, and the rights and duties accompanying a security entitlement under the revisions, see Rogers, *supra* note 11, at 1505-11.

118. Vaaler, *supra* note 2, at 295-96.

119. Vaaler, *supra* note 2, at 296.



in that financial asset held by the securities intermediary are held by the securities intermediary for the 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.<sup>120</sup> Thus, subsection (a) expresses the general understanding that the securities which a firm holds for its customers are not considered general assets of the firm subject to the claims of firm creditors.<sup>121</sup>

The nature of an entitlement holder's property interest under Section 8-503 is described under the revisions as "a pro rata property interest in all interests in that financial asset held by the securities intermediary, 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."<sup>122</sup> Because the pro rata common interest relates to a particular type of financial asset and not to identifiable units of that asset, particular financial assets are not traceable to specific entitlement holders.<sup>123</sup> Entitlement holders have a pro rata interest in

120. U.C.C. § 8-503(a).

121. U.C.C. § 8-503 cmt. 1.

122. U.C.C. § 8-503(b).

123. As recognized by Vaaler, this is a fundamental difference between the indirect holding system rules under Revised Article 8 and the rules of the direct holding system. See Vaaler, *supra* note 4, at 297 n.187. The Official Comments to Section 8-503 elaborate as follows:

Although this section recognizes that the entitlement holders of a securities intermediary have a property interest in the financial assets held by the intermediary, the incidents of this property interest are established by the rules of Article 8, not by common law property concepts. The traditional Article 8 rules on certificated securities were based on the idea that a paper certificate could be regarded as a nearly complete reification of the underlying right. The rules on transfer and the consequences of wrongful transfer could then be written using the same basic concepts as the rules for physical chattels. A person's claim of ownership of a certificated security is a right to a specific identifiable physical object, and that right can be asserted against any person who ends up in possession of that physical certificate, unless cut off by the rules protecting purchasers for value without notice. Those concepts do not work for the indirect holding system. A security entitlement is not a claim to a specific identifiable thing; it is a package of rights and interests that a person has against the person's securities intermediary and the property held by the intermediary. The idea that discrete objects might be traced through the hands of different persons has no place in the Revised Article 8 rules for the indirect holding system. The fundamental principles of the indirect holding system rules are that an entitlement holder's own intermediary has the obligation to see to it that the entitlement holder receives all of the economic and corporate rights that comprise the financial asset, and that the entitlement holder can look only to that intermediary for performance of the obligations.

U.C.C. § 8-503 cmt. 2.

common with all other entitlement holders of a particular financial asset.<sup>124</sup> Because temporal factors are irrelevant under Revised Article 8, one entitlement holder cannot claim superior rights to assets held by the intermediary by virtue of having acquired those rights either before or after others with similar rights.<sup>125</sup>

Subsection (c) of Section 8-503 provides that “[a]n entitlement holder’s property interest with respect to a particular financial asset . . . may be enforced against the securities intermediary only by exercise of the entitlement holder’s rights under Sections 8-505 through 8-508,” which are the provisions which establish the duty of an intermediary to ensure that an entitlement holder receives all economic and corporate rights which comprise the security or financial asset.<sup>126</sup> The entitlement holder can look only to the intermediary for performance of these obligations and cannot assert rights directly against third parties, except where the third party was a participant in a wrongful transfer of the interest.<sup>127</sup>

Subsections (d) and (e) establish limited circumstances in which an entitlement holder may assert a claim against a third person to whom the intermediary transferred a financial asset that was subject to the entitlement holder’s claim. To enforce a claim against a third-party purchaser, the intermediary who was obligated to protect the entitlement holder’s rights: (1) must have initiated insolvency proceedings, (2) must not “have sufficient interests in the financial asset to satisfy the security entitlements of all of its entitlement holders to that financial asset,” (3) must have violated its Section 8-504 obligation to maintain sufficient interests in the financial asset to cover all security entitlements, and (4) the purchaser must not be protected under Subsection (e).<sup>128</sup> Thus, so long as the intermediary is solvent, the entitlement holder must assert its claims against the intermediary and not third parties, because if the intermediary does not hold financial assets corresponding to the entitlement holder’s particular claim, the intermediary has a duty to acquire sufficient assets to honor the customer’s entitlement.<sup>129</sup> In effect, the only instance in which entitlement holders can pursue third-party transferees is when the intermediary is unable to perform its legal obligations to the holder and the transfer was in violation of the intermediary’s obligations.<sup>130</sup>

Under Subsection (e), an entitlement holder may not assert his property rights against a transferee if the purchaser “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,” even if the requisites of

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124. U.C.C. § 8-503 cmt. 1.

125. U.C.C. § 8-503 cmt. 1.

126. U.C.C. § 8-503(c). *See also* U.C.C. § 8-503 cmt. 2.

127. U.C.C. § 8-503 cmt. 2.

128. U.C.C. § 8-503(d).

129. U.C.C. § 8-503 cmt. 2.

130. U.C.C. § 8-503 cmt. 2.

Subsection (d) exist.<sup>131</sup> Subsections (d) and (e) protect purchasers-transferees against adverse claims by other entitlement holders that the intermediary wrongfully transferred the financial asset. In most cases, the issue is whether the purchaser acted in collusion with the intermediary to violate the entitlement holder's rights in the financial asset. Revised Article 8 does not require that the transferee purchase without notice of the entitlement holder's interest, thus negating any duty on the purchaser to investigate.<sup>132</sup>

The limitations that Subsections (c) through (e) place on the ability of a failed intermediary's customers to recover assets from purchasers are consistent with the fundamental policies of investor protection and reduction of risk in the marketplace which underlie the various bodies of law governing the investment securities.<sup>133</sup> The drafters recognized that rules enabling customers to assert rights against third parties would impair rather than promote the interest of investors and would disrupt the efficient operation of the clearance and settlement system.<sup>134</sup> As stated by Bryn Vaaler, the drafters "intended to build a fire wall around the failed intermediary to prevent the spread of its failure and the possible shifting of loss from one set of investors to another."<sup>135</sup>

131. U.C.C. § 8-503(e).

132. See U.C.C. § 8-503 cmt. 2. The Official Comments to Section 8-503 provide: Rather than imposing duties to investigate, the general policy of the commercial law of the securities holding and transfer system has been to eliminate legal rules that might induce participants to conduct investigations of the authority of persons transferring securities on behalf of others for fear that they might be held liable for participating in a wrongful transfer.

U.C.C. § 8-503 cmt. 3.

133. U.C.C. § 8-503 cmt. 3.

134. U.C.C. § 8-503 cmt. 3. The Official Comments to Section 8-503 further provide:

The use of the collusion test in Section 8-503(e) furthers the interests of investors generally in the sound and efficient operation of the securities holding and settlement system. The effect of the choice of this standard is that customers of a failed intermediary must show that the transferee from whom they seek to recover was affirmatively engaged in wrongful conduct, rather than casting on the transferee any burden of showing that the transferee had no awareness of wrongful conduct by the failed intermediary. The rule of Section 8-503(e) is based on the long-standing policy that it is undesirable to impose upon purchasers of securities any duty to investigate whether their sellers may be acting wrongfully.

U.C.C. § 8-503 cmt. 3.

135. Vaaler, *supra* note 4, at 299. The Official Comments to Section 8-503 illustrate as follows:

Suppose, for example, that Intermediary A transfers securities to B, that Intermediary A acted wrongfully as against its customers in so doing, and that after the transaction Intermediary A did not have sufficient securities to satisfy its obligations to its entitlement holders. Viewed solely from the standpoint of the customers of Intermediary A, it would seem that permitting

As indicated in Section 8-503(a), Section 8-511 establishes priority rules for situations in which a securities intermediary fails without assets sufficient to satisfy claims of both entitlement holders and creditors.<sup>136</sup> Subsection (a) states the general rule that the claims of entitlement holders have priority over creditors, but when the secured creditor obtains control over the financial asset at issue, the creditor's claim has priority under Subsection (b).<sup>137</sup> In harmony with the rules of Section 8-503, the secured creditor retains its priority rights even if the transfer was wrongful, unless the creditor acted in collusion with the intermediary in violating the intermediary's obligations to the entitlement holder.<sup>138</sup>

## 2. Duty of Securities Intermediary to Maintain the Financial Asset: Section 8-504

Subsection (a) imposes a duty upon the securities intermediary to maintain a quantity of financial assets corresponding to the aggregate of all security entitlements it has established, a duty which the Official Comments to Section 8-504 identify as one of the core obligations of the relationship between intermediary and entitlement holder.<sup>139</sup> The drafters recognized that the realities of today's securities market make it impractical for an intermediary to earmark its own securities as distinguished from those belonging to specific customers.<sup>140</sup> Thus, a securities intermediary is required to maintain only a sufficient inventory

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the property to be recovered from B, would be good for investors. That, however, is not the case. B may itself be an intermediary with its own customers, or may be some other institution through which individuals invest, such as a pension fund or investment company. There is no reason to think that rules permitting customers of an intermediary to trace and recover securities that their intermediary wrongfully transferred work to the advantage of investors in general. To the contrary, application of such rules would often merely shift losses from one set of investors to another. The uncertainties that would result from rules permitting such recoveries would work to the disadvantage of all participants in the securities markets.

U.C.C. § 8-503 cmt. 3.

136. U.C.C. § 8-511 cmt. 1.

137. U.C.C. § 8-511(a)(b).

138. U.C.C. § 8-511 cmt. 1.

139. U.C.C. § 8-504 cmt. 1. Section 8-504(a) specifically provides as follows:

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 other securities intermediaries.

U.C.C. § 8-504 cmt. 1.

140. U.C.C. § 8-504 cmt. 1.

of a particular security to cover all claims, and the securities may be held either directly or indirectly through other securities intermediaries.<sup>141</sup>

Subsection (b) explicitly provides that, except as authorized by its customers, it is wrongful for a securities intermediary to grant security interests in positions needed to satisfy customers' claims.<sup>142</sup> This corollary to the basic duty of Subsection (a) is implicit in the notion that a securities intermediary must maintain financial assets corresponding to the claims of all entitlement holders.<sup>143</sup>

The "agreement-due care" provision of Subsection (c) was included to provide sufficient flexibility in accommodating the general rule of Subsection (a) to the various circumstances which might be encountered in the modern securities holding system.<sup>144</sup> Subsection (a) was not intended to foreclose special circumstances in which an intermediary's duty may be excused, nor was it intended as a detailed specification of precisely how the intermediary is to perform its duty.<sup>145</sup> Thus, Subsection (c) provides that a securities intermediary satisfies its duty to maintain sufficient financial assets to cover the claims of all its entitlement holders if: (1) the intermediary acts with respect to that duty in accordance with an agreement between the intermediary and the entitlement holder, or (2) if no agreement exists, Subsection (a) is satisfied if the intermediary exercises due care according to reasonable commercial standards in maintaining the financial asset in question.<sup>146</sup> The agreement-due care formulation provides the standard by which satisfaction of the various duties a securities intermediary owes an entitlement holder is achieved under Part 5 of Revised Article 8. Accordingly, whether established by agreement or the statutory due care standard, the duties of Part 5 are shaped by the general obligation of good faith performance in Sections 1-203 and 8-102(a)(10).<sup>147</sup>

Section 1-203 provides that "[e]very . . . duty within this Act imposes an obligation of good faith in its performance,"<sup>148</sup> while Section 8-102(a)(10) defines "good faith" as "honesty in fact and the observance of reasonable

141. U.C.C. § 8-504 cmt. 1.

142. U.C.C. § 8-504 cmt. 2.

143. U.C.C. § 8-504 cmt. 1.

144. U.C.C. § 8-504 cmt. 4.

145. U.C.C. § 8-504 cmt. 3.

146. U.C.C. § 8-504(c).

147. U.C.C. § 8-504 cmt. 4; *See also* Vaaler, *supra* note 4, at 302.

148. U.C.C. § 1-203. *See also* U.C.C. § 8-504 cmt. 4, which provides:

The duty of care includes both care in the intermediary's own operations and care in the selection of other intermediaries thorough whom the intermediary holds the assets in question. The statement of the obligation of due care is meant to incorporate the principles of the common law under which the specific actions or precautions necessary to meet the obligation of care are determined by such factors as the nature and value of the property, the customs and practices of the business, and the like.

U.C.C. § 8-504 cmt. 4.

commercial standards of fair dealing.”<sup>149</sup> Accordingly, the agreement-due care standard is violated by an agreement in which the securities intermediary disclaims one of the basic elements of its relationship with an entitlement holder.<sup>150</sup> For example, an agreement stating that an intermediary is not responsible for protecting an entitlement holder’s securities positions is inconsistent with the intermediary’s duty to maintain financial assets corresponding to the entitlement holder’s security entitlements.<sup>151</sup> The Official Comments to Section 8-504 explain that the drafters deliberately established the duty of a securities intermediary to maintain financial assets in an abstract and general manner, for the details are specified by federal securities laws.<sup>152</sup> Compliance with federal securities law generally constitutes compliance with Revised Article 8.<sup>153</sup>

### 3. Duty of Securities Intermediary with Respect to Payments and Distributions: Section 8-505

A primary reason investors utilize professional intermediaries is to obtain performance of various services which ensure that payments and other distributions are received.<sup>154</sup> Therefore, Section 8-505 imposes a duty upon securities intermediaries to take appropriate actions which ensure that entitlement holders receive the economic benefits of ownership of a financial asset. Subsection (a) incorporates the agreement-due care formulation in the satisfaction of this duty,<sup>155</sup> while Subsection (b) provides that a securities

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149. U.C.C. § 8-102(a)(10). According to Professor Rogers, the duty of good faith applies both to the performance of the statutory duty and the making of an agreement as a means of carrying out the duty:

Making an agreement specifying the details of the intermediary’s duties and performing in accordance with that agreement would be a method by which the intermediary seeks to carry out its statutory duty. Whether action taken in accordance with such agreement is sufficient depends on whether that action can be said to satisfy the obligation of good faith performance of the underlying statutory duty.

Rogers, *supra* note 11, at 1507-08.

150. U.C.C. § 8-504 cmt. 4.

151. U.C.C. § 8-504 cmt. 4.

152. U.C.C. § 8-504 cmt. 5.

153. U.C.C. § 8-504 cmt. 5.

154. U.C.C. § 8-505 cmt. 1.

155. Official Comment 2 to Section 8-505 provides:

[The] formulation permits the parties to specify by agreement what action, if any, the intermediary is to take with respect to the duty to obtain payments and distributions. In the absence of specification by agreement, the intermediary satisfies the duty if the intermediary exercises due care in accordance with reasonable commercial standards.

U.C.C. § 8-505 cmt. 2.

intermediary is obligated to its entitlement holders for payments or distributions received by the intermediary from the issuer.<sup>156</sup>

#### 4. Duty of Securities Intermediary to Exercise Rights as Directed by Entitlement Holders: Section 8-506

Because of the nature of the indirect holding system, the intermediary may be the one who has the power to exercise various corporate rights vested in one who holds a security, such as voting, redemption, and exchange rights.<sup>157</sup> However, Section 8-506 clearly dictates that the intermediary is acting for the entitlement holder in a representative capacity, rather than at the intermediary's own discretion.<sup>158</sup> Section 8-506 provides that a securities intermediary "shall exercise rights with respect to a financial asset if directed to do so by an entitlement holder."<sup>159</sup> The wording "if directed to do so" recognizes that an entitlement holder is not precluded from conferring discretionary authority on the intermediary.<sup>160</sup> As with other Part 5 duties, the agreement-due care formula is invoked as the standard for compliance with Section 8-506. However, because many rights attendant upon ownership of a security are far removed from matters which intermediaries are expected to perform, such as derivative and other litigation, Section 8-506 also provides that an intermediary satisfies its duty if it places the entitlement holder in a position to exercise such rights directly.<sup>161</sup>

Once again, Section 8-509 establishes that compliance with applicable federal regulatory requirements constitutes compliance with Section 8-506.<sup>162</sup> According to the Official Comments, the rule of Section 8-509 is significant because federal securities laws provide comprehensive regulation of the exercise

156. U.C.C. § 8-505(b).

157. U.C.C. § 8-506 cmt. 1.

158. U.C.C. § 8-506 cmt. 1. As pointed out in the Official Comments, the rule that a securities intermediary is acting in a representative capacity distinguishes a securities account from other arrangements whereby one holds securities on behalf of another, such as the relationships between a mutual fund and its shareholders or a trustee and its beneficiary. U.C.C. § 8-506 cmt. 1.

159. U.C.C. § 8-506.

160. U.C.C. § 8-506 cmt. 2. For example, investors often do not wish their intermediaries to forward proxy materials and other information. U.C.C. § 8-506 cmt. 2.

161. U.C.C. § 8-506 cmt. 2.

162. U.C.C. § 8-509(a) provides: "If the substance of a duty imposed upon a securities intermediary by Sections 8-504 through 8-508 is the subject of other statute, regulation, or rule, compliance with that statute, regulation, or rule satisfies the duty." U.C.C. § 8-509(a).

of voting rights and the distribution of corporate information with respect to securities held through intermediaries.<sup>163</sup>

### 5. Duty of Securities Intermediary to Change Entitlement Holder's Position to Other Form of Security Holding: Section 8-507

Under Section 8-507(a), a securities intermediary has a duty to:

comply with an entitlement order if the entitlement order is originated by the appropriate person, the securities intermediary has had a reasonable opportunity to assure itself that the entitlement order is genuine and authorized, and the securities intermediary has had reasonable opportunity to comply with the entitlement order.<sup>164</sup>

The duty is satisfied if the intermediary comports with the agreement-due care standard.<sup>165</sup> Because customers hold securities through intermediaries to effectuate rapid transfer and settlement, the right to have orders for disposition of the security entitlement honored is vital in ensuring the most efficient relationship between an entitlement holder and a securities intermediary.<sup>166</sup> Subsection (b) establishes correlative liability of the securities intermediary for transferring a financial asset pursuant to an ineffective entitlement order.<sup>167</sup>

Regarding an entitlement order, the "appropriate person" is normally the entitlement holder.<sup>168</sup> Under Section 8-102(a)(7), an entitlement holder is the person "identified in the records of a securities intermediary as the person having a security entitlement."<sup>169</sup> In addition, an entitlement order is defined as "a notification communicated to a securities intermediary directing transfer or redemption of a financial asset to which the entitlement holder has a security

163. U.C.C. § 8-506 cmt. 4.

164. U.C.C. § 8-507(a).

165. *See supra* notes 144-53.

166. U.C.C. § 8-507 cmt. 1.

167. U.C.C. § 8-507 cmt. 1. Section 8-507(b) specifically provides:

If a securities intermediary transfers a financial asset pursuant to an ineffective entitlement order, the securities intermediary shall reestablish a security entitlement in favor of the person entitled to it, and pay or credit any payments or distributions that the person did not receive as a result of the wrongful transfer. If the securities intermediary does not reestablish a security entitlement, the securities intermediary is liable to the entitlement holder for damages.

168. U.C.C. § 8-107(a)(3). In addition, an appropriate person may be the designated person's successor or personal representative upon death, or the entitlement holder's guardian, conservator, or other person who has power to act in the event of the entitlement holder's incapacity. U.C.C. § 8-107(a)(4), (5).

169. U.C.C. § 8-102(a)(7).



entitlement,” and is the means of transacting a securities entitlement transfer.<sup>170</sup> An entitlement order is effective if it originates from the entitlement holder herself or her authorized agent.<sup>171</sup>

Another basic principle of the indirect holding system is that securities intermediaries owe duties only to their customers.<sup>172</sup> Therefore, because the duty applies only to entitlement orders emanating from an appropriate person, the securities intermediary’s duty to act in compliance with an entitlement order, as a general rule, runs only to the entitlement holder.<sup>173</sup> If the entitlement holder is alive and competent, even one who has the power to act as an agent of the entitlement holder is not considered an “appropriate person.”<sup>174</sup> Thus, an intermediary is not required to guess whether one who purports to have agency powers is in fact authorized to act for the entitlement holder, for the entitlement holder needs to establish agency relationships in advance with the securities intermediary.<sup>175</sup> On the other hand, as stated by Vaaler, the intermediary will not be liable under Section 8-507(b) for complying with an entitlement order from an authorized agent, since the order is effective under Section 8-107(b)(2).<sup>176</sup>

If the entitlement holder grants a security interest to a third party lender, the intermediary does not owe a duty to the secured party unless the entitlement holder, the secured party, and the securities intermediary enter a three-party control agreement under which the intermediary agrees to act on entitlement orders of the secured party.<sup>177</sup> However, once the parties enter such an agreement, the secured party has control<sup>178</sup> and has perfected its security interest under Revised Article 9. As a result, under Section 8-507,

[W]hen the secured lender submits an entitlement order pursuant to the control agreement, the securities intermediary can act in accordance with it without exposure to liability under section 8-507(b) (because the entitlement order is “effective”) and without violating its duty to the entitlement holder under section 8-507(a) (because the intermediary has acted in conformity with the agreement/due care standard).<sup>179</sup>

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170. U.C.C. § 8-102(a)(8).

171. U.C.C. § 8-107(b).

172. U.C.C. § 8-507 cmt. 3.

173. U.C.C. § 8-507 cmt. 3. *See also* Vaaler, *supra* note 4, at 305.

174. U.C.C. § 8-507 cmt. 3.

175. U.C.C. § 8-507 cmt. 3.

176. Vaaler, *supra* note 4, at 305.

177. U.C.C. § 8-507 cmt. 3. For an explanation of a three-party control agreement and its effect on perfection and control under Revised Article 9, see *infra* notes 223-26 and accompanying text.

178. *See* Section II.H.2 and accompanying text.

179. Vaaler, *supra* note 4, at 305-06.

## 6. Duty of Securities Intermediary to Change Entitlement Holder's Position to Other Form of Security Holding: Section 8-508

Under Section 8-508, a securities intermediary has a duty, at the direction of the 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."<sup>180</sup> The intermediary satisfies its duty by complying with the agreement-due care formulation.<sup>181</sup>

### *G. Transaction Finality: The Limitations for Adverse Claims Under Revised Article 8*

While Section 8-503 provides adverse claim limitations for directly held securities, Sections 8-502 and 8-510 specify the guidelines for the indirect holding system. Section 8-502 provides that "an adverse claim to a financial asset . . . may not be asserted against a person who acquires a security entitlement under Section 8-501 for value and without notice of the adverse claim."<sup>182</sup> With transactions consummated in the indirect holding system, it is practically impossible for one to effectively trace a particular security. Thus, protection is afforded to a bonafide purchaser in a system in which securities trades are settled on a net basis by relevant entries on the books of the issuer or intermediary.<sup>183</sup> Conversely, a claimant will not likely be able to trace a particular security to a particular entitlement holder, causing the protections of Section 8-502 to be somewhat theoretical.<sup>184</sup>

180. U.C.C. § 8-508. The Official Comment to Section 8-508 is illustrated as follows:

If security certificates in registered form are issued for the security, and individuals are eligible to have the security registered in their own name, the entitlement holder can request that the intermediary deliver or cause to be delivered to the entitlement holder a certificate registered in the name of the entitlement holder or a certificate indorsed in blank or specially indorsed to the entitlement holder. If security certificates in bearer form are issued for the security, the entitlement holder can request that the intermediary deliver or cause to be delivered a certificate in bearer form. If the security can be held by individuals directly in uncertificated form, the entitlement holder can request that the security be registered in its name. The specification of this duty does not determine the pricing terms of the agreement in which the duty arises.

U.C.C. § 8-508 cmt. 1.

181. U.C.C. § 8-508.

182. U.C.C. § 8-502.

183. U.C.C. § 8-502 cmt. 2.

184. Vaaler, *supra* note 4, at 307. The Official Comments to Section 8-502

More importantly, Section 8-510 specifies certain rules concerning the rights of purchasers who acquire an interest in a security entitlement from an entitlement holder.<sup>185</sup> In such cases, “the purchaser’s rights are derivative from the rights of another person who is and continues to be the entitlement holder.”<sup>186</sup> Subsection (a) provides that “an adverse claim to a financial asset . . . may not be asserted against a person who purchases a security entitlement . . . from an entitlement holder if the purchaser gives value, does not have notice of the adverse claim, and obtains control.”<sup>187</sup> In effect, Section 8-510 seeks to protect secured parties who obtain control but do not become entitlement holders.<sup>188</sup> To illustrate, suppose Bart steals a certificated bearer bond from Milhouse. Bart then delivers the certificate to Ralph & Co. (Ralph) for credit in his securities account and later grants Nelson’s bank a security interest in the security entitlement. When Bart deposits the bonds with Ralph, he acquires a securities entitlement in which he later grants Nelson a security interest. Under Subsection (a), if Nelson obtains control by virtue of an agreement with Ralph, Milhouse cannot assert an adverse claim against Nelson.<sup>189</sup> However, if Nelson perfected his security interest but did not obtain control, Milhouse may assert a claim against Nelson.<sup>190</sup>

In addition to the basic adverse claim limitations of Subsection (a), Subsection (b) applies a limited version of the “shelter principle” to the indirect holding system, providing that “[i]f an adverse claim could not have been asserted against an entitlement holder under Section 8-502, the adverse claim cannot be asserted against a person who purchases a security entitlement, or an interest therein, from the entitlement holder.”<sup>191</sup> Therefore, Subsection (b)

illustrate the impracticality of adverse claims in the indirect holding system as follows:

Suppose, for example, that S has a one thousand share position in XYZ common stock through an account with a broker, Able & Co. S’s identical twin impersonates S and directs Able to sell the securities. That same day, B places an order with Baker & Co., to buy one thousand shares of XYZ common stock. Later, S discovers the wrongful act and seeks to recover “her shares.” Even if S can show that, at the stage of the trade, her sell order was matched with B’s buy order, that would not suffice to show that “her shares” went to B. Settlement between Able and Baker occurs on a net basis for all trades in XYZ that day; indeed Able’s net position may have been such that it received rather than delivered shares in XYZ through the settlement system.

U.C.C. § 8-502 cmt. 2.

For further examples of the operation for section 8-502, see U.C.C. § 8-502 cmt.

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185. U.C.C. § 8-510 cmt. 1.

186. U.C.C. § 8-510 cmt. 1.

187. U.C.C. § 8-510(a).

188. U.C.C. § 8-510 cmt. 2.

189. U.C.C. § 8-510 cmt. 2.

190. U.C.C. § 8-510 cmt. 2.

191. U.C.C. § 8-510(b). See also U.C.C. § 8-510 cmt. 3.

provides the exclusive means of adverse claim cut-off only in a limited class of cases.<sup>192</sup>

## H. Revised Article 9

### 1. Introduction

Article 9 of the Uniform Commercial Code was amended along with Article 8 in order to specifically address security interests in “investment property”<sup>193</sup> under the indirect holding system. Section 9-115 sets out the principal rules, while Section 9-116 establishes some special provisions to help provide stability in the security settlement system.<sup>194</sup> Other revisions of Article 9 serve the purpose of excluding investment property from other types of collateral, including goods,<sup>195</sup> instruments,<sup>196</sup> and general intangibles.<sup>197</sup>

With respect to attachment, perfection, and priority of investment property, the idea of control plays a crucial role in defining the rights of purchasers, including secured parties, under the amendments to Article 9.<sup>198</sup> Basically, a secured party who obtains control of a security or other investment property has a perfected security interest in that property.<sup>199</sup> In perfecting a security interest by acquiring control, the secured party with control has priority over the security

192. See U.C.C. § 8-510 cmt. 3 (illustration of the limited circumstances in which the shelter principle will protect the purchaser of a security entitlement).

193. U.C.C. § 9-115(1)(f). Investment property is defined to include “(i) a security, whether certificated or uncertificated; (ii) a security entitlement; (iii) a securities account; (iv) a commodity contract; or (v) a commodity account.” *Id.* For a discussion of the definition of “investment property,” “security entitlement,” and “security account,” see Section II.D.3.4.

194. U.C.C. § 9-115 cmt. 1. See also U.C.C. § 9-116 cmt. 1.

195. U.C.C. § 9-105(1)(h) (“‘Goods’ includes all things which are movable at the time the security interest attaches or which are fixtures (Section 9-313), but does not include money, documents, instruments, investment property, commodity contracts, accounts, chattel paper, general intangibles, or minerals or the like (including oil and gas) before extraction.”).

196. U.C.C. § 9-105(1)(i) (“‘Instrument’ means a negotiable instrument (defined in Section 3-104), or any other writing which evidences a right to the payment of money and is not itself a security agreement or lease and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment. The term does not include investment property.”).

197. U.C.C. § 9-106 (“‘General Intangibles’ includes any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, investment property, rights to proceeds of written letters of credit, and money.”).

198. Vaaler, *supra* note 4, at 309.

199. Vaaler, *supra* note 4, at 309.

interest of a party who has not obtained control in that same property.<sup>200</sup> Furthermore, if multiple secured parties have control over the same financial asset, the separate security interests rank equally,<sup>201</sup> except that a security interest granted to the debtor's own intermediary has priority over any other security interest granted by the debtor to another secured party.<sup>202</sup> Thus, if the debtor's intermediary has acquired control over secured investment property, its security interest trumps all others. This merely is another type of purchase money priority designed to protect brokers who lend on the margin. Otherwise, all other controlling security interests rank equally and have priority over non-controlled security interests, regardless of the time the security interest was perfected and whether the secured party was aware of conflicting security interests.<sup>203</sup> Therefore, to understand the treatment of investment property under the revisions to Article 9, one must understand the concept of control.

## 2. Control

As defined in Section 8-106, obtaining control means that the secured party "has taken whatever steps are necessary, given the manner in which the securities are held, to place itself in a position where it can have the securities sold, without further action by the owner."<sup>204</sup>

### a. Obtaining Control of Certificated Securities

A purchaser has control of a certificated security in bearer form if the security is delivered<sup>205</sup> to the purchaser.<sup>206</sup> A purchaser has control of a certificated security in registered form when the purchaser: 1) takes delivery of a certificated security indorsed to the purchaser or in blank, or 2) takes delivery and becomes the registered holder of the certificated security on the books of the issuer.<sup>207</sup> Thus, the control concept encompasses both the traditional possessory pledge of certificated securities and arrangements by which the secured party becomes the actual registered holder and is entitled to exercise all rights of ownership.<sup>208</sup>

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200. U.C.C. § 9-115(5)(a).

201. U.C.C. § 9-115(5)(b).

202. U.C.C. § 9-115(5)(c).

203. U.C.C. § 9-115 cmt. 5. *See also* Vaaler, *supra* note 4, at 310.

204. U.C.C. § 8-106 cmt. 1.

205. U.C.C. § 8-301(a)(1)(2) provides that delivery of a certificated security occurs when the purchaser obtains possession of the security certificate, or when an agent for the purchaser, other than a securities intermediary, either acquires possession or acknowledges that the agent holds for the purchaser. *See also* U.C.C. § 8-106 cmt. 1.

206. U.C.C. § 8-106(a).

207. U.C.C. § 8-106(b)(1), (2).

208. Vaaler, *supra* note 4, at 310-11.

## b. Obtaining Control of Uncertificated Securities

A purchaser obtains control of an uncertificated security when: 1) the uncertificated security is delivered<sup>209</sup> to the purchaser, causing the purchaser to become the registered holder of the security on the records of the issuer, or 2) the issuer has agreed to act on the instructions of the purchaser, even though the owner remains listed as the registered holder.<sup>210</sup> Under the first method, so far as the issuer is concerned, the secured party becomes the registered owner and is entitled to exercise all rights of ownership.<sup>211</sup> However, as between the parties to the transaction, their contract determines allocation of ownership rights.<sup>212</sup> Under Revised Article 8, the registered pledge arrangements provided in the 1978 version are neither required nor prohibited.<sup>213</sup>

Under the second method, the issuer acts if it enters into an agreement without the consent of the registered owner;<sup>214</sup> however, the provision makes it possible for issuers to offer a service similar to the registered pledge provided pursuant to the 1978 version of Article 8.<sup>215</sup> Revised Article 8 contemplates a three-party agreement whereby the issuer promises to comply with the secured party's instruction without the further consent of or notice to the debtor or registered owner.<sup>216</sup> Because the key to the control concept is that the purchaser has the present ability to have the securities sold or transferred without further action by the owner, entering into a three-party agreement gives the secured party control even if the debtor-registered owner retains the right to make substitutions for the uncertificated security or security entitlement, to originate instructions or entitlement orders to the issuer or securities intermediary, or otherwise to deal with the uncertificated security or security entitlement.<sup>217</sup> The purchaser has the right to sell or transfer, and there is no requirement that the powers held by the purchaser be exclusive.<sup>218</sup> Subsection (f) makes clear the point of Subsection (c) that the test of control is not whether the debtor has retained certain powers, but instead whether the purchaser has acquired the requisite powers of control under Section 8-106.<sup>219</sup> Accordingly, there is no

209. U.C.C. § 8-301(b) provides that delivery of an uncertificated security occurs when the purchaser becomes the registered holder.

210. U.C.C. § 8-106(c).

211. U.C.C. § 8-106, cmt. 3.

212. U.C.C. § 8-106, cmt. 3.

213. Vaaler, *supra* note 4, at 311.

214. U.C.C. § 8-106, cmt. 3.

215. U.C.C. § 8-106, cmt. 3.

216. Vaaler, *supra* note 4, at 312.

217. U.C.C. § 8-106(f).

218. For example, in a secured lending arrangement, if the secured party wishes, it can allow the debtor to retain the right to make substitutions, or to direct the disposition of the uncertificated security, as provided in 8-106(f).

219. U.C.C. § 8-106 cmt. 7.

implication in Revised Article 8 that retention of power by the debtor is inconsistent with the purchaser having control.<sup>220</sup>

### c. Security Entitlements

A secured party has control of a security entitlement if “(1) the purchaser becomes the entitlement holder; or (2) the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder.”<sup>221</sup> Under the first mechanism, a secured party has control as an entitlement holder whether it holds through the same intermediary as the debtor or has the financial asset position credited to its account at another intermediary.<sup>222</sup> The second method provides that a purchaser has control if the securities intermediary has agreed to act on entitlement orders originated by the purchaser, contemplating “a three-party control agreement between the debtor-entitlement holder, the secured party, and the securities intermediary in which the intermediary promised to comply with entitlement orders originated by the secured party.”<sup>223</sup> As with uncertificated securities under Subsection (c), Subsection (d) specifies only the minimum requirements to vest control in the secured party, and the details of the arrangement may be specified by agreement.<sup>224</sup> The revisions do not require that the secured party have exclusive rights to originate entitlement orders; furthermore, the controlling party’s right to give entitlement orders need not be exclusive, and control may even be granted to more than one secured party by agreement.<sup>225</sup> Although three-party control agreements were standard practice for many intermediaries prior to Revised Article 8, securities intermediaries are not required to participate in such arrangements under the revisions.<sup>226</sup>

The following examples illustrate the rules of Subsection (d):

1. Homer (Debtor) grants Springfield Bank a security interest in one thousand shares of Smithers Corp. (Smithers) stock that Homer holds through an account with Burns & Co. (Burns). Springfield Bank also has an account with Smithers. Homer instructs Burns to transfer its shares of Smithers to Springfield Bank, and Burns does so. Springfield Bank has control of the one thousand shares under Subsection (d)(1), because Springfield is the entitlement holder.<sup>227</sup>

220. U.C.C. § 8-106 cmt. 7.

221. U.C.C. § 8-106(d).

222. U.C.C. § 8-106 cmt. 4. *See also* Vaaler, *supra* note 4, at 312-13.

223. *See* Vaaler, *supra* note 4, at 313. *See also* U.C.C. § 8-106 cmt. 4.

224. U.C.C. § 8-106 cmt. 4.

225. U.C.C. § 8-106 cmt. 4.

226. *See* U.C.C. § 8-106 cmt. 4.

227. U.C.C. § 8-106 cmt. 4.

2. Homer grants Springfield Bank a security interest in one thousand shares of Smithers Corp. stock that Homer holds through an account with Burns & Co. Homer, Burns, and Springfield enter into an agreement under which Homer will continue to receive dividends and distributions, and will continue to have the right to direct dispositions, but Springfield Bank also has the right to direct dispositions. Springfield Bank has control of the one thousand shares under Subsection (d)(2).<sup>228</sup>

3. Burns & Co., a securities dealer, holds a wide range of securities through its account at Moe's Clearing Corp. (Moe's). Burns enters into an arrangement with Springfield Bank pursuant to which Springfield provides financing to Burns, secured by securities identified as the collateral on lists provided by Burns to Springfield on a daily or other periodic basis. Burns, Springfield Bank, and Moe's Clearing Corporation enter into an agreement under which Moe's agrees that if at any time Springfield directs Moe's to do so, Moe's will transfer any securities from Burn's account at Springfield's instructions. Because Moe's has agreed to act on Springfield's instructions with respect to any securities carried in Burns's account, at the moment that Springfield's security interest attaches to securities listed by Burns, Springfield obtains control of those securities under Subsection (d)(2). There is no requirement that Moe's be informed of which securities Burns has pledged to Springfield.<sup>229</sup>

#### d. Securities Accounts

Just as a debtor may grant a security interest in a specific asset or entitlement, a debtor also may grant a security interest in all securities or security entitlements held in an account.<sup>230</sup> Referring to the collateral as the securities account is simply a method of describing all financial asset positions in an account.<sup>231</sup> As such, a security interest in a securities account vests all rights the debtor holds against the securities intermediary in the secured party. A secured party, therefore, obtains control of a securities account by controlling all the securities entitlements which comprise the account, or through a three-party control agreement, as with uncertificated securities and individual securities entitlements.<sup>232</sup>

228. U.C.C. § 8-106 cmt. 4.

229. U.C.C. § 8-106 cmt. 4.

230. U.C.C. § 9-115 cmt. 4.

231. U.C.C. § 9-115 cmt. 4.

232. U.C.C. § 9-115(1)(e). *See also* U.C.C. § 9-115 cmt. 4, which provides: [T]he rules in Section 8-106(d) on control with respect to security entitlements determine whether a secured party has control over a securities account. Control with respect to a securities account is defined in terms of obtaining control over the security entitlements simply for drafting convenience.



### 3. Creation and Attachment

Section 9-203 states the three basic prerequisites for the creation of a security interest: agreement, value, and collateral.<sup>233</sup> Unless the collateral is in the possession of the secured party or her agent, the agreement must be in writing.<sup>234</sup> Section 9-115 provides guidelines for the description of investment property collateral in a security agreement.<sup>235</sup> When all of the above elements are present, the security agreement between the parties “attaches” and the agreement becomes enforceable.<sup>236</sup> Absent a security agreement, a security interest may nonetheless be created if the secured party obtains control of the investment property.<sup>237</sup>

A few special rules governing creation and attachment of a security interest were adopted in the amendments to Article 9. Under Section 9-115(6), when a security certificate is delivered to a secured party pursuant to an agreement, delivery suffices for creation and perfection of the security interest.<sup>238</sup> A written security agreement is not required for enforceability of such an interest.<sup>239</sup> In addition, Section 9-116 establishes two rules of automatic attachment to provide

233. U.C.C. § 9-203(1)(a)-(c). Subsection (1)(a) further provides that:  
[A] security interest is not enforceable against the debtor or third parties with respect to the collateral and does not attach unless:

(a) the collateral is in the possession of the secured party pursuant to agreement, the collateral is investment property and the secured party has control pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral . . . .

234. U.C.C. § 9-203, cmt. 1. *See also* U.C.C. § 9-305 cmt. 2.

235. U.C.C. § 9-115(3) provides:

A description of collateral in a security agreement or financing statement is sufficient to create or perfect a security interest in a certificated security, uncertificated security, security entitlement, securities account, commodity contract, or commodity account whether it describes the collateral by those terms, or as investment property, or by description of the underlying security, financial asset, or commodity contract. A description of investment property collateral in a security agreement or financing statement is sufficient if it identifies the collateral by specific listing, by category, by quantity, by a computational or allocational formula or procedure, or by any other method, if the identity of the collateral is objectively determinable.

236. U.C.C. § 9-115(3). *See also* U.C.C. § 9-203(2), which provides, “A security interest attaches when it becomes enforceable against the debtor with respect to the collateral. Attachment occurs as soon as all of the events specified in Subsection (1) have taken place unless explicit agreement postpones the time of attaching.”

237. Vaaler, *supra* note 4, at 316-17. For a discussion of the methods by which control is obtained over various forms of investment property, *see supra* notes 204-232.

238. U.C.C. § 9-115(6).

239. U.C.C. § 9-115(6).

a measure of certainty in the securities settlement system.<sup>240</sup> Subsection (1) applies to the situation in which securities dealers allow customers to pay for securities by check.<sup>241</sup> If the intermediary credits the customer's securities account before actually receiving final payment, the customer will acquire a security entitlement prior to payment.<sup>242</sup> Thus, the intermediary has an automatically perfected security interest in the entitlement without an agreement or any other action. Under Subsection (2), if a certificated security or other financial asset represented by a writing is transferred by delivery<sup>243</sup> pursuant to an agreement calling for delivery instead of payment, the seller automatically perfects a security interest in the certificate or other financial asset.<sup>244</sup> Again, however, "[a] security agreement is not required for attachment or enforceability of the security interest . . . ."<sup>245</sup>

#### 4. Perfection

Under Revised Article 9, Section 9-115(4), a security interest in investment property may be perfected by 1) obtaining control or 2) by filing a financing statement if control has not been obtained.<sup>246</sup> However, because a secured party who obtains control has priority over a secured party without control, a secured party who perfects by filing takes the risk of holding an interest subordinate to one who has control of the security interest.<sup>247</sup> Nevertheless, filing will create priority over the much-feared bankruptcy trustee.

Any secured party with control has priority regardless of the time of filing or perfection by another, and without regard to whether the controlling secured party had knowledge of the filed financing statement.<sup>248</sup> As stated by Vaaler, "The revisions to Article 9 add filing as an alternative means of perfection, but it is not the preferred mechanism and is trumped in all cases by control."<sup>249</sup> Thus, control is the safest, most effective mechanism of perfecting a security interest.

240. U.C.C. § 9-116 cmt. 1.

241. U.C.C. § 9-116 cmt. 2.

242. U.C.C. § 9-116 cmt. 2.

243. See *supra* notes 205, 209 for definitions of delivery for certificated and uncertificated securities.

244. U.C.C. § 9-116(2).

245. U.C.C. § 9-116(2).

246. U.C.C. § 9-115(4). Prior to the adoption of Revised Article 8, certificated securities were instruments and could not be perfected by filing, and uncertificated securities were considered general intangibles and required filing for perfection. See *generally* the 1990 version of Article 9, Sections 9-105 and 9-106.

247. U.C.C. § 9-116 cmt. 4. For a discussion of the priority rules concerning secured interests, see Section II.H.5.

248. U.C.C. § 9-116 cmt. 5.

249. Vaaler, *supra* note 4, at 318.

Concerning security interests granted by securities intermediaries, Section 9-115 provides that “[i]f the debtor is a broker or securities intermediary, a security interest in investment property is perfected when it attaches.”<sup>250</sup> Furthermore, filing a financing statement has no effect on perfection or priority with respect to a security interest granted by a securities intermediary, meaning a non-control secured lender of a securities intermediary does not need to file.<sup>251</sup>

Other mechanisms exist by which secured firms can create secured financing arrangements. First of all, lenders may require a “hard pledge,” mandating that the debtor instruct the clearing corporation to transfer securities held by the debtor to either the lender’s account or a special pledge account.<sup>252</sup> Once in a special pledge account, the securities cannot be disposed of without the specific consent of the lender.<sup>253</sup> The hard pledge lender has control and has perfected a security interest.<sup>254</sup> In addition, the parties may enter into an “agreement to pledge,” also known as an “AP” arrangement, in which the debtor retains its securities position in its own account but promises to transfer to the secured party’s account on demand.<sup>255</sup> Under prior law, AP lenders<sup>256</sup> had a perfected security interest for twenty-one days without either filing or obtaining possession.<sup>257</sup> However, this meant that AP secured loans had to be rolled over for new value every twenty-one days to maintain a perfected interest, and the debtor’s securities could be subject to interests undiscoverable to a creditor upon examination of public records.<sup>258</sup> Subsection (4)(c) imposes no time limit for automatic perfection of an AP arrangement; thus, it is unnecessary to engage in the burdensome formality of rolling over loans.<sup>259</sup>

## 5. Priority

Section 9-115(5)(a) states the basic priority rule governing secured transactions: a secured party who obtains control has priority over a secured party who does not obtain control.<sup>260</sup> The priority rules in Subsections (5)(b) through (5)(e) deal with unusual circumstances not covered by the control

250. U.C.C. § 9-115(4)(c).

251. U.C.C. § 9-115(4)(c).

252. U.C.C. § 9-115 cmt. 6.

253. U.C.C. § 9-115 cmt. 6.

254. U.C.C. § 9-115 cmt. 6. *See also* Vaaler, *supra* note 4, at 319.

255. U.C.C. § 9-115 cmt. 6. *See also* Vaaler, *supra* note 4, at 319.

256. U.C.C. § 9-115 cmt. 6.

257. U.C.C. § 9-115 cmt 6.

258. U.C.C. § 9-115 cmt 6.

259. U.C.C. § 9-115 cmt 6.

260. U.C.C. § 9-115(5)(a). Subsection (5)(a) specifically provides that “[a] security interest of a secured party who has control over investment property has priority over a security interest of a secured party who does not have control over the investment property.”

priority rule.<sup>261</sup> “[C]onflicting security interests of secured parties each of whom has control rank equally,” regardless of when the secured party perfected its interest or whether such party was aware of the existence of another security interest with control.<sup>262</sup> Thus, secured parties with control have equal priority in most secured transactions. Subsection (5)(c) provides an exception by stipulating that “a security interest in a security entitlement or a securities account granted to the debtor’s own securities intermediary has priority over any security interest granted by the debtor to another secured party,” absent an agreement to the contrary by the securities intermediary.<sup>263</sup> The rule of Subsection (5)(c) is best illustrated by the following example:

Homer (Debtor) holds securities through a securities account with Smithers & Co. Homer’s agreement with Smithers provides that Smithers has a security interest in all securities carried in the account as security for any obligations of Homer to Smithers. Homer then borrows from Burns and grants Burns a security interest in one thousand shares of Nuclear Power Co. stock carried in the account with Smithers. Homer, Smithers, and Burns enter into an agreement under which Homer will continue to receive dividends and distributions and will continue to have the right to direct dispositions, but Burns will also have the right to direct dispositions and receive the proceeds. Suppose Homer incurs obligations to Smithers and later defaults on the obligations to both Smithers and Burns. Both have control, so the general control priority rule of Subsection (5)(a) does not apply. However, because Subsection (5)(c) provides that a security interest held by a securities intermediary in positions of its own customers has

261. See U.C.C. § 9-115 cmt. 5.

262. U.C.C. § 9-115(5)(b). See also U.C.C. § 9-115 cmt. 5, which further provides: The control priority rule does not turn on either temporal sequence or awareness of conflicting security interests. Rather, it is a structural rule, based on the principle that a lender should be able to rely on the collateral without question if the lender has taken the necessary steps to assure itself that it is in a position where it can foreclose on the collateral without further action by the debtor. The control priority rule is necessary because the perfection rules provide considerable flexibility in structuring secured financing arrangements.

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[A] lender who wants to be entirely sure of its position will want to obtain control. The control priority rule of Subsection (5)(a) is an essential part of this system of flexibility. It is feasible to provide more than one method of perfecting secured transactions only if the rules ensure that those who take the necessary steps to obtain the full measure of protection do not run the risk of subordination to those who have not taken such steps. A secured party who is unwilling to run the risk that the debtor has granted or will grant a conflicting security interest should not make a loan without obtaining control of the collateral.

263. U.C.C. § 9-115(5)(d).

priority over a conflicting security interest of an external lender, Smithers has priority over Burns. The agreement between Homer, Smithers, and Burns could determine the relative priority of secured interests, but the mere fact that an intermediary (Smithers) has agreed to act on the instructions of a secured party (Burns) does not itself imply any agreement by the intermediary to subordinate its interest to the secured party's claim.<sup>264</sup> Rather, the external secured lender with control must negotiate a subordination provision with the intermediary in order to have equal or higher priority on the debtor's collateral.

Under section 9-115(6), if a security interest in registered form is delivered pursuant to an agreement, delivery of the certificate suffices for perfection of the security interest, which has priority over a conflicting security interest perfected by any means other than control.<sup>265</sup> An interest under Subsection (6) is created for the benefit of a secured party in possession of a security certificate without the necessary endorsements.<sup>266</sup> In addition, conflicting security interests granted by a securities intermediary perfected without control under Section 9-115(4)(c)<sup>267</sup> rank equally among themselves, but are subordinate to a conflicting security interest with control.<sup>268</sup>

Conflicting security interests in all other cases, primarily those perfected by filing, are governed by Section 9-312(5), (6), and (7).<sup>269</sup> The general priority rules of Section 9-312 apply to those situations not provided for in Subsection (5).<sup>270</sup> Security interests under Subsection (f) are governed by the normal rules of temporal sequence, wherein the first secured party to perfect by filing has priority over all subsequent filings.<sup>271</sup> The control priority rule is designed to ensure that secured parties who obtain control are unaffected by filings, rather than assuming that parties who secure control by the usual mechanisms will

264. See U.C.C. § 9-115 cmt. 5, ex. 5.

265. U.C.C. § 9-115(6).

266. See Vaaler, *supra* note 4, at 320.

267. See *supra* notes 250-59 and accompanying text. No perfected, non-control security interests granted by a securities intermediary exist other than those automatically perfected under section 9-115(4)(c).

268. U.C.C. § 9-115(5)(e).

269. U.C.C. § 9-115(f).

270. U.C.C. § 9-115(f). Section 9-312 applies primarily to purchase money security interests in crops and other inventories. Thus, as stated by Vaaler, *supra* note 4, at 321:

The special priority in Section 9-312(4) for purchase money security interests in other types of collateral is inapplicable to investment property because the basic control priority rule in Section 9-115(5) already gives primacy to intermediaries in the ordinary cases in which investment property is purchased on margin or other credit.

271. See Vaaler, *supra* note 4, at 321.

search the files for other perfected interests.<sup>272</sup> Thus, a security interest perfected by filing can be trumped by a control secured interest, without regard to awareness by either party or the time for filing or attaining control.<sup>273</sup> For example, suppose Homer (Debtor) borrows from Smithers and grants Smithers a security interest in a variety of collateral, including all of Homer's investment property. At that time Homer owns one thousand shares of Nuclear Destruction Co. stock for which Homer has a certificate. Smithers perfects by filing. Later, Homer borrows from Burns and grants Burns a security interest in the one thousand shares of Nuclear Destruction. Homer delivers the certificate to Burns, properly indorsed. Both Smithers and Burns have perfected security interests in the stock. However, Burns has control under Section 8-106(b)(1), and therefore has priority over Smithers.<sup>274</sup> The result is the same if Homer, Burns, and the intermediary through which Homer holds his stock enter into an agreement whereby Burns attains the right to direct dispositions and receive the proceeds of Nuclear Destruction stock. Burns again has control, through Section 8-106(d)(2), and because Smithers perfected by filing, Burns has priority over Smithers to the investment collateral.<sup>275</sup>

The control priority rule is simply a consequence of the perfection and priority rules for investment property of Revised Articles 8 and 9 which are designed to take account of circumstances in the securities markets, where filing is not given the same effect as for some other forms of investment property.<sup>276</sup>

### III. REVISED ARTICLE 5

#### A. Introduction

The original Article 5 was written more than forty years ago primarily for paper transactions, and before many innovations in letters of credit.<sup>277</sup> It did not allow letters of credit to evolve in the marketplace and ignored the Uniform Customs and Practice for Documentary Credits (UCP), although bankers routinely used the UCP both internationally and domestically.<sup>278</sup> Because of the discrepancies between the UCC and the UCP,<sup>279</sup> many bankers and lawyers

272. See U.C.C. § 9-115 cmt. 5.

273. U.C.C. § 9-115 cmt. 5.

274. See U.C.C. § 9-115 cmt. 5, ex. 1.

275. See U.C.C. § 9-115 cmt. 5, ex.1.

276. See U.C.C. § 9-115 cmt. 5, ex.1.

277. Prefatory Note 5, *supra* note 1.

278. James G. Barnes & James E. Byrne, *Revision of U.C.C. Article 5*, 50 BUS. LAW. 1449, 1449-50 (1995). This article provides an excellent background of the law regulating letters of credit.

279. For the last 30 to 40 years, U.S. bankers and customers have generally used U.C.P. terminology, and asked "what is the practice" when faced with a tough question, however, U.S. lawyers have generally used U.C.C. terminology, and asked "what will

(especially internationally) have relied primarily on the general customs and practices of letters of credit as reflected in the current version of the UCP.<sup>280</sup>

The use of letters of credit has increased significantly in recent years.<sup>281</sup> Currently, more than \$500 billion of standby letters of credit are issued annually throughout the world, of which \$250 billion are issued in the United States.<sup>282</sup> In addition, electronic and other media have assisted in this dramatic increase in letters of credit.<sup>283</sup> In light of prior Article 5 and the significant increase in letters of credit, an ABA task force stated that "almost forty years of hard use have revealed weaknesses, gaps, and errors in the original statute which compromise [Article 5's] relevance."<sup>284</sup>

In light of the weaknesses of prior Article 5, the UCC drafting committee had these goals in mind prior to drafting: conforming the Article 5 rules to current customs and practices, accommodating market changes,<sup>285</sup> maintaining letters of credit as an inexpensive and efficient instrument facilitating trade, and resolving conflicts among reported decisions.<sup>286</sup>

### B. Definitions

There are generally three parties to a letter of credit transaction. As an example, assume that a Missouri corporation named Wiggins Widgets is negotiating the sale of 10,000 Widgets to a Brazilian corporation named Henning's Wholesalers. If Wiggins Widgets has never dealt with the Brazilian Wholesaler, then Wiggins might be concerned about the prospects of being paid once his widgets leave the country. Thus, a possibly lucrative deal between two viable merchants might not materialize. The letter of credit will facilitate this type of transaction. Wiggins Widgets will require that Henning's Wholesalers secure a third party, usually a bank, to ensure payment. The third party will post a letter of credit. In the letter of credit, the bank promises to pay Wiggins Widgets upon a set of conditions enumerated in the letter of credit document.<sup>287</sup> The person (Henning's Wholesalers) at whose request or for whose account the

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the courts say" when faced with a tough question. *Id.* U.S. courts outside of New York have generally applied U.C.C. provisions in place of conflicting U.C.P. provisions. *Id.* (citing James G. Barnes, *Nonconforming Presentations Under Letters of Credit: Preclusion and Final Payment*, 56 BROOK. L. REV. 103 (1990)).

280. Prefatory Note 5, *supra* note 1.

281. Prefatory Note 5, *supra* note 1.

282. Prefatory Note 5, *supra* note 1.

283. Prefatory Note 5, *supra* note 1.

284. Prefatory Note 5, *supra* note 1.

285. Prefatory Note 5, *supra* note 1.

286. Prefatory Note 5, *supra* note 1.

287. These conditions usually include some form of documentation that is prepared once the goods are received by the buyer. Prefatory Note 5, *supra* note 1.

letter of credit is issued is termed the “applicant.”<sup>288</sup> The person (Wiggins Widgets) to whom drawing rights have been transferred is termed the “beneficiary.”<sup>289</sup> The bank or third party that issues the letter of credit is termed the “issuer.”<sup>290</sup>

While this example outlines the traditional letter of credit, there are numerous types and formats of letters of credit,<sup>291</sup> all of which Article 5 regulates. The scope of Article 5 applies “to letters of credit and to certain rights and obligations arising out of transactions involving letters of credit.”<sup>292</sup> While the scope of Article 5 is very broad, the parties in most circumstances may alter the terms of the agreement.<sup>293</sup> Thus, the parties are free to adopt portions of the UCP where the UCC allows. If the parties expressly reject the UCP, it does not apply.<sup>294</sup>

In addition, Revised Article 5 authorizes the use of electronic technology,<sup>295</sup> deferred payment letters of credit,<sup>296</sup> and two-party letters of credit.<sup>297</sup> These rules were not promulgated to create new rules for letters of credit, but were created to clarify existing rules.<sup>298</sup>

### C. *The Independence Principle*

The independence principle represents one of the foundations of the letter of credit. The independence principle is a doctrine that states that the issuer of the letter of credit must honor the credit regardless of whether the underlying contract was performed.<sup>299</sup> The independence principle is continued in the

288. U.C.C. § 5-102(a)(2).

289. U.C.C. § 5-102(a)(3).

290. U.C.C. § 5-102(a)(9).

291. *See generally* John M. Czarnetzky, *Modernizing Commercial Financing Practices: The Revisions to Article 5 of the Mississippi UCC*, 66 MISS. L.J. 325, 334 (1996). Examples include commercial letters of credit, standby letters of credit, red clause letters of credit, revolving letters of credit, back-to-back letters of credit, and two-party letters of credit. *Id.*

292. U.C.C. § 5-103(a).

293. U.C.C. § 5-103(c).

294. U.C.P. 500 § 1 (1993). *See generally* Katherine A. Barski, *An Analysis of the Recent Revision to Article Five of the Uniform Commercial Code: Letters of Credit*, 101 COM. L.J. 177, 179 (1996) (discussion of the impact between the U.C.P. and Revised Article 5 of the U.C.C.).

295. Prefatory Note 5, *supra* note 1. *See* U.C.C. §§ 5-102(a)(14), 5-104.

296. Prefatory Note 5, *supra* note 1. *See* U.C.C. § 5-102(a)(8).

297. Prefatory Note 5, *supra* note 1. *See* U.C.C. § 5-102(a)(10).

298. Prefatory Note 5, *supra* note 1. The promulgation of these rules helps to accomplish the drafting committee’s goal of providing uniformity to Article 5.

299. Czarnetzky, *supra* note 291, at 339 (citing JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* 702, 703 (4th ed. 1995)) (“The key to the



Article 5 revision.<sup>300</sup> The drafters of Article 5 note that the independence principle should be strictly construed to give letters of credit continuing vitality in terms of certainty and speed of payment.<sup>301</sup>

#### D. Benefits of Revised Article 5

In the Prefatory Note to Revised Article 5, the changes to Article 5 are divided into separate benefits to issuers, applicants and beneficiaries. The remainder of this Law Summary will outline the specific changes to Article 5 and explain why they benefit a specific party to a letter of credit transaction.

### 1. Benefits of Revised Article 5 to Issuers

#### a. Consequential Damages

The greatest benefit of Revised Article 5 to issuers is Section 5-111, which precludes consequential and punitive damages. However, this section provides strong incentives to issuers to honor their obligations, such as attorney's fees and expenses of litigation,<sup>302</sup> interest and specific performance.<sup>303</sup> Consequential and punitive damages were precluded to prevent "rais[ing] the cost of the letter of credit to a level that might render it uneconomic."<sup>304</sup>

#### b. Statute of Limitations<sup>305</sup>

Section 5-115 states that an action must be commenced under Article 5 within one year after the expiration date of the relevant letter or one year after

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uniqueness of the letter of credit and to its commercial vitality is that the promise by the issuer is independent of any underlying contracts.").

300. U.C.C. § 5-103(d) states:

Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.

301. U.C.C. § 5-103 cmt 1.

302. For an examination of the compromise between the ALI and NCCUSL leading to this provision, see Barski, *supra* note 204, at 185-6.

303. Prefatory Note 5, *supra* note 1.

304. U.C.C. § 5-111 cmt. 4.

305. See generally Dellas W. Lee, *Letters of Credit: What Does Revised Article 5 Have to Offer Issuers, Applicants, and Beneficiaries?*, 101 COM. L.J. 234, 246 (1996).

the claim for relief accrues.<sup>306</sup> This rule is fair to potential plaintiffs because it is usually clear to all parties when a breach has occurred.<sup>307</sup>

c. Choice of Law

The choice of law and forum may be chosen by the parties and must be disclosed in the letter of credit if different from the jurisdiction in which the parties are located.<sup>308</sup> The choice of law or forum does not need to bear any relation to the transaction.<sup>309</sup>

d. Assignment of Proceeds<sup>310</sup>

Section 5-114 provides a specific procedure for assigning proceeds of a letter of credit.<sup>311</sup> This section of Revised Article 5 now conforms with existing practices and international law.<sup>312</sup> It is important to note that the priorities of the assignee's rights and the assignor's rights to enforce an assignment of proceeds against an issuer are governed by Article 5.<sup>313</sup>

e. Subrogation

The original Article 5 did not codify subrogation rights. Revised Article 5 does not create new subrogation rights, but "does no more than to remove an impediment that some courts have found to subrogate because they conclude that the issuer's or other claimant's rights are 'independent' of the underlying obligation."<sup>314</sup> To preserve the sanctity of the independence principle, only one who has completed performance in a letter of credit transaction is entitled to subrogation under Revised Article 5.<sup>315</sup>

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306. U.C.C. § 5-115.

307. Prefatory Note 5, *supra* note 1.

308. U.C.C. § 5-116.

309. U.C.C. § 5-116(a).

310. *See generally* Edwin E. Smith & James J. White, *Letters of Credit: Highlights of Revised Article 5*, SB29 ALI-ABA 57, 65-7 (1996).

311. Prefatory Note 5, *supra* note 1.

312. U.C.C. § 5-114 cmt. 3.

313. U.C.C. § 5-114 cmt. 2.

314. U.C.C. § 5-117 cmt. 1. This section endorses the position in *Tudor Dev. Group, Inc. v. United States Fidelity & Guar.*, 968 F.2d 357 (Cir. 1991).

315. U.C.C. § 5-117 cmt. 2. *See generally* Robert J. Graves & John T. Perugini, *Maintaining the Commercial Vitality of Letters of Credit: Revised Illinois UCC Article 5*, 85 ILL. B.J. 220, 224 (1997).

## 2. Benefits of Revised Article 5 to Applicants

### a. Warranties

Revised Section 5-110 outlines the warranties made by a beneficiary.<sup>316</sup> These warranties are premised upon an honored letter of credit. No breach of warranty under this Subsection can be a defense to dishonor by the issuer, because the warranties are not given unless the letter of credit has been honored. The warranty does not run to the issuer, it only runs to the applicant.<sup>317</sup> The damages for breach of warranty are not specified under Article 5, but courts can find analogous damage provisions in Articles 2, 3, and 4.<sup>318</sup> Section 5-110 allows the applicant of a letter of credit a direct cause of action if a drawing is fraudulent, forged, or if the drawing violates any agreement under the letter of credit.<sup>319</sup>

### b. Strict Compliance

Under Section 5-108, the issuer must dishonor a presentation that does not strictly comply under standard practice with the terms and conditions of the letter of credit, absent agreement by the parties.<sup>320</sup> The strict compliance doctrine requires that the documents (on their face) strictly comply and that other terms of the letter of credit such as time and presentation are also strictly complied with.<sup>321</sup> Strict compliance does not mean "slavish conformity" to the terms of the letter of credit, but allows standard practice as a way of measuring strict compliance.<sup>322</sup> As the courts move away from slavish conformity to the language in the letter of credit, the number of lawsuits to determine the parameters of strict compliance will increase significantly. This is especially true where strict compliance is measured against the incredibly subjective "standard practice."

316. Prefatory Note 5, *supra* note 1.

317. U.C.C. § 5-110 cmt. 2.

318. U.C.C. § 5-110 cmt. 3.

319. Prefatory Note 5, *supra* note 1.

320. Prefatory Note 5, *supra* note 1.

321. U.C.C. § 5-108 cmt. 1.

322. U.C.C. § 5-108 cmt. 1. The drafters adopted the conclusion of the court in *New Braunfels National Bank v. Odiorne*, 780 S.W.2d 313 (Tex. Ct. App. 1989), where the court allowed the beneficiary to collect when draft requested payment on "Letter of Credit No. 86-122-5" and the letter of credit specified "Letter of Credit No. 86-122-S." The court held that strict compliance does not demand oppressive perfectionism. This Section also endorses the result in *Tosco Corp. v. Federal Deposit Insurance Corp.*, 723 F.2d 1242 (6th Cir. 1983).

### c. Subrogation

As discussed in Section D.1.e. of this Part, the codified procedure of subrogation outlined in Section 5-117 is also a benefit to applicants of letters of credit.

### d. Limitations on General Disclaimers and Waivers

Section 5-103 allows the parties to vary the effect of Article 5 by agreement or by a provision stated or incorporated by reference in an undertaking.<sup>323</sup> In addition, this section limits the effect of general disclaimers and waivers in a letter of credit, reimbursement or other agreement.<sup>324</sup> This limitation is based more on procedural than on substantive unfairness.<sup>325</sup> The limitation only requires that disclaimers and changes in liability be sufficiently clear and explicit in reallocating liability.<sup>326</sup>

## 3. Benefits of Revised Article 5 to Beneficiaries

### a. Irrevocability

Revised Section 5-106(a) provides that a letter of credit is irrevocable unless the language in the letter provides that it is revocable.<sup>327</sup> "Given the usual commercial understanding and purpose of letters of credit, revocable letters of credit offer unhappy possibilities for misleading the parties who deal with them."<sup>328</sup>

### b. Preclusion

Section 5-108(c) provides that an issuer is precluded from asserting, as a basis for dishonor, any discrepancy if timely notice is not given, or any discrepancy not stated in the notice if timely notice is given except for fraud, forgery or expiration.<sup>329</sup> This section substitutes a strict preclusion principle for the doctrines of waiver and estoppel that might otherwise apply under Section

323. U.C.C. § 5-103(c).

324. Prefatory Note 5, *supra* note 1.

325. U.C.C. § 5-103 cmt. 2.

326. U.C.C. § 5-103 cmt. 2.

327. This section takes the position adopted by several courts. *See* *Weyerhaeuser Co. v. First Nat'l Bank*, No. 78-34-W, 1979 WL 30093 (S.D. Iowa Sept. 19, 1979); *West Virginia Housing Development Fund v. Sroka*, 415 F. Supp. 1107 (W.D. Pa. 1976). This is also the position of the current UCP. U.C.C. § 5-106 cmt. 1.

328. U.C.C. § 5-106 cmt. 1.

329. U.C.C. § 5-108(c).

1-103.<sup>330</sup> This doctrine is taken from a similar provision in the UCP<sup>331</sup> and is intended to promote certainty and finality.<sup>332</sup>

#### c. Timely Examination

Section 5-108(b) provides that an issuer has a reasonable time after presentation, but not beyond the end of the seventh business day after the issuer receives the documents, to honor or provide notice of discrepancies.<sup>333</sup> This provision prevents an issuer from sitting on the letter of credit and allows a beneficiary the opportunity to cure any discrepancies.<sup>334</sup>

#### d. Transfers by Operation of Law

New Section 5-113 allows a successor of a beneficiary to present documents and receive payments in the name of the beneficiary without disclosing its status as a successor.<sup>335</sup> The issuer is entitled to rely on the documents which purport to demonstrate that presentation is made by a successor of a beneficiary.<sup>336</sup> Therefore, the issuer is not obligated to make an independent investigation to determine the fact of succession.<sup>337</sup>

#### e. Damages

The damages provided by Revised Article 5 are expanded and clarified.<sup>338</sup> These include reasonable attorney's fees and expenses of litigation to the prevailing party.<sup>339</sup> In addition, the prevailing party is entitled to the full amount of the wrongfully dishonored letter of credit plus interest without an obligation to mitigate damages.<sup>340</sup>

330. U.C.C. § 5-108(c).

331. See generally Banco Gen. Runinahui v. Citibank Inter., 97 F.3d 480, 486 (11th Cir. 1996).

332. U.C.C. § 5-108 cmt. 3.

333. U.C.C. § 5-108(b).

334. U.C.C. § 5-108 cmt. 4. This rule follows the holding in *Datapoint Corp. v. M & I Bank*, 665 F. Supp 722 (W.D. Wis. 1987), and *Esso Petroleum Canada, Division of Imperial Oil, Ltd. v. Security Pacific Bank*, 710 F. Supp. 275 (D. Or. 1989).

335. U.C.C. § 5-113. This section follows the holding in *Paster v. National Republic Bank*, 76 Ill.2d 139, 390 N.E.2d 894 (Ill. 1979) and *Federal Deposit Insurance Co. v. Bank of Boulder*, 911 F.2d 1466 (10th Cir. 1990). See also U.C.C. § 5-114 cmt..

336. U.C.C. § 5-113 cmt..

337. U.C.C. § 5-113 cmt..

338. Prefatory Note 5, *supra* note 1. See *supra* Part III.D.1.

339. U.C.C. § 5-111(e).

340. U.C.C. § 5-111.

#### IV. CONCLUSION

The revisions to Articles 5 and 8 are welcome additions to Missouri law, as they are a significant improvement over the prior version. Investors, intermediaries, and issuers all benefit from a system of securities regulation which not only conforms with commercial reality, but also provides sufficient flexibility for future adaptation to a changing marketplace. Prior to these revisions, Articles 5 and 8 did not accurately track the evolution and current practice of the market. The drafters did not make drastic substantive changes. Their goal was to promote uniformity of current practices and analogous laws, while creating a legal framework capable of evolving with market changes. Only time will tell whether the drafters have achieved their goals. While these revisions are not perfect and litigation will be necessary to clarify some issues, Revised Articles 5 and 8 are integral to the continuing vitality of the UCC in Missouri.

The general framework of these articles will allow Missouri's customs and practices to evolve with domestic and international market changes. While these revisions do not make drastic substantive changes, Missouri judges and practitioners should be aware of the subtle impact of these revisions in deciding cases and advising clients. We encourage Missouri courts to interpret these revisions in a manner that provides uniformity for Missouri practitioners in national and international transactions.

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