

Winter 1987

A Critical Look at Secured Transactions Under Revised UCC Article 8

Paul B. Rasor

Washburn University School of Law

Follow this and additional works at: <http://ir.law.fsu.edu/lr>



Part of the [Secured Transactions Commons](#)

Recommended Citation

Paul B. Rasor, *A Critical Look at Secured Transactions Under Revised UCC Article 8*, 14 Fla. St. U. L. Rev. 859 (2017).
<http://ir.law.fsu.edu/lr/vol14/iss4/2>

This Article is brought to you for free and open access by Scholarship Repository. It has been accepted for inclusion in Florida State University Law Review by an authorized editor of Scholarship Repository. For more information, please contact bkaplan@law.fsu.edu.

A CRITICAL LOOK AT SECURED TRANSACTIONS UNDER REVISED UCC ARTICLE 8

PAUL B. RASOR*

In 1978, the Uniform Commercial Code underwent a major revision in its treatment of security interests in investment securities. As an outgrowth of the blizzard of paper generated on Wall Street during the 1960's, the Code was revised to authorize certificateless securities. In this Article, Professor Rasor examines the history behind the 1978 revision and analyzes the rules as they relate to security interests in certificated and uncertificated securities. Although he criticizes the one pledge rule for uncertificated securities and other aspects of the revision, he concludes that the changes are generally a welcome reform that will ease commerce.

Over half of the jurisdictions have adopted the 1978 Official Text of the Uniform Commercial Code (UCC), and most of the others will no doubt soon follow.¹ The 1978 Official Text completely revises article 8 of the UCC on investment securities. These revisions establish, for the first time, a legal framework governing the rights and duties of issuers and others who deal with uncertificated securities. The revisions also address secured transactions,

* Professor of Law, Washburn University; Visiting Professor of Law, 1986-1987, University of Texas at Austin. B. Mus., 1968, University of Michigan; J.D., 1972, University of Michigan.

1. Jurisdictions that have adopted the 1978 revision are **Arkansas**: ARK. STAT. ANN. §§ 85-1-101 to 9-507 (1985); **California**: CAL. COM. CODE §§ 1101-12104 (West 1986); **Colorado**: COLO. REV. STAT. §§ 4-1-101 to 11-102 (1986); **Connecticut**: CONN. GEN. STAT. ANN. §§ 42a-1-101 to 10-109 (West 1986); **Delaware**: DEL. CODE ANN. tit. 6, §§ 1-101 to 10-104 (1984); **Idaho**: IDAHO CODE §§ 28-1-101 to 10-104 (1986); **Kansas**: KAN. STAT. ANN. §§ 84-1-101 to 10-102 (Supp. 1986); **Kentucky**: KY. REV. STAT. ANN. §§ 355.1-101-11-108 (Baldwin 1987); **Massachusetts**: MASS. GEN. LAWS ANN. ch. 106, §§ 1-101 to 9-507 (West 1986); **Minnesota**: MINN. STAT. ANN. §§ 336.1-101 to 11-108 (West 1987); **Montana**: MONT. CODE ANN. §§ 30-1-101 to 9-511 (1986); **Nevada**: NEV. REV. STAT. § 104.1101-9507 (1985); **New York**: N.Y. U.C.C. §§ 1-101 to 13-105 (McKinney 1987); **North Dakota**: N.D. CENT. CODE. §§ 41-01-02 to 09-53 (1986); **Ohio**: OHIO REV. CODE ANN. §§ 1301.01-1309.50 (Baldwin 1985); **Oklahoma**: OKLA. STAT. ANN. tit. 12A, §§ 1-1-1 to 11-107 (West 1986); **Oregon**: OR. REV. STAT. §§ 71.1010-79.6010 (1985); **South Dakota**: S.D. CODIFIED LAWS ANN. §§ 57A-1-101 to 11-108 (Supp. 1985); **Tennessee**: TENN. CODE ANN. §§ 47-1-101 to 84-10-102 (1986); **Texas**: TEX. BUS. & COM. CODE ANN. §§ 1.101-11.108 (Vernon 1985); **Virginia**: VA. CODE §§ 8.1-101 to 11-108 (Supp. 1986); **Washington**: WASH. REV. CODE ANN. § 62A.8-102 (1987); **West Virginia**: W. VA. CODE §§ 46-1-101 to 11-108 (1985); **Wisconsin**: WIS. STAT. ANN. §§ 401.101-409.507 (West 1985); **Wyoming**: WYO. STAT. §§ 34-21-101 to -1002 (1985). In addition, Maine has adopted portions of revised article 8. ME. REV. STAT. ANN. tit. 11, §§ 1-101 to 10-108 (Supp. 1986).

prescribing detailed procedures for obtaining and perfecting security interests in uncertificated securities. Adjustments in the law affecting security interests in traditional certificated securities are also made.

This Article has two purposes. The first is to present two fundamental dilemmas which the 1978 Code drafters confronted and to offer a critical evaluation of the choices they made. The second is to provide a detailed analysis and critical assessment of the new rules for security interests both for certificated and uncertificated investment securities which grew out of these choices.

I. BACKGROUND

The extension of article 8 to uncertified shareholder interests did not have anything to do with the problems of secured lenders. Instead, it grew out of the so-called "paperwork crunch" which came to a head in the late 1960's in the securities industry.² The growth in volume of stock trading had dramatically increased paper use. Calls for reform, both of the legal system and the industry, were heard regularly.³

A. *Industry Developments*

Legal reforms normally follow, not precede, changes in technology or business practices, and so it was in the securities industry. By the time any legal reforms appeared, the industry was well on its way to digging out from under the paper avalanche. Several devices were developed which permitted the handling of at least some securities transactions without paper. Perhaps the most basic example is the street name brokerage account. In a street name account, stock is registered in the name of the broker, who holds the certificate as the agent of an undisclosed principal, the shareholder.⁴ When a broker holds the certificate, one step in the paper flow is eliminated because the broker does not have to send the shareholder a certificate. In those rare cases where one customer buys and another sells the same security, more paperwork is elimi-

2. See generally Guttman, *Toward the Uncertificated Security: A Congressional Lead for the States to Follow*, 37 WASH. & LEE L. REV. 717 (1980).

3. See, e.g., Jolls, *Can We Do Without Stock Certificates? A Look At the Future*, 23 BUS. LAW. 909 (1968); Smith, *A Piece of Paper*, 25 BUS. LAW. 923 (1970).

4. Securities accounts held for customers by the trust departments of banks and other financial institutions are the functional equivalent. See C. ISRAELS & E. GUTTMAN, *MODERN SECURITIES TRANSFERS* § 3.09 (rev. ed. 1971).

nated because the transfer can be accomplished simply by a notation on the broker's books.⁵

The central depository system, or "clearing corporation,"⁶ permits even more paperless transactions. A central depository, like a broker, holds stock certificates in its name and acts as agent of its customers, who are usually called "participants."⁷ In central depository systems transactions between participants are the norm.⁸ These transactions are made through "appropriate entries on the books of [the] clearing corporation"⁹ rather than through physical transfer of the certificates.

A similar book-entry system is used for certain transactions in federal securities. For example, many United States Treasury securities are now issued in nonpaper form.¹⁰ Transfers and other transactions are simply recorded in accounts maintained by a Federal Reserve bank.¹¹

Other common investment devices which normally operate without certificates include mutual funds and dividend reinvestment plans. In a typical mutual fund, investors buy and sell (redeem) shares directly from the issuer or the issuer's transfer agent. Fund shareholders are entitled to have certificates, but few of them bother, presumably because transfers to third parties are rare and certificates therefore have little use.¹² In dividend reinvestment plans, cash dividends are automatically reinvested by the purchase of additional shares from the issuer. Normally, certificates are not

5. U.C.C. § 8-313(1)(d) (1978); see also Aronstein, *A Certificateless Article 8? We Can Have It Both Ways*, 31 Bus. Law. 727, 729 (1976).

6. Under U.C.C. § 8-102(3) (1978), the basic definition of "clearing corporation" is "a corporation registered as a 'clearing agency' under the federal securities laws." A "clearing agency" is defined as "any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities . . . or [who] acts as custodian of securities in connection with a system for the central handling of securities whereby [they] . . . may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates." 15 U.S.C. § 78c(23)(A) (1982). See also *id.* § 78q-1(b) (creating a national system for clearing and settling securities transactions).

7. Aronstein, *supra* note 5, at 729.

8. *Id.*; M. RHODES, *TRANSFER OF STOCK* § 4:7 (6th ed. 1985).

9. U.C.C. § 8-320 (1978). This section was added to the UCC in 1962 specifically to permit these sorts of transactions. See *id.* comment 1.

10. See *Book Entry Procedure*, 31 C.F.R. §§ 306.115-122 (1986). For a thorough discussion of the federal role in developing uncertificated securities, see Guttman, *supra* note 2.

11. 31 C.F.R. § 306.118 (1986).

12. Aronstein, *supra* note 5, at 730; Aronstein, *Security Interests in Securities: How Code Revision Reflects Modern Security-Holding Practices*, 10 U.C.C. L.J. 289, 292 (1978).

issued. Instead, shareholders receive statements reflecting the amount reinvested and the number of shares acquired.¹³

These paper-reducing systems are based on agency principles. In both the street name brokerage account and the central depository, a third party holds the certificate as agent of the customer. In mutual funds, dividend reinvestment plans, and the federal securities system the issuer or his transfer agent acts as the shareholder's agent. Extending this idea leads naturally to a de facto certificateless system. For example, unless a shareholder expressly requested a certificate, shares could be held in uncertificated form by the issuer and transferred to third parties merely by making book entries. A system like this, known as the Transfer Agent Depository, already exists.¹⁴

These systems demonstrate the trend toward uncertificated systems. But while these systems reduce the paper flow in many securities transactions, they nevertheless operate on the assumption that a certificate exists or can be produced on demand. As a result, these systems are often referred to as paper-"immobilizing" rather than paperless.¹⁵ As one authority noted, "It is easier to achieve the immobilization of the certificated security than to attain its elimination."¹⁶

Moreover, the law of agency seems too fragile a foundation to support a truly certificateless system. This is especially true for secured transactions, which, at least with investment securities, have always proceeded on the assumption that there was ultimately something tangible which could be pledged. As one observer has noted, "While the agency-bailment rationale . . . may satisfy a law professor or even a judge, it does not respond to the questions which the prudent businessman or his counsel needs to have answered before he can proceed with confidence."¹⁷ As a result, a truly certificateless system was unlikely to appear without a change in the underlying legal framework. With revised article 8 that change finally came.

13. Aronstein, *supra* note 12, at 293.

14. See Aronstein, *supra* note 5, at 730-32; C. ISRAELS & E. GUTTMAN, *supra* note 4, at § 2.08 (Supp. 1985).

15. See Guttman, *supra* note 2, at 731-32.

16. C. ISRAELS & E. GUTTMAN, *supra* note 4, at § 2.12 (Supp. 1985) (footnote omitted).

17. Aronstein, *supra* note 5, at 732.

B. Overview of Changes

The revision process began in 1971 when the American Bar Association, responding to the continuing paperwork problems in the securities industry, established the Committee on Stock Certificates within the Section on Corporation, Banking and Business Law.¹⁸ The Committee was charged with determining what new legislation might help eliminate or reduce the need for stock certificates and with drafting recommended legislation. The Committee's 1975 report contained two principal recommendations for changes in state law: (1) to amend the Model Business Corporation Act (MBCA) to allow corporations to issue stock in uncertificated form, and (2) to amend article 8 to establish a framework of rules governing the rights and responsibilities of issuers, purchasers, creditors, and others who would deal with uncertificated securities. Both recommendations were incorporated into the draft offered to the states for adoption.¹⁹

1. Article 8 Revisions

Nearly every section of article 8 was rewritten, and four new sections were added. Summarizing all of these changes is unnecessary; those most significant to secured lending practices are discussed below.

2. Model Business Corporation Act Revisions

Relatively few changes were recommended for state corporation codes, but these changes were important. A legal framework for uncertificated securities would be of little value unless corporations could issue securities in uncertificated form. Revised article 8 does not address this concern; it neither requires nor authorizes corporations to issue uncertificated shares. However, prior to the revisions, the corporation codes of nearly every state either required corporations to issue certificates or entitled shareholders to get

18. The process is outlined in U.C.C. Appendix I, at 779 (1978) (Reporter's Introductory Comment).

19. The Committee attached an appendix to its 1975 report which contained a suggested revision of article 8. This draft was submitted to the Permanent Editorial Board of the UCC, under whose watchful eye it underwent a process of review, comment, and revision. The final draft was approved and recommended for adoption to the states by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute in 1977. After some tinkering by the NCCUSL Committee on Style, this draft became the 1978 Official Text of the UCC. See U.C.C. Appendix I, at 779 (1978) (Reporter's Introductory Comment).

them on request.²⁰ These statutory barriers would have to be removed before any systematic departure from the certificated securities system could get underway.

Accordingly, the drafters recommended that section 23 of the MBCA be amended by adding a provision which would expressly allow corporations to issue shares in uncertificated form.²¹ While most states adopting the 1978 revisions appear to have followed the suggested language,²² Delaware altered it significantly. In Delaware, corporations may now issue uncertificated shares, but holders of those shares are entitled to have certificates if they so request.²³ This provision is curious, especially in Delaware. It is common knowledge that Delaware has the most permissive corporation laws and is a mecca for large, publicly held corporations.²⁴ Convincing large, publicly held corporations to go paperless is important because many of the original paper problems were generated by increased trading on the stock exchanges.²⁵ A truly certificateless system probably cannot take hold until the large corporations quit using certificates. The Delaware rule could prevent this.

II. BASIC CHOICES

The treatment of secured transactions under revised article 8 cannot be fully grasped without an understanding of two fundamental choices made by the drafters. Neither of these choices was inevitable; a perfectly workable system for uncertificated securities could have been produced if different choices had been made. The choices were important, however, because they set the tone for the specific provisions enacted to implement the new system. These

20. Statutes are collected in C. ISRAELS & E. GUTTMAN, *supra* note 4, at § 1.08 n.100 (Supp. 1985).

21. See *Proposed Legislation Permitting Elimination of Negotiable Stock Certificates and Debt Instruments*, 32 BUS. LAW. 1183, 1253-54 (1977). The proposed amendment reads:

Unless otherwise provided by the articles of incorporation or by-laws, the board of directors of a corporation may provide by resolution that some or all of any or all classes and series of its shares shall be uncertificated . . . [T]he rights and obligations of the holders of uncertificated shares and . . . of the holders of certificates representing shares of the same class and series shall be identical.

Id. at 1254 (emphasis in original).

22. See, e.g., **Minnesota**: MINN. STAT. ANN. § 302A.417(7) (West 1985); **New York**: N.Y. BUS. CORP. LAW § 508(f) (1986).

23. DEL. CODE ANN. tit. 8, § 158 (1983).

24. See H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* 31, 185 (3d ed. 1983).

25. See Guttman, *supra* note 2, at 717-19.

choices were: (1) to create for uncertificated securities a legal framework which, to every possible extent, parallels that for certificated securities, and (2) to shift the law governing creation and perfection of security interests in investment securities from article 9 to article 8.

A. *Parallelism*

When they created the uncertificated security, the drafters of revised article 8 brought into the commercial world a new form of intangible right. The appearance of a new form of property produces tension in the legal system. New forms are rarely cut from whole cloth; the break from the past is never clean. Ultimately, the new form may displace the old, since perceived inadequacies in the old form often bring about the new. Meanwhile, the two must co-exist. Because the new form comes into the world unadorned by legal structures or rules, it is only natural that the legal system tends to swaddle it in the structures and rules long applied to the old.

In many cases, more than one older form's structures could apply. There were two possibilities for uncertificated securities. The first was obvious; the new offspring could be treated like its older sibling, the certificated security. Second, it could be treated like its first cousins, accounts receivable and the rest of the family of commercial intangibles.

Legal hand-me-downs, like their human counterparts, are seldom the right size, and alterations are often necessary. For uncertificated securities, the main problem was the matter of negotiability. Investment securities had long been fully negotiable,²⁶ and it seemed logical to extend negotiability to the new forms. But negotiable securities (and other negotiable intangibles) had always been based on the existence of paper,²⁷ and by definition there would be no paper for uncertificated securities. By the same token, accounts receivable and other paperless intangibles had never been fully negotiable,²⁸ so following this model would eliminate an essential at-

26. Investment securities were "promoted to full negotiability" by the widespread adoption of the Uniform Stock Transfer Act just after the turn of the century. See Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 *YALE L.J.* 1057, 1075 (1954).

27. See *id.* at 1118.

28. Accounts receivable, over the years, have acquired many of the attributes of negotiability even though they do not carry with them an indispensable writing. This came about because of increased judicial and statutory willingness to allow their free transfer, see U.C.C. § 9-318(4) (1978), and by the same willingness to uphold clauses waiving defenses

tribute of the modern security. As a result, either model was bound to present problems. The drafters found more problems with the second, and so chose the first.

Creating a parallel universe, especially one that includes negotiability, is an intriguing prospect. The appearance of a new form of negotiable right is in itself unremarkable; the tendency of negotiability over the years has been to expand, not contract.²⁹ But this one is different. For the first time, our system has encountered a fully negotiable intangible which is not represented by an essential piece of paper. In the law, one often encounters form without substance. Here we have the reverse. The uncertificated security comes into the world as antimatter: the "negotiable non-instrument."³⁰

It would serve no purpose to discuss all of the parallels which were created. The specific rules dealing with issuance, registration, and the like are beyond the scope of this Article. Details relevant to the law of secured transactions are discussed below. At this point it is enough to consider the principle of parallelism and attempt to determine whether the drafters made the right choice. Any analysis is preliminary; it will take many years of experience before firm conclusions can be drawn. My preliminary judgment is that they did.

A choice must be evaluated in light of the purpose for which it was made. The purpose of creating a system of uncertificated securities in the first place was to eliminate the need for paper. A parallel system was supposed to further this process because it would be more acceptable in the real commercial world than the alternative. The drafters feared that an industry accustomed to dealing in negotiable rights would balk at having to deal in something of lesser stature.³¹

This fear seems justified. After all, the whole purpose of negotiability is to facilitate the transfer of commercial property rights. That is why certificated investment securities eventually became negotiable; nonnegotiable securities simply did not serve the larger

against prior parties. *See id.* § 9-206(1). But accounts are not fully negotiable by any definition, *see Gilmore, supra* note 26, at 1118, and the appearance of negotiable paperless securities is still a milestone. A modern counterpart might be the electronic fund transfer (EFT), which, by its very nature, must be negotiable. But the concept of negotiability probably does not matter much because an EFT is "spent" more or less instantly, not held and traded.

29. *See generally Gilmore, supra* note 26.

30. This descriptive and clever term was first used in Aronstein, Haydock & Scott, *Article 8 Is Ready*, 93 HARV. L. REV. 889, 896 (1980).

31. *See Aronstein, supra* note 5, at 728.

commercial purpose.³² Buyers of corporate shares, having become accustomed to greater rights, understandably would not want to suddenly be subjected to lingering claims and defenses. Lenders would not want to give up the traditional benefits they enjoyed as pledgees of negotiable paper. As a result, it was possible that, in the absence of negotiability, the new paperless shares simply would not be used. That would defeat the purpose of their development.

There are other factors which favor negotiability. If nonnegotiable uncertificated securities did come into widespread use, devices to guard against the risks of nonnegotiability could be expected to appear. For example, buyers of corporate shares might begin to insist on indemnification against losses from prior claims. Lenders might charge higher rates or tighten credit requirements. These developments could increase the cost of all securities transactions.

History provides yet another reason for making the new shares negotiable. Most of the negotiable intangible rights now recognized by our legal system were once nonnegotiable,³³ the irresistible attraction of negotiability is apparently in the nature of commercial things. There is no reason to think that uncertificated securities would respond any differently. They would eventually either achieve outright negotiability or acquire most of its essential attributes through the use of waiver clauses or the like. All in all, omitting negotiability for uncertificated shares hardly seems worth the trouble.

A parallel universe also can be justified by considering the proper role of the legal system in commercial transactions. A corporate decision to issue certificated or uncertificated shares should be based on business needs or transactional efficiency, not on which carries more advantageous legal consequences. The law should channel this decision only for sound underlying policy reasons, and no reasons have been offered which would justify giving holders of uncertificated shares second-class rights. In fact, the drafters' assumption was that holders of both certificated and uncertificated shares would ordinarily have identical rights.³⁴ Of course, the issuing corporation may create varying rights by issuing different classes of shares, but the decision should be based on underlying corporate needs, not on artificial distinctions of legal form.

32. See Gilmore, *supra* note 26, at 1072-76.

33. See generally Gilmore, *supra* note 26.

34. This view is reflected in the proposed amendments to Model Business Corporation Act (MBCA) § 23. See *supra* note 21 and accompanying text.

B. *The Shift to Article 8*

Once a parallel system for uncertificated investment securities had been created, the next question was where it should fit within the overall UCC scheme. With respect to provisions on issuance, registration, and the like, the answer was easy: uncertificated securities should go into article 8 along with their certificated counterparts. But the situation was not so clear with respect to security interests. Normally, any provisions affecting security interests would go into article 9. It deals broadly with all forms of secured transactions, and the rules governing security interests in certificated securities were already there. Indeed, but for the decision to adopt parallelism, the rules for uncertificated securities were there, too.³⁵ Yet the drafters chose to place the rules governing creation and perfection of security interests in uncertificated securities into article 8. And, to keep the family together, they moved the existing rules on certificated securities from article 9 to article 8. I believe this was a bad choice. There is no precedent in the drafting history of the UCC for the removal of an entire category of secured transactions from article 9. In fact, the history is exactly the opposite. Early proposals for separate treatment of different types of collateral were rejected in favor of the unitary approach finally adopted.³⁶ Article 9 was to be a comprehensive statute governing nearly all forms of personal property security transactions, including, until now, security interests in investment securities.³⁷

It is true that there are exclusions from article 9. Most of them are understandable; they include transactions which are not really voluntary security interests,³⁸ or are pre-empted,³⁹ or raise important questions of public policy,⁴⁰ or are otherwise outside the range of normal commercial transactions.⁴¹ The separate listing of exclusions does not detract from article 9's grand design. It is also true that security interests occasionally arise under other articles of the UCC. However, these instances are minor and involve specific fea-

35. Under former article 9, uncertificated securities would have been considered general intangibles. U.C.C. § 9-106 (1972).

36. See 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 9.2 (1965).

37. See U.C.C. § 9-102 & official comment (1978).

38. An example is a landlord's lien, *id.* § 9-104(b), or a statutory lien for services or materials, *id.* § 9-104(c).

39. An example is a security interest subject to federal law, *id.* § 9-104(a), or government borrowing, *id.* § 9-104(e). But see *id.* § 9-109(2) (categories of collateral used by a government debtor).

40. *E.g.*, *id.* § 9-104(d) (assignment of earnings as security).

41. An assignment of a tort claim is such a type of transaction. *Id.* § 9-104 (k).

tures inherent in particular transactions. They provide no precedent for jettisoning investment securities.

The three security interests which may arise under article 2 in sales transactions are probably the most familiar of these special cases.⁴² A seller may reserve title⁴³ or ship under reservation,⁴⁴ or a buyer may hold goods after rejection or revocation of acceptance.⁴⁵ All three arise naturally out of the situations which produce them. As a result there is no contractual or transactional reason to require compliance with the formal requirements of article 9. For example, the rejecting buyer's claim is more in the nature of a statutory lien than a voluntary security interest; it would be ludicrous to require a breaching seller to sign a security agreement. Reservation of title by the seller, without more, is probably meaningless under article 2, as it creates no rights against either the buyer or third parties.⁴⁶ A seller who wants any real security must obtain a security agreement under article 9.

Shipment under reservation using documents of title creates more real security, but even this device has limited range. It is normally used in transactions which at bottom are either cash sales or sales on unsecured credit. In the cash sale, the documents help the seller ensure that he gets paid. He may attach a negotiable bill of lading to a sight draft drawn on the buyer, for example, and turn the paper over only when the buyer honors the draft.⁴⁷ In the credit sale, the documents preserve the seller's control over the carrier. But this control, and the security interest behind it, vanish as soon as the documents are turned over to the buyer.⁴⁸ Like the other article 2 security interests, this one is temporary and is based on possession, or its equivalent, by the party secured. As with reservation of title, a seller who wants any lasting security will have to comply with article 9 and get a security agreement.

42. There are other examples. Perhaps the most widely cited is the security interest given a collecting bank. *Id.* § 4-208. See also *id.* § 4-504, which allows a presenting bank to deal with the goods underlying a dishonored documentary draft and gives it a lien to secure expenses.

43. *Id.* § 2-401(1).

44. *Id.* § 2-505.

45. *Id.* § 2-711(3).

46. See *id.* § 2-401, -403, preamble. Of course, title may be important for non-UCC purposes such as taxation or criminal responsibility.

47. For a general discussion of the uses and treatment of documentary transactions, see Farnsworth, *Documentary Drafts Under the Uniform Commercial Code*, 22 *BUS. LAW.* 479 (1967).

48. See U.C.C. § 9-313 & official comment (1978).

The unitary approach has always meant that article 9 applied to secured transactions even though other law regulated other transactions involving the same property. For example, article 2 applies to sales transactions in goods, but it has never been suggested that the law on security interests in goods should be moved to article 2.⁴⁹ Nor, for that matter, has it been suggested that security interests in negotiable instruments be controlled by article 3 or in documents of title by article 7. Yet this is precisely what has been done for security interests in investment securities by the 1978 revisions.

While article 9's unitary approach is not etched in stone, it represents such a milestone in the law of secured transactions that any move away from it should be taken cautiously and be based on sound policy reasons. Apparently the drafters did move cautiously, for as the reporter noted, the decision to abandon article 9 "was reached somewhat reluctantly."⁵⁰ Sound policy reasons, however, are harder to find. Unlike the special and limited article 2 security interests, there is no transactional justification for separate treatment. A security interest in securities is basically the same as a security interest in any other collateral. Security interests in certificated securities involve the special problem of negotiable paper, but even this is not unique to securities. The fact that they are commonly pledged distinguishes them from the most common forms of commercial secured transactions, yet the drafters have never thought the pledge so unique as to justify its exclusion from article 9. Pledges of other negotiable paper and even of goods still fall under the article 9 umbrella.⁵¹ A pledge substitute, now required for uncertificated securities by the decision to follow a parallel approach, should fall under it as well.

Despite all this, the drafters were able to articulate two reasons for moving the basic treatment of security interests in securities to article 8. First, the changes in securities holding systems and the appearance of uncertificated securities "required a great many [UCC] provisions expressly directed to securities. General provi-

49. Professor Coogan made the same point. See Coogan, *Security Interests in Investment Securities Under Revised Article 8 of the Uniform Commercial Code*, 92 HARV. L. REV. 1013, 1052 (1978). This point also was considered by the drafters; indeed it was said to have been made "with some force." Aronstein, *supra* note 12, at 307. Apparently it was not considered persuasive.

50. Aronstein, *supra* note 12, at 307. Professor Aronstein was the chief reporter for revised article 8. See Aronstein, Haydock & Scott, *supra* note 30, at 890 n.4. Though there is no reason to doubt Professor Aronstein's report, there is almost no discussion of this point in the published material about the revisions.

51. See U.C.C. § 9-305 (1978).

sions [like UCC 9-305] were just not of much use."⁵² Second, all of this detail would "unnecessarily encumber" article 9 with rules which would be irrelevant or confusing to nonspecialists.⁵³

These expressions boil down to a concern that the required new rules would clutter article 9 with too many details.⁵⁴ This concern with technical problems of statutory drafting is admirable, as far as it goes. In the right circumstances, drafting reasons might be as good as any other reason for making a particular choice. Clean drafting and clear expression need no justification, and the drafters' concern reflects sensitivity to article 9's use of generic terminology and broad concepts.

In this instance, however, the stated reasons are unpersuasive. For one thing, drafting concerns cut both ways. Because certificated securities were already taken care of in article 9, it would have taken fewer words and meant fewer linguistic disruptions to add the new rules for uncertificated securities to article 9 than it did to put them into article 8.⁵⁵

In addition, this would not be the first time article 9 had to include separate rules for particular types of collateral. The perfection rules provide several examples. There are special rules for various categories of goods⁵⁶ as well as for special circumstances involving instruments and documents.⁵⁷ Even article 9's priority rules reflect the need for some forms of special treatment as several apply to only one or two of article 9's categories of collateral.⁵⁸ It was never thought that the unitary concept could be carried through completely; some special rules would be necessary.⁵⁹ In this light, a few new rules for uncertificated securities (the rules for certificated securities were already there) look a lot less like clutter.

52. Aronstein, *supra* note 12, at 307.

53. *Id.*

54. I am reminded of Emperor Joseph's complaint, at the first performance of Mozart's "The Abduction From the Seraglio," that it had "too many notes." Shaffer, *Amadeus*, Act I, sc. viii (1981).

55. Article 9 is now peppered with parenthetical exclusions such as "(other than certificated securities)." See, e.g., U.C.C. § 9-305 (1978).

56. See, e.g., *id.* §§ 9-302(1)(d) (consumer goods subject to purchase money security interests); (3)(b) (goods covered by certificate of title legislation), -304(2), (3) (goods covered by documents of title).

57. *Id.* §§ 9-304(4)-(5).

58. See, e.g., *id.* §§ 9-307(2) (consumer goods), 9-308 (chattel paper and instruments), 9-309 (negotiable paper), 9-312(2) (farm products), 9-312(3) (inventory).

59. See generally 1 G. GILMORE, *supra* note 36, at § 9.2.

Other explanations for the shift to article 8 can be found, but none is wholly persuasive. One possibility is a sort of drafting inertia, or flywheel effect, which might have taken hold once the revision process got cranked up. Because article 8 had to be revised to accommodate uncertificated securities anyway, it must have seemed relatively painless to include the new rules for security interests, which, after all, had to be put somewhere. The now-parallel rules for certificated securities presumably got caught up in the vortex. It is inconceivable that security interests in certificated securities would have been moved to article 8 had there not been an ongoing process of revision involving uncertificated securities.

Another possibility has to do not so much with inertia as fatigue. Perhaps, after the agonizing and exhausting process of producing the 1972 revisions, no one wanted to mess with article 9 again so soon. Indeed, there is a hint of this sentiment in the drafters' discussions.⁶⁰

In any case, the deed is done. Of course this is not the end of the world. Secured transactions will continue to come and go, and after the necessary period of adjustment perhaps nothing will change at all. But for the first time, the caretakers of the UCC have deliberately reduced the scope of the unifying article on secured transactions. It seems unfitting.

III. SECURITY INTERESTS IN CERTIFICATED SECURITIES

The 1978 revisions made few substantive changes in the law of secured transactions with respect to traditional certificated securities. Despite these changes, however, secured transactions in certificated investment securities will remain much the same.

A. *Creation and Perfection*

The rules on creating and perfecting security interests in certificated securities were tightened by the 1978 revisions. Adjustments were made to account for modern securities holding systems, and some ambiguities in the bailee notification procedures were resolved.

60. See Aronstein, *supra* note 5, at 739 (discussing new article 8's prospects for adoption).

1. *In General*

The pledge is the oldest and simplest form of security, and it has always been the model for the UCC's treatment of security interests in investment securities. This model corresponds to what must have been the nearly universal practice of lenders at the time the UCC was drafted. Because securities are negotiable, both the model and the practice make perfect sense.

The article 9 rules naturally followed the pledge model. If the secured party took possession of the collateral, no written security agreement was necessary to create the relationship.⁶¹ Moreover, the same act, taking possession, also perfected the secured party's interest against third parties.⁶² Nothing could be simpler. Because the 1978 revisions removed the law from article 9, these particular rules no longer apply. The model remains, however, and the new article 8 counterpart accomplishes the same end. The new article 8 keeps the same basic procedures for creating security interests, but some of the terminology has been changed. The key concept is now that of transfer: "A security interest in a security is enforceable and can attach only if it is transferred to the secured party or a person designated by him pursuant to a provision of Section 8-313(1)."⁶³ "Transfer," as the cross-reference suggests, is defined in 8-313(1). This section lists ten ways to transfer a security. Among them is 8-313(1)(a), which provides that transfer occurs when the transferee "acquires possession" of the security. Thus, as under former article 9, a security interest is created when the debtor delivers the certificate to the creditor.

A security interest created under revised article 8 is automatically perfected.⁶⁴ This was the normal result under the prior UCC provisions, because possession of the security accomplished both creation and perfection. Under the revision, it is the only result. This is not to say that a secured party remains perfected forever under all circumstances; it is possible to lose perfection under some

61. U.C.C. § 9-203(1) (1972). Despite this legal structure, it was (and is) a common and sensible business practice to have a security agreement.

62. *Id.* § 9-304(1). Under this provision, possession is the only way to perfect. Public filing is unavailable.

63. *Id.* § 8-321(1). Section 8-321 was added by the 1978 revisions. Under former law, the key was "delivery." Because the system was expanded to encompass paperless securities, "delivery" would no longer do the job. "Transfer" has taken its place. *See id.* Appendix I, at 779 (Reporter's Introductory Comment).

64. *Id.* § 8-321(2). This assumes the creditor has given value.

methods of transfer. But it is not possible to create an unperfected security interest in the first instance.

While creation and perfection are normally sufficient, there were other precautions a secured creditor could take. For instance, a creditor might require the debtor to indorse the certificate before handing it over. This transformed the creditor into a bona fide purchaser,⁶⁵ cutting off any prior adverse claims.⁶⁶ It also gave the secured creditor priority over any other security interest which might have been outstanding.⁶⁷ The creditor also might have the issuing corporation reregister the security.⁶⁸ This would increase the creditor's protection because dividends and notices from the issuer would then go directly to it. These actions remain available under the revisions. But while they may in fact increase the creditor's security, they are not necessary to create or perfect rights under either former article 9 or revised article 8.

2. *Effect of Modern Securities-Holding Systems*

In an uncomplicated world in which shareholders always had certificates, the simple pledge model worked well. However, as the security-holding systems described above gain increased prominence, fewer and fewer shareholders will keep certificates lying around. This can create problems for secured lenders. One obvious solution is to make the debtor produce the certificate as a condition of the loan. In theory, this should always be possible because under most states' corporation laws the debtor has a right to have a certificate.⁶⁹ But it might not be as simple as it sounds. Professor Aronstein describes the likely scenario:

Suppose, for example, Borrower owns 200 shares of XYZ Corp. common stock held in Borrower's cash account with Broker. Borrower calls Broker and tells him that he wishes to use those shares as collateral for a loan from Bank and that Bank, quite understandably, requires that the certificates representing these shares be physically pledged to it as security. Borrower asks Broker to send him his certificates. But, Broker has no certificates. What Broker does have is an account with Depository showing its

65. *Id.* § 8-302.

66. *Id.* § 8-302(3).

67. *Id.* § 9-309.

68. *Id.* § 8-401; see also *id.* § 8-316 (obligating transferor to supply any requisites the purchaser or pledgee may need to obtain registration).

69. This is based on the assumption that the original issue was certificated. See *supra* note 20 and accompanying text.

balance of 200,000 shares of XYZ, among which Borrower's 200 shares are included. So Broker asks Depository to send Broker a certificate for 200 shares of XYZ registered in Borrower's name. Of course, Depository does not have *any* certificate registered in Borrower's name and, indeed, may have no certificate for 200 shares in any name. What depository does have is a collection of XYZ certificates, in, perhaps, 100,000 share denominations, some or all of which may be physically possessed by Depository's Custodian Bank. So Depository, or its Custodian Bank on Depository's instructions, must somehow get some certificate to the issuer or its transfer agent and request that a 200 share certificate registered in Borrower's name be 'carved out' of it and returned. Such a certificate is, in due course, issued, delivered to Depository, transmitted to broker, and retransmitted to Borrower who, unaware of what had to be accomplished but thoroughly exasperated at the time it took to accomplish it, marches into Bank, hands over the certificate, duly indorsed, and gets his money.⁷⁰

This process is cumbersome and inefficient. These problems have no doubt contributed to the development of many of the paper reducing securities systems already in use.

Article 9 contained one rule which recognized that there was often an unavoidable delay before the debtor could get the certificate. This rule has been carried over into revised article 8. It permits temporary perfection without possession if there is a written security agreement and the creditor gives new value.⁷¹ This can be useful in a purchase money transaction because the debtor might need the money to buy the security before it is actually transferred to him. Theoretically, this rule ought to help as well in modern securities systems such as street name or depository accounts. But the temporary period of perfection without possession is limited to twenty-one days, and that might not be long enough.⁷² After this period, the creditor becomes unperfected and stays unperfected until gaining possession. Like other pledge rules, this one was not designed to deal with current securities-holding practices.

Revised article 8 does authorize two methods of transfer for certificated securities, both available to secured lenders, which do re-

70. Aronstein, *supra* note 12, at 293-94 (emphasis in original).

71. U.C.C. § 8-321(2) (1978) (which must be read in conjunction with § 8-313(1)(i)). These provisions supercede § 9-304(4) of the 1972 official text. Temporary perfection without possession is not risk-free; if the certificate ends up in the hands of a bona fide purchaser (BFP), the creditor loses protection. *Id.* § 9-309.

72. *Id.* § 8-321(2).

fect some concern for modern systems. The first and simplest method is a provision which applies to lenders who already hold securities as financial intermediaries. These lenders can acquire security interests by having the debtor sign a security agreement containing a description of the security and giving value.⁷³ No other transfer or registration is necessary.

The second method applies to securities held by clearing corporations. A clearing corporation may hold securities on deposit from institutions such as brokers and banks. Membership trading is accomplished simply by making appropriate book entries; a transfer of a security interest can be accomplished in the same way.⁷⁴ For certificated securities, this saves paperwork because no certificate need be transferred.

Thus, it can be seen that few of the new rules dealing with certificated securities adequately address the problems of modern securities holding systems. But then that is why uncertificated shares were created.

3. *Bailee Notification and Junior Lenders*

When the collateral is in the hands of a third-party bailee, the law has always allowed the creditor to perfect his rights simply by notifying the bailee of his interest.⁷⁵ This idea found its way into the UCC: "[T]he secured party is deemed to have possession from the time the bailee receives notification of the secured party's interest."⁷⁶ In cases involving investment securities, perhaps the most common situation in which the bailee notification rule would be applied is that of the junior lender. When a prior lender already had the certificate safely tucked away in the vault, the junior lender could perfect simply by notifying the senior lender.⁷⁷

In other situations, however, third-party problems might exist even for senior lenders. For example, any lender might have to deal with the modern securities systems, and it was never clear how the bailee notification rule should be applied in this context. The rule assumes that the certificate exists and can be identified. While this was theoretically possible in these systems, the process could be

73. *Id.* § 8-313(1)(j).

74. *See supra* note 6 and accompanying text.

75. *See* 1 G. GILMORE, *supra* note 36, at § 14.2.

76. U.C.C. § 9-305 (1972).

77. *Id.* This was also the rule at common law. *See, e.g.,* *Pierce v. National Bank of Commerce*, 268 F. 487, 493 (8th Cir. 1920).

cumbersome.⁷⁸ Additionally, the cases did not always agree on who was a proper third party to receive notice,⁷⁹ and it was by no means clear that a depository could be a bailee for this purpose. Presumably this is one reason nervous lenders continued to insist on certificates. Still, there was no theoretical reason why the bailee notification rule could not apply to these systems. If it worked, it would eliminate the need to go through the difficult process of obtaining a certificate. For lenders, the trouble was uncertainty.

Revised article 8 contains an innovation which resolves these ambiguities and makes it clear that bailee notification is indeed available in these modern systems. A special provision applying only to security interests provides that transfer, and therefore perfection, occurs when "written notification . . . is received by (i) a financial intermediary on whose books the interest of the transferor in the security appears."⁸⁰ "Financial intermediary" includes brokers and clearing corporations,⁸¹ so this provision should eliminate any confusion as to who is the proper person to receive notice. It should also eliminate the need to rely on certificates because it applies "regardless of whether [the financial intermediary] has physical possession or registration in its own name or whether it has securities in an account with another intermediary."⁸² In fact, this provision says nothing about certificates, so it should be available in either certificated or uncertificated systems. The only condition is that there must be a written security agreement,⁸³ but this is no impediment because few lenders are likely to go without one anyway. Even under the old rules a lender who did not take possession needed a written security agreement.⁸⁴ In any case, the new rule should allow secured lenders to proceed in these modern settings with some degree of confidence.

78. See Aronstein's description of the process *supra* text accompanying note 70.

79. See, e.g., *Landmark Land Co. v. Sprague*, 33 U.C.C. Rep. Serv. (Callaghan) 53 (S.D.N.Y. 1981) (first pledgee can be bailee with notice); *Heinicke Instruments Co. v. Republic Corp.*, 543 F.2d 700 (9th Cir. 1976) (issuer cannot be secured party's agent for purposes of receiving notice); *In re Copeland*, 531 F.2d 1195 (3d Cir. 1976) (escrow agent can be bailee with notice); *In re Dolly Madison Indus.*, 351 F. Supp. 1038 (E.D. Pa. 1972) (escrow agent cannot be bailee with notice).

80. U.C.C. § 8-313(l)(h)(i) (1978). The notice deviates from prior law as it requires the signature of the debtor.

81. *Id.* § 8-313(4).

82. *Id.* § 8-313 official comment 3.

83. *Id.* § 8-313(l)(h). This echoes other provisions which allow perfection without actual possession. See, e.g., the 21-day grace rule discussed *supra* text accompanying note 72.

84. U.C.C. § 9-203(l)(a) (1972).

Another ambiguity in the prior code was whether the bailee had to acknowledge or "attorn" to the lender who gave the notice. Article 9 followed the common law and did not require any form of acknowledgment.⁸⁵ The trouble was that article 8 had a different rule. Under former article 8, the transaction was complete only when the bailee acknowledged that he held the security for the party giving notice.⁸⁶ This was inconsistent with the rule under article 9. The 1978 revisions resolve this inconsistency by adopting the rule of article 9 (but moving it to article 8). Transfer, and therefore perfection, is deemed to occur when a third party in possession of a certificated security receives the notice.⁸⁷ No acknowledgment is necessary.

An acknowledgment rule might have made some transactional sense, especially in the context of a junior lender. Few sophisticated junior lenders are likely to advance funds without some assurance of cooperation from the senior lender. On the other hand, requiring acknowledgment would have bucked the common law trend and would have made the rule for securities different than that for other types of collateral. More importantly, a no-acknowledgment rule is probably more flexible. A rule requiring acknowledgment might give too much control to the prior party, who could effectively prevent the debtor from finding new sources of financing. Finally, the mere notice rule should enable the junior lender to establish a claim that will at least survive bankruptcy.⁸⁸

B. Other

Article 9 has not been abandoned completely. Even though the rules on creation and perfection have been moved to article 8, article 9 still applies to the rest of the secured relationship.⁸⁹ Probably the most important rule during the life of a secured transaction in

85. *Id.* § 9-305 official comment 2. There was very early authority that the bailee must attorn, but this rule was fairly well eroded even in pre-UCC law. See 1 G. GILMORE, *supra* note 36, at § 14.2.

86. U.C.C. § 8-313(l)(d) (1972).

87. U.C.C. § 8-313(l)(h)(ii) (1978).

88. As any law student of commercial transactions knows, a perfected secured lender defeats the trustee in bankruptcy. *Id.* § 9-301(l)(b); Bankruptcy Code, 11 U.S.C. § 544(a) (1982). There is one form of transfer for which acknowledgment is necessary. A transfer of an identified certificated security held by a third person who is not a financial intermediary is complete when the third person acknowledges that he holds for the new purchaser. U.C.C. § 8-313(l)(e) (1978). But this rule should not apply to security interests, inasmuch as § 8-313(l)(h) is a specific rule for security interests and allows transfer by notice only.

89. U.C.C. § 8-321(3).

investment securities is that which imposes on the secured party the duty to "use reasonable care in the custody and preservation of [the] collateral."⁹⁰ Thus, the secured party holding certificates will have the same problems it always had in responding to market fluctuations or conversion calls.⁹¹ It is beyond the scope of this Article to address these duties. Note, however, that article 8 now specifies that the secured party has these duties "whether or not the security is certificated, and, if certificated, whether or not it is in his possession."⁹² It is possible that this new language could increase the traditional duties of the secured party, although how the courts will interpret this provision remains to be seen.

Another issue raised by modern securities-holding systems is the problem of determining priorities among secured creditors. The law here is the same as in any other priority dispute; the simple first-to-perfect rule controls.⁹³ When one lender holds the certificate, he will almost certainly have priority, either as a bona fide purchaser⁹⁴ or as the bailee to whom others must give notice. In cases involving multiple notices to one bailee, the problem is more one of proof than of law. Wise lenders will no doubt send notices by certified mail, return receipt requested, and financial intermediaries and other bailees will presumably have records showing which notices were received when. Nothing in the revised article 8 affects this.

IV. SECURITY INTERESTS IN UNCERTIFICATED SECURITIES

The principle of parallelism has largely shaped the rules governing security interests in uncertificated securities. The statutory framework is the same as that applied to certificated securities; there must be a "transfer" and all security interests are automatically perfected.⁹⁵ The specific methods of transfer are also parallel.

A. *Creation and Perfection*

Every method available for creating security interests in certificated securities has a counterpart for uncertificated securities. This

90. *Id.* § 9-207(1).

91. *See, e.g.,* *Reed v. Central Nat'l Bank*, 421 F.2d 113 (10th Cir. 1970); *Dubman v. North Shore Bank*, 271 N.W.2d 148 (Wis. Ct. App. 1978).

92. U.C.C. § 8-321(3)(b) (1978).

93. *Id.* § 9-312(5)(a). The rule is actually "first to file or perfect," but filing is unavailable for investment securities. *Id.*; *see also id.* § 8-321(3).

94. *Id.* § 9-309.

95. *Id.* § 8-321.

is true even for the pledge, the prototype secured transaction in certificated securities. Because a pledge is not possible for uncertificated securities, the drafters created the "registered pledge" as an equivalent.⁹⁶ The term "pledge" was used, even though there can be no true pledge, because of its familiarity.⁹⁷ The registered pledge will no doubt become the standard form of secured transaction for uncertificated securities.

1. *The Registered Pledge*

To create a parallel for the true pledge, it was necessary to identify the essential characteristics of the pledge and then recreate those characteristics in a form which could be used in paperless transactions. The drafters identified two essential characteristics. First, the pledge removes the collateral from the control of the debtor. The debtor is no longer able to let the collateral burn up in a fire or defeat the creditor's interest by transferring the certificate to a bona fide purchaser. Second, the pledge "enables the pledgee, before or upon default, to transfer the security to himself or a third party without the further cooperation of the pledgor."⁹⁸ These characteristics cannot be duplicated in the public filing system used for most nonpledge secured transactions under article 9. A new device was needed, the registered pledge fits the bill.

The registered pledge is exactly what it sounds like; the secured transaction, or "pledge," is simply registered. But instead of being registered by a filing in a public office, it is registered by a notation on the books of the issuing corporation.⁹⁹ This is merely an extension of the normal registration process used for other types of transfers. Outright sales of uncertificated securities, for example, are accomplished by book registration, and it makes perfect sense to apply the same idea to transfers of limited interests such as security interests.

The mechanics of pledge registration are easy. The current registered owner (i.e., the debtor) gives an "instruction"¹⁰⁰ telling the

96. *Id.* § 8-108.

97. *Id.* § 8-108 official comment.

98. Aronstein, Haydock & Scott, *supra* note 30, at 897.

99. U.C.C. § 8-401 (1978).

100. "An 'instruction' is an order to the issuer of an uncertificated security requesting that the transfer, pledge, or release from pledge of the uncertificated security specified therein be registered." *Id.* § 8-308(4). Instructions must be in writing or in a form agreed upon in a writing. *Id.* § 8-308 (5). The instruction is basically the counterpart for uncertificated securities to the process of indorsement and presentation for reregistration for certificated securities.

issuer to register the pledge. The issuer is required to obey.¹⁰¹ The issuer is also required to send to both the debtor and creditor, within two business days, an "initial transaction statement" (ITS).¹⁰² The ITS contains basic information about the securities issue which, in certificated shares, would ordinarily appear on the certificate.¹⁰³

Additional rules reproduce for the registered pledge the protective characteristics of the real pledge. First, once a pledge is registered, only the pledgee may give an instruction.¹⁰⁴ This shifts control from the debtor to the creditor. Second, until the pledge is released, the registered owner (the debtor) is not permitted to order the registration of any transfer.¹⁰⁵ Finally, the registered pledgee is expressly given the power to reregister the uncertificated security to itself or to anyone else.¹⁰⁶ This corresponds to the power a true pledgee has in cases where the certificates are indorsed over or are in bearer form. As a result of these rules, the registered pledge should give the secured lender as much protection as enjoyed with the true pledge.

One characteristic of the true pledge which cannot be duplicated by the registered pledge is that of privacy. A true pledge could be a private matter between the debtor and his bank because no public records were required.¹⁰⁷ This is not true for security interests perfected by public filing, and it is not true for the registered pledge. Whether this distinction will affect or inhibit the use of uncertificated securities in secured transactions remains to be seen, but it seems unlikely.

2. Other Methods

The other methods of transfer available for creating security interests in uncertificated securities are also counterparts to the methods used for certificated securities. In fact, for several of them, article 8 makes no distinction. Transfer by entry on the books of a clearing corporation is the same for both certificated

101. *Id.* § 8-401. The issuer is entitled to assurances of genuineness and the like, as are issuers of certificated securities. *Id.*

102. *Id.* § 8-408(2), (4).

103. *See id.* § 8-408 official comment 1.

104. *Id.* § 8-308(5), (7)(b).

105. *Id.* § 8-207(3). Only the pledgee can order a release. *Id.* § 8-308(5), (7).

106. *Id.* § 8-207(4).

107. This feature was noted in Steadman, *The Lender in the Certificateless Society*, 26 *BUS. LAW.* 623, 626 (1971).

and uncertificated securities,¹⁰⁸ as is transfer of a security interest when the creditor is a financial intermediary to whom the security already has been transferred in that capacity.¹⁰⁹ The same is true with respect to the rule providing a twenty-one day period of automatic perfection when new value is given under a written security agreement.¹¹⁰

The bailee notification rule cannot be applied literally to uncertificated securities because there can be no bailee of a non-instrument. But parallelism has produced an equivalent here as well. Instead of giving notice to a bailee, the secured party perfects its interest by giving notice, as appropriate, to the registered owner, registered pledgee, or financial intermediary.¹¹¹ Note that the issuer will not be a party or otherwise privy to security interests in uncertificated securities created by any method other than the registered pledge. Other transfers are completed when a third party either receives a notice or makes a book entry; in neither case will the issuer necessarily learn about the transaction. In addition, the secured party will not receive an ITS¹¹² and may therefore receive less than complete information about the particular issue. Of course the creditor may, and presumably will, insist upon seeing the ITS sent to the debtor. In fact, the creditor can ask the debtor to obtain a current statement from the issuer which contains the same information.¹¹³ As a result, a careful creditor should be able to get all the information it needs.

These distinctions make the other methods less attractive, and the registered pledge no doubt will become the favored form of secured transaction for uncertificated securities. In many cases, however, the registered pledge will be unavailable. This is because of the one registered pledge rule, an unfortunate feature of the new article 8.

108. See U.C.C. § 8-313(1)(g) (1978).

109. See *id.* § 8-313(1)(j).

110. See *id.* §§ 8-313(1)(i), -321(2).

111. *Id.* § 8-313(1)(h)(i), (iii), (iv). The rule for financial intermediaries applies whether the securities are certificated or uncertificated.

112. See *id.* § 8-408.

113. Under *id.* § 8-408(6), the debtor has the right to request this statement at any time. The issuer must send one at least annually in any case.

B. *The One Pledge Rule*

Under revised article 8, there can be only one registered pledge of an uncertificated security at a time.¹¹⁴ This rule is an obvious parallel to the inherent limitations of certificated securities; it corresponds to the fact of life that there can be only one real pledge of certificated securities at a time. Its primary impact will be in cases involving junior lenders because they will ordinarily have to perfect their interests using one of the other recognized methods of transfer.

In my view, the one pledge rule is a mistake. Accepting the need for parallelism, and granting that a filing system is inadequate to the secured transactions task for investment securities, there is still no need to permit so many methods of perfecting security interests in uncertificated securities. The registered pledge makes perfect sense as a parallel to the true pledge, but the other methods only clutter up the system. The one pledge rule needlessly perpetuates the problems of certificated securities. This is unfortunate because the absence of inherent limitations (no paper) provided an opportunity to clear up these problems. The drafters claimed that they "did not allow [their] desire to achieve parallelism to foreclose an opportunity for improvement where . . . improvement was feasible."¹¹⁵ By adopting the one pledge rule, however, they missed an opportunity for major improvement.

It is my position that multiple registered pledges should not only be permitted, they should be required. That is, the registered pledge should be the only way to create and perfect a security interest in uncertificated securities, for junior as well as senior lenders. A multiple pledge system would eliminate the problems junior lenders are bound to have with the one pledge rule. Despite the drafters' fears, a multiple pledge system would not unduly increase the burden on issuers.

1. *The Issuer's Burden*

The drafters recognized that there is "nothing inherent in the system that would preclude multiple registered pledges."¹¹⁶ The decision to adopt a one pledge rule was "based on practical rather than theoretical considerations."¹¹⁷ These practical considerations

114. *Id.* § 8-108.

115. Aronstein, *supra* note 12, at 301.

116. Aronstein, Haydock & Scott, *supra* note 30, at 900.

117. *Id.*

dealt mainly with the fear that a multiple registration system would increase the burden on issuers, and that the increased burden would produce such opposition that it would "constitute an obstacle to the adoption of uncertificated systems."¹¹⁸ There was the additional fear that a system of multiple registration "might involve issuers in disputes about the priorities of competing security interests."¹¹⁹

All of this is possible, of course, but the multiple registered pledge, even if allowed, is simply not likely to appear often enough to worry about. Under the present system, most lenders will presumably opt for the registered pledge when it is available. This leaves the other methods to junior lenders, and even the drafters admit that junior interests are not a significant part of secured transactions involving securities.¹²⁰ A system of multiple registered pledges would therefore not produce much of an extra burden.

If second lenders are rare, third or fourth lenders are nearly non-existent. The drafters do their cause no good by presenting bizarre hypotheticals in which a fourth lender pays off a second lender and then argues with the issuer over whether the fourth lender should be subrogated over the third lender. According to the drafters, "[O]ne need conjure up only one such situation to give a wavering issuer cause to decide against moving toward uncertificated securities."¹²¹ "Conjure" is the right word. Ordinarily, only a law professor could come up with a scenario this weird. This sort of example might be useful for making an analytical point in the classroom, but it should not form the basis for a fundamental decision in a statute of general application.

As a practical matter, even when multiple pledges do appear the burden on issuers is not likely to be any greater than in a one pledge system. The ITS is an example. In a multiple pledge system, the issuer will have to repeat the ITS process for each pledge. While this increases the paperwork slightly, it is unlikely to create much of a burden. In fact, the ITS will probably become a matter of institutionalized routine for most issuing corporations. This is because an ITS is also required when ordinary share transfers are registered.¹²² Transfers by purchase and the like will take place much more frequently than transfers which create security inter-

118. Aronstein, *supra* note 12, at 300.

119. *Id.*

120. Aronstein, Haydock & Scott, *supra* note 30, at 899.

121. *Id.* at 901.

122. U.C.C. § 8-408(1) (1978).

ests. For issuers with widely traded shares, the registered pledge is likely to be merely a minor annoyance. Registering a second pledge, when one occurs, would hardly be noticed. In addition, creditors using other methods of creating security interests may insist on seeing a current ITS, and the issuer must respond to these special requests.¹²³ As a result, allowing only one pledge will not prevent the extra paperwork.

While the burden on the issuer does not seem to be much affected, the burden on creditors would be considerably reduced in a multiple pledge system. As a consequence, the overall burden on the securities system would be much smaller. The task of the junior lender once again illustrates the point. He can learn that he is second in line through the original ITS or the ITS update he received from his potential debtor. Once he learns the identity of the registered pledgee, he must then inquire whether anyone else has given notice to perfect a subordinate security interest. Most prior secured parties would cooperate, but cooperation is not required by law. Moreover, keeping track of subordinate security interests is presumably not in the ordinary course of events for most lenders because subordinate interests appear only rarely and the senior lender, being senior, has little to gain by spending a lot of energy on the problem. An issuer who was required to register a second pledge would probably keep better track, and a potential creditor would feel more secure seeing the ITS than asking the prior lender.

Under the one pledge system, the potential second lender must make inquiries not only of the prior registered pledgee but also of financial intermediaries and clearing corporations. Security interests can be perfected in some circumstances by giving notice to these parties, and a lender could not be sure of his status unless he made these inquiries. And how will the lender learn whom to ask? Presumably he will not wish to call every bank in town on the off-chance that one of them may have received a notice, and the ITS will not reflect the existence of financial intermediaries.¹²⁴ As a result, the lender must rely on the debtor's honesty. Creditors are not known for their trusting natures in this regard; extra policing or investigating costs may be necessary. And even when the debtor happily tells the creditor that his shares are held by an intermediary, the potential lender must still ask the intermediary about notices.

123. *Id.* § 8-408(6).

124. *Id.* § 8-408.

In a one pledge system, these investigative burdens will exist even when there is no registered pledge on record. The registered pledge is only one of many ways to perfect a security interest, and it is always possible that a senior lender perfected using one of the other methods. Thus, learning that there are no registered pledges is not enough to guarantee a creditor first priority, and the cautious creditor must embark on his investigative voyage in any case. The whole system is unnecessarily cumbersome and inefficient. A multiple pledge system would eliminate these problems.

Justifying the one pledge rule on the basis that it keeps issuers out of priority fights is also weak. It is not clear how issuers would be drawn into these fights in the first place because creditors argue priority issues with each other, not with an issuer. In a multiple pledge system, the issuer's involvement probably would be no more than producing records showing which creditor's pledge was registered first. This degree of involvement seems to exist even in a one pledge system because that same record has to be produced to determine whether the pledge was registered before or after another security interest was perfected by some other method. In fact, if all the records were found in one place, as would be the case in a multiple pledge system, there might be fewer priority fights because there would be less confusion about identifying the sources and timing of the various competing interests.

True priority fights between issuers and secured creditors might arise, of course. An issuer might have a lien on¹²⁵ or otherwise restrict transfer of¹²⁶ a security, and it is always possible that this sort of claim might lead to a dispute. For example, an issuer's lien or other restriction on transfer must appear on the ITS.¹²⁷ A purchaser, including a secured creditor, is charged with notice of the information contained on the ITS,¹²⁸ so the creditor would take the security subject to the lien or restriction. Arguments about these claims may be priority conflicts,¹²⁹ but they are not caused by the registered pledge, and they would not be aggravated by a multiple pledge system.

125. *Id.* § 8-103.

126. *Id.* § 8-204.

127. *Id.* §§ 8-103(b), -204(b).

128. *Id.* § 8-304(2); *see also id.* § 8-103 official comment 2.

129. In the few reported cases, the issuers usually lose for failure to have the claim noted. *See, e.g.,* *Edina State Bank v. Mr. Steak, Inc.*, 487 F.2d 640 (10th Cir. 1973) (restriction on transfer), *cert. denied*, 419 U.S. 883 (1974); *Travis v. Del State Bank*, 553 P.2d 486 (Okla. 1976) (issuer's lien).

Apparently no one has suggested that the issuers' reluctance to embrace a multiple pledge system, if there was any, could have been overcome with money. Issuers could be allowed to collect a small fee, akin to a filing fee, for registering a pledge. The burden of handling inquiries about prior registered pledges and other requests for information could be relieved in the same way. Indeed, under present rules, the issuer is entitled to charge for some periodic statements.¹³⁰ A special ITS issued at the request of a potential creditor would often fall within this category. Expanding the fee system to cover registered pledges should not be objectionable to creditors, especially if they were able to get rid of the investigative burdens they have under the one pledge system.

2. *The Junior Lender's Burden*

In addition to investigative burdens, the one pledge rule causes at least two additional problems for junior lenders. One of these problems is caused by the possible action of the senior lender, the other by the action of the debtor. In both cases, these actions can result in the junior lender losing its security.

a. *Release By Senior Lender*

In a certificated system, if the senior lender perfects a security interest by a true pledge, a junior lender will have to perfect by notifying the senior. If the senior is paid off and returns the certificate to the debtor, the junior's interest is cut off. This result is inherent in the pledge idea. The pledge puts the world on notice by removing the collateral from the debtor's control; the bailee notification device builds on this principle. But bailee notification can work only if there is bailment. Once the collateral is returned to the debtor, the bailment is destroyed and so is the security interest.¹³¹

The parallel system for uncertificated securities unnecessarily perpetuates this problem for junior lenders. In the comparable scenario, the senior lender will perfect through the registered pledge,

130. U.C.C. § 8-408(8) (1978).

131. This was the result at common law, see L. JONES, A TREATISE ON THE LAW OF COLLATERAL SECURITIES AND PLEDGES § 40 (3d ed. 1912), and remains the rule under the UCC. See *Smith v. Dean Vincent, Inc.*, 615 P.2d 1097 (Or. Ct. App. 1980). The second lender should protect itself by getting an agreement from the senior lender to turn over the collateral. See *Landmark Land Co. v. Sprague*, 33 U.C.C. Rep. Serv. (Callaghan) 53 (S.D.N.Y. 1981).

and the junior lender will perfect, as before, by notifying the senior. If the debtor pays the senior and obtains a release of the registered pledge, what happens to the junior's interest? Article 8 does not address this situation. The notice and control ideas which support the true pledge do not apply directly, but parallels in an uncertificated system may suggest that the junior is cut off here as well. If the senior's interest is released, future ITS's from the issuer will not show any registered pledge. Just as in the certificated situation, the debtor could wrongfully (as against the junior) sell the security or otherwise deal with it on the basis of the appearance of a right to do so. Further, just as the releasing senior can no longer be a bailee of a certificated security, he no longer fits any of the categories of third parties to whom the junior may give notice.

There is no reason, in an uncertificated system, to perpetuate this risk for junior lenders. The problem is inherent in true pledges involving certificated securities; it is not inherent in uncertificated systems. A multiple pledge rule instantly eliminates the problem. During the time both interests are outstanding, any ITS will show them both. When the senior's interest is released, the junior's interest remains and will continue to appear on future ITS's. Risks of debtor misbehavior are reduced, if not eliminated.

b. Transfer to a Bona Fide Purchaser

For any secured creditor, there is always the risk that the collateral will end up in the hands of a good faith transferee who is entitled to take the property free of the security interest. For investment securities, the transferee with these rights is the bona fide purchaser (BFP).¹³² This is a problem for secured creditors for both certificated and uncertificated securities. In cases of certificated securities, the BFP is a problem only if there is not a true pledge because the BFP must take delivery of the certificate.¹³³ The parallel for uncertificated securities is that the BFP is not a problem for the registered pledgee because the registration will appear in the ITS and any purchaser will have notice of it.¹³⁴

132. U.C.C. § 8-302 (1978).

133. *Id.* § 8-302(1)(a). "Delivery" means voluntary transfer of possession. *Id.* § 1-201(14). In some cases there might be constructive delivery, of course, but this could not happen if the creditor has actual physical possession of the certificate. There can be no doubt that the true pledgee is safe from any potential BFP.

134. A purchaser is charged with notice of adverse claims which appear in the ITS. *Id.* § 8-304(2). An earlier registered pledge will also appear in the ITS, therefore, a purchaser should also be charged with notice of the pledge as well.

The junior lender cannot perfect by using the registered pledge however, and therefore the BFP is a problem. Release of the senior interest probably cuts off the junior and even if the junior interest survives it can easily be defeated by a BFP. The senior can transfer the security to a new owner on release,¹³⁵ or he simply can release it to the debtor who can then transfer it to a new owner. In either case, the new owner likely will not know of the junior interest, nor will he be charged with knowledge of it. As a result, he should qualify as a BFP and cut off the junior's interest.¹³⁶ Again, multiple pledge registration would prevent this. If all pledges were registered, there could be no BFP who could cut off any secured creditor's interest.¹³⁷

C. Foreclosure

In cases involving certificated securities, post-default foreclosure procedures are controlled by article 9, not article 8.¹³⁸ As in all secured transactions, the foreclosure sale must be commercially reasonable, and, to preserve the debtor's equity, the debtor is entitled to any surplus the resale may bring.¹³⁹ One of the essential characteristics of the true pledge was the ability, in some cases, to reregister the security in the name of the creditor.¹⁴⁰ When a debtor defaults, creditors could attempt to foreclose simply by having the security reregistered to themselves. This procedure denies the debtor his rights under the default provisions of article 9, and it is wholly improper.¹⁴¹

One unclear issue under revised article 8 is whether these foreclosure rules are changed for uncertificated securities. There is one provision which could be interpreted to work such a change. Under this provision, a registered pledgee may instruct the issuer to

135. *Id.* § 8-207(4).

136. *Id.* § 9-309.

137. Coogan suggests that the desperate junior lender might try to improve his status through one of two means: becoming a BFP himself, or getting his security interest noted as an adverse claim. Coogan, *supra* note 49, at 1034-35. As Coogan demonstrates, however, neither of these avenues is likely to be successful. *Id.* Under a multiple pledge system, the attempt is unnecessary.

138. As discussed earlier, only creation and perfection of security interests are governed by article 8. U.C.C. § 8-321(3) (1978).

139. *Id.* § 9-504(2)-(3). The debtor normally is also entitled to advance notice of the sale, but not in cases where the collateral is customarily sold on a recognized market. *Id.* That is often the case with securities.

140. See *supra* text accompanying note 96.

141. See, e.g., *In re Copeland*, 531 F.2d 1195 (3d Cir. 1976).

transfer the security to a new owner "free of pledge."¹⁴² What is more, the new owner may be the registered pledgee himself.¹⁴³ Further, no distinction is drawn between pre- and post-default transfers. As a result, this provision could be read as in effect permitting strict foreclosure without the debtor's consent. At least one drafter's comment indicates that they may have understood this provision as a default provision.¹⁴⁴ If this is what it means, this provision constitutes a drastic change in the law.

However, it is unlikely that the drafters meant to work so major a change. This provision is one among several which allow the registered pledgee generally to control the disposition of the security, and it need not be read as a foreclosure rule. Other than the one cryptic hint, there is no indication that the drafters were thinking at all of foreclosure when they wrote this section. In the absence of some express indication, this section should not be read as allowing strict foreclosure against the wishes of the debtor.¹⁴⁵

V. CONCLUSION

While the treatment of secured transactions could have been cleaner, revised article 8 represents a significant and useful advance in the law of commercial transactions. A statutory structure for the treatment of uncertificated securities was needed, and the framework provided by the drafters seems fundamentally sound. Even the problems identified in this Article can be tolerated. (Perhaps they can be addressed in the next round of UCC revisions.) Real world participants in commercial transactions are resilient; no doubt they will absorb the new system with little difficulty. Indeed, they probably will find ways not apparent to law professors to overcome the few blemishes and get on with the business at hand.

142. U.C.C. § 8-207(4)(a) (1978).

143. *Id.*

144. UCC § 8-207(4)(a) is cited in support of a general statement about the need for a senior creditor, on default of the debtor, to have the security registered free of any junior interest. Aronstein, Haydock & Scott, *supra* note 30, at 901.

145. Coogan apparently came to the same conclusion; he suggested that § 8-207(4)(a) "may prove to be a trap for the unwary secured party seeking a shortcut to enforce his security interest." Coogan, *supra* note 49, at 1054.