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Article Eight—Article Eight?

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ARTICLE EIGHT—ARTICLE EIGHT?†

Professor Douglas R. Heidenreich†

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I. INTRODUCTION

Revised Article Eight¹ is a perfect example of the Uniform

† This material refers to Uniform Commercial Code sections by their official text citations. The Minnesota version of the Code appears in Chapter 336 of Minnesota Statutes.

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1. The Minnesota Legislature adopted the revised official text of Article Eight of the Uniform Commercial Code and accompanying revisions in Articles One, Four, Five and Nine. See Act of May 22, 1995, ch. 194, 1995 Minn. Laws 817. Minnesota thus joined approximately a dozen other states that have adopted the revision. See, e.g., ARK. CODE ANN. §§ 4-8-102 to -603 (Michie Supp. 1995); ARIZ. REV. STAT. ANN. §§ 47-8101 to -8511 (Supp. 1995); IDAHO CODE §§ 28-8-101 to -511 (1995); ILL. ANN. STAT. ch. 810, paras. 5/8-101 to -603 (Smith-Hurd Supp. 1996); IND. CODE ANN. §§ 26-1-8.1-101 to -511 (West Supp. 1995); LA. REV. STAT. ANN. §§ 10:8-101 to -511 (1995); NEB. REV. STAT. ANN. §§ 8-101 to -603 (Michie 1995); TEX. BUS. & COM. CODE ANN. §§ 8.101-511 (West Supp. 1996); WASH. REV. CODE ANN. §§ 62A.8-101 to -601 (West Supp. 1996); W. VA. CODE §§ 46-8-102 to -601 (Supp. 1995); Act of Mar. 5, 1996, ch. 47, N.M. Laws ___ (to be codified at N.M. STAT. ANN. §§ 55-8-101 to -8-511); Act of June 7, 1995, ch. 328, 1995 Or. Laws ___ (to be codified at OR. REV. STAT. §§ 78.1010-5110); Act of Mar. 12, 1996, ch. 204, 1996 Utah Laws ___ (to be codified at UTAH CODE ANN. §§ 70A-8-100 to -8-601); Act of Mar. 16, 1996, ch. 216, 1996 Va. Acts ___ (to be codified at VA. CODE ANN.

Commercial Code's announced purpose to "simplify, clarify and modernize" the law of commercial transactions and to "permit the continued expansion of commercial practices through custom, usage and agreement of the parties."² The new Article establishes a set of rules that will apply to the system of the indirect holding of securities that has developed in recent years. The rules are, however, also designed to be flexible enough to cover traditional methods of holding securities and other devices that might be used in the future.

What follows is a basic explanation of the new terminology that New Article Eight uses; the system of indirect holding and the rules governing the rights of the various parties to a securities transfer; and the rules governing the creation and perfection of a security interest in securities.

II. THE HISTORY OF ARTICLE EIGHT AND THE RISE OF THE INDIRECT HOLDING SYSTEM

The original version of Article Eight, entitled "Investment Securities," was designed to deal with *some of the rights* of parties who issued, traded in or otherwise handled securities.³ It contemplated that those parties would deal in pieces of paper that represented corporate obligations or shares of corporate stock.⁴ Because of a "paperwork crunch" that developed in the securities markets during the late 1960s, the American Bar Association Section of Corporation, Banking and Business Law formed a Committee on Stock Certificates to consider how to

§§ 8.8A-101 to -601). Minnesota's new law became effective on January 1, 1996. MINN. STAT. § 336.8-601 (Supp. 1995).

2. U.C.C. § 1-102(1)-(2) (1994).

3. "Article [Eight] covers a broad spectrum of negotiable investment paper, but deals with only certain transactions involving such paper." *Beck v. American Sharecom, Inc.*, 514 N.W.2d 584, 589, 23 U.C.C. Rep. Serv. 2d (Callaghan) 548, 553 (Minn. Ct. App. 1994), *rev. denied*, (Minn. June 29, 1994). The official comment to the original version of § 8-101 said, "The Article Eight is neither a Blue Sky Law nor a corporation code. It may be likened rather to a negotiable instruments law dealing with securities." U.C.C. § 8-101 official cmt. (1958).

4. The original version of § 8-102(1) defines a security for Article Eight purposes as "an instrument," a term not defined in Article Eight, and speaks of "[a] writing which is a security." U.C.C. § 8-102(1) (1958). The security, among other things, must evidence a share or interest in property or an enterprise, or an obligation of the issuer. *Id.* An instrument that qualifies as an Article Three negotiable instrument but is also a security is governed by Article Eight. *Id.* § 8-102(1)(b).

deal with the problem.⁵

This committee proposed changes in the law that were designed to facilitate the elimination of paper securities.⁶ The result of that committee's work was a proposed new version of Article Eight that set out rules dealing with uncertificated securities—that is, securities not represented by instruments, but “registered upon books maintained for that purpose by or on behalf of the issuer.”⁷ It was anticipated at that time that issuers of securities, rather than issuing pieces of paper that would have to be handled whenever a security was sold or encumbered, would simply enter information on their records in response to instructions transmitted by electronic or other means.

This, however, did not occur—at least not as widely as had been anticipated. Instead, a different system of dealing with securities has developed. Although certificates are issued by the issuer, and many owners of securities still hold pieces of paper, the certificates representing most corporate stock are held by someone else, a securities intermediary⁸—usually a clearing corporation.⁹ Individual ownership of shares of stock is represented by a notation on the records of the securities intermediary rather than on the records of the issuer. When an owner of a security sells the security, the change in ownership is accomplished by a change in the records of the securities intermediary. The new version of Article Eight establishes rules and adopts a

5. U.C.C. art. 8, reporter's introductory cmt. at xv (Proposed Revision Apr. 1, 1977).

6. *Id.*

7. *Id.* This version of Article Eight was adopted in Minnesota and became effective on January 1, 1979. Act of Mar. 28, 1978, ch. 695, 1978 Minn. Laws 550.

8. See U.C.C. § 8-102(a)(14) (1994). The term “securities intermediary” includes a clearing corporation or a person who, in the ordinary course of business, maintains securities accounts for others. *Id.* A securities account is “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 [*sic*] the financial asset.” *Id.* § 8-501(a). A financial asset may be a security, but it can be almost any kind of property if the parties agree that it is to be treated as a financial asset and it is held in a securities account. *Id.* § 8-102(a)(9).

9. See *id.* § 8-102(a)(5). “Clearing corporations” include Federal Reserve banks, persons registered under federal law as “clearing agenc[ies],” and organizations that, were they not exempt, would be registered because they provide clearance or settlement services. *Id.*

set of new terms to deal with this development.¹⁰

III. GENERAL APPROACH OF NEW ARTICLE EIGHT

The drafters of the revised Article Eight understood that the securities holding system may evolve in any number of ways, some of which may not now be predictable; accordingly, they adopted a principle of neutrality. That is, they sought to eliminate barriers to the development of new holding systems, but not to favor any particular system. As a result, the revised Article Eight contains many of the rules, sometimes clarified and simplified, from the earlier version of Article Eight, that relate to the direct holding system. In addition, the drafters created a new Part Five that deals specifically with the indirect holding system. Furthermore, they moved the rules relating to the creation and enforcement of security interests in securities back to Article Nine, where the rules had been before the 1978 amendments, and where they more properly belong. The following material focuses on the changes that new Article Eight has adopted, but will say little about the traditional rules of the old statute that are preserved.

One cannot understand the Code without understanding the definitions. The lawyer who approaches a Code problem must consult the general definitions of section 1-201 and the specific definitions that appear in various substantive Code articles. Revised Article Eight contains some definitions that are essentially those used in the past, but adopts some new terminology, understanding of which is crucial:

A *security* is defined as "an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer."¹¹

An *issuer*, in turn, is defined as a person that authorizes its name to be placed on a security certificate; creates a share, participation, or other interest in property; or undertakes an obligation that is an uncertificated security, et cetera.¹²

Thus, traditional shares of stock, bonds, and so on are

10. The official text of revised Article Eight opens with a prefatory note, which is essential reading for anyone who wants to understand the development of the indirect holding system and the new approach to it. See U.C.C. art. 8, prefatory note (1994).

11. U.C.C. § 8-102(a)(15) (1994).

12. *Id.* § 8-201(a).

obviously securities.¹³ Other interests, such as interests in limited partnerships or interests in limited liability partnerships, may or may not be covered by the term.¹⁴ It is important to know whether a particular interest is a security, because Article Eight governs the rights of people holding or dealing with securities,¹⁵ but other law governs when the subject matter of the transaction or dispute is something other than a security.¹⁶

A. *Rules for Direct Holding of Certificated Securities*

A person wishing to acquire an interest in a security might do so in one of several ways. Traditionally, for example, the person would take possession of a piece of paper that says that she owns a certain number of shares of stock in a corporation. This is commonly referred to as the direct holding system.

1. *Acquisition of an Interest in a Certificated Security*

The rules relating to the transfer of an ownership interest in a certificated security¹⁷ remain much the same under the revised Article Eight.¹⁸ In order to obtain an interest in a certificated security, a person must take delivery—that is, acquire physical possession of the paper—or a third party must do so on

13. *See id.* § 8-103(a). “A share or similar equity interest issued by a corporation, business trust, joint stock company, or similar entity is a security.” *Id.*

14. “An interest in a partnership or limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this Article, or it is an investment company security.” *Id.* § 8-103(c).

15. *See id.* § 8-110 (1994) (describing applicability and providing for choice of law); U.C.C. § 3-102(a) (1990) (stating that Article Three does not apply to securities governed by Article Eight).

16. Note that a “security certificate” is governed by Article Eight even though it may fall within the definition of a “negotiable instrument.” U.C.C. § 8-103(d) (1994); *see also id.* § 8-102(a)(16) (defining “security certificate”); U.C.C. § 3-104(a) (1990) (defining “negotiable instrument”).

17. A “certificated security” is defined as “a security that is represented by a certificate.” U.C.C. § 8-102(a)(4) (1994). Furthermore, a “security certificate” is defined as “a certificate representing a security.” *Id.* § 8-102(a)(16). An “uncertificated security,” on the other hand, is “a security that is not represented by a certificate.” *Id.* § 8-102(a)(18). There seems to be no definition of a certificate. Perhaps that is one of those things about which we can say, “You know one when you see one.”

18. Part Three of Article Eight deals with the process of transfer. The focus now, however, is on the term “delivery.” Whether the security involved is certificated or uncertificated, the new Article Eight refers to the transfer as a delivery. *See* U.C.C. art. 8, prefatory note, at 24-26 (Proposed Final Draft Apr. 5, 1994) (explaining how the terminology evolved).

behalf of the person claiming an interest.¹⁹ The basic rule of the shelter principle, which is well recognized in negotiable instruments law,²⁰ appears in revised Section 8-302(a): a buyer gets what her seller had or had power to transfer.²¹ These rights vest upon the purchaser's acquisition of possession of a certificated security.²²

2. Statute of Frauds

One notable change from the old Article Eight is the elimination of any statute of frauds requirement.²³ New section 8-113 makes enforceable a contract for the sale of a security whether or not there is any writing,²⁴ "even if the contract is not capable of performance within one year of its making."²⁵

19. In *Beck v. American Sharecom, Inc.*, the Minnesota Court of Appeals, applying the previous version of § 8-313, rejected the plaintiff's claim of conversion, wrongful transfer, and tortious interference with contractual rights when the plaintiff claimed that the redemption of stock by an issuer was wrongful because the owner had allegedly promised to transfer some shares to the plaintiff in partial payment for services. 514 N.W.2d 584, 588-89, 23 U.C.C. Rep. Serv. 2d (Callaghan) 548, 552 (Minn. Ct. App. 1994). The court concluded that no conversion had taken place because the plaintiff had no rights in any shares of stock, no transfer having been made. In order for a transfer to take place, the court concluded, "there must be delivery or its legal equivalent." *Id.* at 588, 23 U.C.C. Rep. Serv. 2d at 552. The same principle would apply under the revised § 8-301. See U.C.C. § 8-301 (1994). The *Beck* case also rejects the wrongful transfer claim on the basis of § 8-207, which then as now says that the issuer may treat the registered owner as entitled to exercise all rights in the security until due presentation of a certificated security in registered form for registration of transfer. *Beck*, 514 N.W.2d at 589, 23 U.C.C. Rep. Serv. 2d at 553; see also U.C.C. § 8-207 (1994).

20. *E.g.*, U.C.C. § 3-203(b) (1990).

21. U.C.C. § 8-302(a) (1994).

22. See *id.* § 8-301(a)(1) (defining "delivery" of a certificated security); *id.* § 8-302(a) (describing rights acquired by purchaser upon delivery).

23. The old version's § 8-319, which set out a statute of frauds requirement and several exceptions that tracked the Article Two approach, has been dropped. See U.C.C. § 8-319 (1977) (section withdrawn 1994).

24. Note that the new rule speaks of "a writing signed or a record authenticated." U.C.C. § 8-113 (1994). The use of the term "record" is a harbinger of things to come in the revised version of Article Two that will be promulgated within the next couple of years. See, *e.g.*, U.C.C. §§ 2-201 to -202 (Council Draft No. 1, 1995) (stating that an agreement may be enforceable absent a written "record" thereof; acknowledging that a record of the parties, intended to be the final expression of their agreement, generally may not be contradicted by extrinsic evidence).

25. Both the Article Eight statute of frauds and the general, one-year statute of Minnesota Statutes § 513.01 were implicated in *Belfry v. Collision Center, Inc.*, Nos. C8-90-1107, CX-90-1108, 1990 WL 115109 (Minn. Ct. App. Aug. 14, 1990), *rev. denied*, (Minn. Oct. 18, 1990). The plaintiff claimed that he had an oral understanding that he would receive stock if he were still with the company at the end of five years. *Id.* at *1. The court of appeals noted that neither statute had been satisfied but assumed that

Although relatively few Article Eight cases have arisen in Minnesota, those that have been decided often have dealt with statute of frauds issues. Suppose, for example, that an entrepreneur allegedly makes an oral promise to issue shares of stock in an enterprise to someone in exchange for payment, goods or services. The shares are never issued and the promisor, when sued, pleads the statute of frauds.

The defendant successfully pled the statute of frauds in *Holmes v. Torguson*,²⁶ a case involving an alleged joint venture for the development of certain gambling operations. When the joint venture was aborted, the plaintiff sued the other alleged venturer. Because a crucial aspect of the venture involved the alleged oral agreement that the plaintiff would purchase half of the stock in two of the defendant's companies, the defendant argued that the entire venture would fail due to the unenforceability of the alleged stock purchase provision. Judge Murphy agreed, disposing of the case on summary judgment motions and observing, "There is no enforceable joint venture because its essential term, the sale of the stock, is unenforceable under the statute of frauds."²⁷

Similarly, in *Dullea v. Dullea Co.*,²⁸ the Minnesota Court of Appeals summarily disposed of plaintiff's attempt to enforce an alleged oral stock transfer agreement. Judge Lansing upheld the trial court's denial of a claim for specific performance: "Any oral contract for purchase of Dullea Co. stock is unenforceable under [Minnesota Statutes section 336.8-319]."²⁹

These cases now are of historical interest only. In fact, the statute of frauds governing sales of goods may go the way of the Article Eight statute. The current proposed revision of Article Two takes an approach a lot like that of revised Article Eight.³⁰

both applied. *Id.*

26. No. CIV. 4-92-259, 1993 WL 385614 (D. Minn. Aug. 20, 1993), *aff'd*, 41 F.3d 1251, 25 U.C.C. Rep. Serv. 2d (Callaghan) 517 (8th Cir. 1994).

27. *Id.* at *6.

28. No. C8-91-498, 1991 WL 271479 (Minn. Ct. App. Dec. 24, 1991), *rev. denied*, (Minn. Feb. 19, 1992), *and further rev. denied*, (Minn. Aug. 6, 1993).

29. *Id.* at *3.

30. The current proposed revision of § 2-201 says that a sale of goods contract would be enforceable even though no record exists, even if the contract cannot be performed within one year of its making. See U.C.C. § 2-201 (Council Draft No. 1, 1995). The notes to that section observe that an attempt to reintroduce the writing requirement was rejected at the 1995 meeting of the National Conference of Commissioners on Uniform State Laws, the Code's co-sponsoring body. *Id.* cmt. 1.

When the smoke clears, perhaps there will be only some sort of general statute of frauds and, within the Code, a writing requirement for the creation of a security interest under Article Nine and the anachronistic island of section 2A-201, the statute governing leases of personal property.

Of course, the abandonment of the statute of frauds rule extends to contracts involving the sale of uncertificated securities or securities entitlements as well. No writing will be required to make any sale of a security enforceable.

B. Rules for Uncertificated Securities

The new Article Eight has preserved the old rules that govern the transfer of uncertificated securities and the rights and obligations of those who deal in them. Thus, under revised section 8-301(b)(1), *delivery* of an uncertificated security occurs when the issuer registers the transfer; under Section 8-112(b), a creditor who seeks to obtain rights in an uncertificated security must serve legal process upon the issuer at its chief executive office in the United States. Security interests in uncertificated securities are treated below.

C. The Indirect Holding System

Most securities issued by corporations whose stock is publicly traded are held through the indirect method. Consider, as an example, Vera Rich, a shareholder in such a corporation. She could obtain a certificate issued in her name in the traditional way. On the other hand, her interest could be evidenced only by its being registered on the issuer's books, as would be the case if she were the holder of an uncertificated security.

Instead of either of these two methods of holding a security, however, she may hold by the indirect method: her broker will have marked its books to reflect the fact that she holds a certain number of shares of stock in the issuer. The broker, in turn, will not have a piece of paper, but the broker's interest—which comprises the rights of its customers and, if it holds shares in its own name, itself—is reflected by an entry on the books of some other entity. Somewhere, in the hands of a depository, is a certificate that names as the shareholder an entity denominated as Cede & Co. Professor Rogers, the drafter of revised Article Eight, explains it this way:

If one examined the shareholder records of any large

corporation whose shares are publicly traded on the exchange or in the over the counter market, one would find that one entity—Cede & Co.—is listed as the shareholder of record of somewhere in the range of sixty to eighty per cent of the outstanding shares of all publicly traded companies. Cede & Co. is the nominee name used by The Depository Trust Company (“DTC”), a limited purpose trust company organized under New York law for the purpose of acting as a depository to hold securities for the benefit of its participants, some 600 or so broker-dealers and banks.³¹

DTC’s books break down the total number of shares of each security that it holds in the aggregate into accounts for each of its participants. To settle each day’s trading, DTC simply adjusts the amounts shown in the participants’ accounts.³²

This does not mean that all individual trades are reflected in changes in book entries at this level. Any individual broker-dealer, some of whose customers buy and some of whose customers sell stock in a particular company, will make changes on its own books to reflect these changes in ownership, but, unless it must buy or sell in the market in such a way that its total net position changes, no entries on DTC’s books will be necessary. If net changes must be made, the clearing and netting functions are carried out by the National Securities Clearing Corporation.

IV. NEW TERMINOLOGY, NEW RULES

While the new version of Article Eight retains the basic principles that govern the direct holding system for certificated and uncertificated securities, the new law takes a different conceptual approach to the indirect holding system. The owner of the security is no longer considered a holder of a security.³³ Instead, the owner is thought of as having a property right which comprises a set of rights against the securities intermediary³⁴ and an interest in the property held by that securities intermediary.

31. U.C.C. art. 8, prefatory note, at 2 (Proposed Final Draft Apr. 5, 1994).

32. *Id.*

33. Remember, however, that in the *direct* holding system, the owner of the right is said to hold a security. See *supra* Section III.A.

34. A securities intermediary usually is a broker-dealer or a bank. See *infra* text accompanying note 37 (discussing Article Eight’s definition of “securities intermediary”).

This approach requires the use of new terminology. The important new terms are:

A *security entitlement* is described as the “rights and property interest of an entitlement holder with respect to a financial asset specified” in Part Five of new Article Eight.³⁵

An *entitlement holder* is “a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary.”³⁶

A *securities intermediary* is “(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.”³⁷

A *financial asset* may be something that is held in a securities account but is not a security, such as an interest in a partnership or a limited liability company,³⁸ but a security is a financial asset.³⁹ Section 8-103 gives guidance on when something is a security or a financial asset.

A *securities account* is “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 [*sic*] the financial asset.”⁴⁰

The new rules appear in a new Part Five of Article Eight. The approach differs from the traditional one of considering a buyer of a security a purchaser of a specific quantity of securities that are held by the broker. Rather, the entitlement holder acquires a property interest in all of the property held by the intermediary and a set of *in personam* rights against that intermediary. The blend of traditional notions and new concepts balances the interests of the securities intermediary and the entitlement holders.

The traditional “broker’s lien” is preserved by section 8-502, which gives to the intermediary an automatic security interest in

35. U.C.C. § 8-102(a)(17) (1994).

36. *Id.* § 8-102(a)(7).

37. *Id.* § 8-102(a)(14).

38. However, such an interest could be a security if “its terms expressly provide that it is a security governed by [Article Eight].” *Id.* § 8-103(c).

39. *Id.* §§ 8-102(a)(9), 8-103.

40. *Id.* § 8-501(a).

the securities entitlement to secure payment of the agreed consideration.⁴¹ On the other hand, the securities intermediary is treated rather as a trustee of the financial assets and securities entitlements that it holds for entitlement holders. These assets are not the property of the intermediary and are not subject to claims of the intermediary's creditors.⁴²

"A securities intermediary shall maintain a sufficient quantity of financial assets or securities entitlements to satisfy the securities entitlements of all of its entitlement holders."⁴³ If the securities intermediary violates that obligation, the entitlement holder may compel the securities intermediary to reestablish the securities entitlement or to pay damages.⁴⁴ However, if the intermediary goes broke, the entitlement holder may not pursue any purchaser of the financial asset or interest who has given value, obtained control⁴⁵ and has not colluded with the intermediary.⁴⁶

The securities intermediary must pass payments and distributions through to the entitlement holder;⁴⁷ follow the entitlement holder's entitlement orders;⁴⁸ and generally follow the entitlement holder's instructions about what to do with the financial asset or securities entitlement.⁴⁹ Indeed, the securities intermediary must follow entitlement orders issued only by an authorized person. The securities intermediary is liable if it follows an entitlement order from an unauthorized person.⁵⁰

For such comfort as it may give, the securities intermediary that follows an unauthorized payment order may have a breach

41. *Id.* § 8-502; *accord id.* § 9-116.

42. *Id.* § 8-503(a).

43. *Id.* § 8-504(a).

44. *Id.* § 8-503(c)-(d).

45. See § 8-106(b)-(d) for a definition of "control." This is an important concept that will be discussed below in the material on security interests. See *infra* notes 63-72 and accompanying text.

46. U.C.C. § 8-510 (1994).

47. *Id.* § 8-505.

48. *Id.* § 8-507. An entitlement order is a communication "directing disposition of an entitlement holder's securities entitlement." *Id.* § 8-102(a)(8).

49. *Id.* §§ 8-506, 8-508.

50. *Id.* § 8-507(b). The securities intermediary that follows an ineffective entitlement order is liable for damages if it does not reestablish the securities entitlement, *id.* § 8-507(b); an entitlement order is effective if it is made by the appropriate person or, under the law of agency, the appropriate person is bound by it, *id.* § 8-107(b)-(c); an appropriate person is the entitlement holder, *id.* § 8-107(a)(3).

of warranty claim against the person who issued the order. A person who gives an instruction to transfer a security or who issues an entitlement order gives a series of warranties of genuineness of the security, the right to make the transfer or issue the order, the absence of adverse claims to the security, et cetera.⁵¹

Innocent third parties who act in accordance with normal procedures will be protected from challenges from other claimants. A purchaser⁵² for value who obtains control and who does not have notice of adverse claims takes free of adverse claims.⁵³ A securities intermediary is considered a purchaser for value of a financial asset if it establishes a security entitlement to the financial asset.⁵⁴

Creditors seeking to establish rights in a security may reach a certificated security only by seizure of the certificate; they may obtain rights in an uncertificated security through legal process on the issuer "at its chief executive office in the United States"; they may reach a security entitlement through "legal process upon the securities intermediary with whom the securities account is maintained."⁵⁵

To know what jurisdiction's rules govern the parties' rights, one must consult the choice of law rules that appear in section 8-110. Rights relating to the issuance, registration of transfer, etc. are governed by the law of the issuer's jurisdiction, which is the jurisdiction in which it is organized unless it is allowed to specify another jurisdiction and does so.⁵⁶ Rights involving a securities entitlement are governed by the law of the securities intermediary's jurisdiction, which is any jurisdiction that the securities intermediary and the entitlement holder agree to, or, failing that agreement, where the securities account is main-

51. *Id.* §§ 8-108 to -109.

52. See also the definition of "protected purchaser," *id.* § 8-303(a), and the statement of the rights of a purchaser of a certificated or an uncertificated security, *id.* §§ 8-302, 8-303(b).

53. *Id.* § 8-510; see also *id.* §§ 8-102(a)(1), 8-105 (defining "adverse claims" and "notice of an adverse claim"). Note that "good faith" is not used in Article Eight, but because of the general § 1-203 obligation of good faith, is defined for Article Eight purposes to include the observance of reasonable commercial standards of fair dealing. *Id.* § 8-102(a)(10).

54. *Id.* § 8-116.

55. *Id.* § 8-112(b)-(c).

56. *Id.* § 8-110(a), (d).

tained.⁵⁷

V. SECURITY INTERESTS IN SECURITIES AND SECURITIES ENTITLEMENTS

All of the rules governing the rights of the parties to a security interest in securities or a securities entitlement now appear in Article Nine.⁵⁸ Although under the original version of Article Nine, securities were included in the term "instruments,"⁵⁹ this definition has been changed so that securities and investment property are now subject to independent rules. While the rules remain much the same as before, there is one major change. *It is now possible for a secured party to perfect a security interest in certificated or uncertificated securities by filing.*⁶⁰ The filing does not help very much, however, as a review of the priorities rules demonstrates.

Here again, some new terminology creeps in. A new form of collateral, "investment property," may be subject to a security interest. Investment property includes not only securities and securities entitlements, but securities accounts and commodity contracts, which are neither securities nor financial assets.⁶¹ Investment property is a separate form of collateral; it is not included in the term "general intangible."⁶²

Although, for purposes of the creation and perfection of security interests, many of the same principles apply to securities that apply to other kinds of collateral, the concept of *control* has been substituted for that of possession. Thus, section 9-203 still says that, with certain limited exceptions, a security agreement must be in writing unless the secured party *has possession* of the

57. *Id.* § 8-110(b), (e).

58. In the original version of the Code, the rules governing security interests in securities were in Article Nine. When the 1977 revision of Article Eight was promulgated, the rules governing creation and perfection of security interests in securities were moved to Article Eight. Compare U.C.C. §§ 9-203, 9-304 (1972) with U.C.C. §§ 8-313, 8-321 (1977).

59. See U.C.C. § 9-105(1)(i) (1972).

60. See the discussion of new § 9-115, *infra* notes 73-84 and accompanying text. With the exception of certain limited temporary perfection rights, a secured party could perfect a security interest in certificated securities under the old rules *only* by taking possession of the collateral. U.C.C. § 8-321(4) (1977); U.C.C. §§ 9-304(1), 9-305 (1972).

61. U.C.C. § 9-115(1)(f) (1994); see also *id.* § 8-103(f) (stating that commodity contracts are neither securities nor financial assets). A "commodity contract" is defined in § 9-115(1)(b).

62. *Id.* § 9-106.

collateral pursuant to agreement.⁶³ However, 9-203 now also includes a rule that a security agreement creating a security interest in investment property is unenforceable, unless it is in writing or the secured party *has control* pursuant to agreement.⁶⁴

Control of a certificated security means that a person claiming control has obtained "delivery" of the security⁶⁵ (*i.e.*, she or someone acting on her behalf has taken possession of a certificate indorsed to the possessor or one in which the possessor is named as the registered owner).⁶⁶ *Control of an uncertificated security* means that the person claiming control has obtained "delivery" of the security⁶⁷ (*i.e.*, he has had the security registered in his name or in the name of someone acting on his behalf),⁶⁸ or that the issuer has agreed to act on behalf of the person claiming control without further consent of the registered owner.⁶⁹ *Control of a securities entitlement* means that the person claiming control has become the entitlement holder or that the securities intermediary has agreed to act pursuant to instructions issued by the person, without further consent of the entitlement holder.⁷⁰ *The securities intermediary who is also a secured party always has control.*⁷¹

The secured party retains control even though the debtor (the registered owner or entitlement holder) retains the right to deal with the securities entitlement or uncertificated security. Furthermore, while the issuer of the uncertificated security or the securities intermediary may not enter into a control agreement without the consent of the registered owner or entitlement holder, it is not required to do so even at the request of the registered owner or entitlement holder.⁷²

The new rules governing security interests in securities

63. *Id.* § 9-203(1).

64. *Id.*; *see also id.* § 8-104 (concerning the acquisition of security, financial asset, or interest).

65. *Id.* § 8-106(b); *see also id.* § 8-301(a) (describing when delivery of a certificated security occurs).

66. *Id.* § 8-301(a).

67. *Id.* § 8-106(c)(1).

68. *Id.* § 8-301(b).

69. *Id.* § 8-106(c)(2).

70. *Id.* § 8-106(d).

71. *Id.* § 8-106(e). A similar idea appears in proposed new Article Nine rules relating to deposit accounts. *See* U.C.C. § 9-117(a)(1) (Discussion Draft Nov. 1, 1995) (stating that the depository institution has "control" over a deposit account).

72. U.C.C. § 8-106(g) (1994).

entitlements appear for the most part in sections 9-115 and 9-116. The rules facilitate the use of the securities entitlement as collateral.

Description of the Collateral. A security agreement or a financing statement contains a sufficient description of the collateral if it describes the collateral in specific terms or simply as investment property or some other generic term that describes the asset (*e.g.*, “certificated security”).⁷³

Attachment. If a security interest attaches to or is perfected in a securities account, this constitutes attachment to or perfection in the securities entitlements carried in the account.⁷⁴

Perfection. A security interest in investment property (remember, this includes a securities account) may be perfected either through the secured party’s taking control⁷⁵ or by filing.⁷⁶ A security interest in investment property granted by a broker or securities intermediary is automatically perfected upon attachment.⁷⁷

Priorities. The rules basically follow traditional concepts, but are adjusted to fit the indirect holding system and to take account of the filing option. The priorities rules govern several sorts of conflicts involving different types of claimants to the same collateral.

Secured Party v. Secured Party. The resolution of this sort of problem depends upon the sort of collateral involved and the method of perfection that each claimant has used.

For example, a secured party in possession of a certificated security pursuant to agreement has priority over secured parties perfected by other means.⁷⁸

A securities intermediary with a security interest in a securities entitlement or a securities account prevails over all other secured parties, unless the securities intermediary agrees otherwise.⁷⁹ *Remember that the securities intermediary has an automatic, perfected security interest in financial assets for which it has*

73. *Id.* § 9-115(3).

74. *Id.* § 9-115(2).

75. *Id.* § 9-115(4)(a).

76. *Id.* § 9-115(4)(b).

77. *Id.* § 9-115(4)(c).

78. *Id.* § 9-115(6).

79. *Id.* § 9-115(5)(c).

not been paid if the assets are credited to a securities account.⁸⁰

A secured party in control has priority over a secured party that does not have control.⁸¹ If more than one secured party has control and none of them is the securities intermediary that holds the account, they rank equally.⁸² This equality principle is new. Other priorities rules follow a winner-takes-all approach.

The relative priorities of secured parties who are not in control will be governed by the normal first-to-file-or-perfect rules;⁸³ there is no "purchase money" priority position in this kind of collateral.⁸⁴

Secured Party v. Other Claimants. A transferee of investment property in which there is an unperfected security interest, who gives value and acts without knowledge, prevails over the secured party.⁸⁵

A lien creditor takes priority over an unperfected secured party.⁸⁶ It is here, however, that perfection by filing is most likely to be of some value, for the secured party who has perfected by filing, though subordinate to other secured parties, is, after all, perfected, and will beat the trustee in bankruptcy.

Entitlement Holders v. Secured Party. If a securities intermediary has given a security agreement in financial assets and it proves to hold an insufficient number of those financial assets to satisfy its creditors and its entitlement holders, the entitlement holders come first unless the secured party has control.⁸⁷

Treatment of Proceeds. The normal proceeds rules apply. It is now clear that "[a]ny payments or distributions made with respect to investment property collateral are proceeds,"⁸⁸ and that the perfected secured party with a security interest in investment property has a continuing perfected security interest

80. *Id.* § 9-116(1).

81. *Id.* § 9-115(5)(a).

82. *Id.* § 9-115(5)(b).

83. *Id.* § 9-312(5)-(7).

84. *Id.* § 9-115(5)(f).

85. *Id.* § 9-301(1)(d).

86. *Id.* § 9-301(1)(b). Likewise, a trustee in bankruptcy takes priority over an unperfected secured party. *Id.* § 9-301(3); see also Bankruptcy Code, 11 U.S.C. § 544 (1994).

87. U.C.C. § 8-511(a)-(b) (1994); see also *id.* §§ 8-503, 8-504 (defining scope of entitlement holder's property interest in a financial asset held by a securities intermediary; describing securities intermediary's duty to maintain the asset).

88. *Id.* § 9-306(1).

in cash proceeds.⁸⁹

Choice of Law. Although section 8-110 establishes choice of law principles for Article Eight purposes, choice of law rules governing securities interests in investment property appear in section 9-103(6). In general, the law of the jurisdiction in which a certificated security is located governs rights in certificated securities.⁹⁰ The law of the issuer's jurisdiction, as defined in section 8-110(d), governs rights in uncertificated securities.⁹¹ The law of the securities intermediary's jurisdiction governs rights in a security entitlement or a securities account.⁹² Remember, however, that the securities intermediary's jurisdiction is whatever the securities intermediary and the entitlement holder agree it will be.⁹³ If a broker or securities intermediary is the debtor, the law of the debtor's jurisdiction governs.⁹⁴

VI. TRANSITION TO THE NEW ARTICLE EIGHT

The new rules became effective in Minnesota on January 1, 1996.⁹⁵ However, the new statute does not apply to any actions or proceedings commenced prior to that date.⁹⁶

A security interest in a security that was perfected when the new law took effect remains perfected if the method by which perfection was achieved would be sufficient to result in perfection under the new rules.⁹⁷ This means that for the most part secured parties will not have to do anything to preserve their perfection in certificated securities or in uncertificated securities because in the former case, they will have possession of the collateral, and in the latter case, their interests will be noted on the books of the issuer.⁹⁸ These are proper means—indeed, the only really safe means—of perfecting under the new rules, although filing is also available.

If a secured party has perfected in some way that would not constitute perfection under the new law, the security interest

89. *Id.* § 9-306(3)(c).

90. *Id.* § 9-103(6)(b).

91. *Id.* § 9-103(6)(c).

92. *Id.* § 9-103(6)(d).

93. *Id.* § 8-110(e)(1).

94. *Id.* § 9-103(6)(f).

95. MINN. STAT. § 336.8-601 (Supp. 1995).

96. MINN. STAT. § 336.8-603(a) (Supp. 1995).

97. U.C.C. § 8-603(b) (1994).

98. *See* U.C.C. §§ 8-313, 8-321 (1977) (sections withdrawn 1994).

remains perfected for four months, following which it becomes unperfected unless the secured party perfects under the new rules within that time. This will be a rare situation. If, however, a secured party does wish to make a filing during the four-month period, she may do so by filing a financing statement signed by the secured party rather than the debtor.⁹⁹

VII. SUMMARY

The Minnesota lawyer should have little trouble with the principles of revised Article Eight, but the new terminology that reflects the use of the indirect holding system for the holding of securities may take some getting used to. Perhaps the most important thing to remember is that Article Nine now governs the creation and enforcement of securities interests in securities and, indeed related sorts of collateral such as financial assets as defined in the new statute.

The lawyer must keep in mind the importance of possession or its functional equivalent, control, and not be misled by the possibility of a filing as a means of perfection of a security interest. While filing may be a useful precaution for the secured party who is worried about a trustee in bankruptcy, it gives little protection against anyone else.

99. U.C.C. § 8-603(b) (1994).