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3-27-2001

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Reviewing Article 8's Revised Collusion Standard; Outside Counsel

Francis J. Facciolo

Outside Counsel

The first published case to deal with the new collusion standard in revised Article 8 has been decided by Judge Bransten in Supreme Court, New York County.[1] As New York City is the center of the securities industry, it is not surprising that the first published case to deal with collusion was decided here. The result reached by Judge Bransten, however, is surprising in the liberality with which collusion was construed.

The 1994 revision of Article 8 took effect in New York State on Oct. 10, 1997.[2] For those readers that are unfamiliar with Article 8, it is the article that deals with the transfer of securities. The 1977 version of Article 8, a slight variation of which was New York law for 20 years, included elements that are analogous to both Article 3 (negotiable instruments) and Article 9 (security interests), articles with which most lawyers are more familiar.

Revised Article 8 has moved the provisions dealing with security interests in securities back to Article 9. The 1994 revision dealt with the indirect holding system for securities and involved a complete reconceptualization and clarification of the prior Article 8, creating separate parts to address both the direct and indirect holding systems.

In describing the indirect holding system, revised Article 8 utilizes a whole new vocabulary that will be unfamiliar to those lawyers whose practice does not regularly include Article 8 matters.

Among the most important new defined terms are the following: financial asset (broader than just securities, includes obligations, shares, participations, and interests held through securities intermediaries); securities intermediary (a clearing corporation or a person such as a bank or broker that holds securities accounts for others); entitlement holder (persons who hold financial assets through intermediaries in the indirect holding system); and securities entitlement (the rights and property interest of a person who holds securities or other financial assets through a securities intermediary).[3]

Certain changes in revised Article 8 that offered increased protection to transfees of securities, in particular secured lenders, against claims that a transfer was wrongful were the most controversial provisions of revised Article 8. Some commentators believe that beneficial owners of securities have been materially disadvantaged by these changes.[4] Other commentators, notably Professor Rogers, the reporter for revised Article 8, believe that prior law, including that of New York, has not been materially altered by these changes.[5] The latter is the position that was taken by the two committees of the Association of the Bar of the City of New York.[6] that played a large role in the adoption of revised Article 8 in New York.

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Facts in Drage

Nathan W. Drage, P.C. v. First Concord Securities, Ltd. is the first to deal with what, up until now, have been abstract policy arguments.[7] Drage involved a motion, based upon Sections 8-503(d) and (e) of revised Article 8, to dismiss the plaintiff's claims. Although she did not need to reach the issue of collusion, Judge Bransten held that the plaintiff had pled sufficient facts to withstand the motion to dismiss. These facts did not involve the type of knowledge or conspiratorial conduct that the supporters of revised Article 8 conceived collusion as involving. Rather, these facts, at most, could have established that the alleged colluder acted in bad faith. The plaintiff in Drage had transferred 430,000 shares of GS Telecom, Ltd. (GS) to an account with First Concord Securities, Ltd. First Concord was a Nevis, West Indies corporation with offices in the West Indies and Mexico,[8] and was not registered with the SEC. First Concord had opened a security clearance account with a subsidiary of M&T Bank Corporation (M&T Bank). Several months after the security clearance account was established, M&T Bank began extending credit to [First Concord] in connection with its trading activities. These loans were secured pursuant to a written agreement between M&T Bank and First Concord. The loans eventually totaled $4.9 million, although First Concord had executed a note in the face amount of $1.5 million. After seven months of providing financing to First Concord, M&T Bank, as it was allowed to under the loan documentation, declared an event of default and seized all the securities in First Concord's account, including the Drage GS shares.[9]Drage sued First Concord and its principal, and M&T Bank and various of its affiliates on a number of claims. A conversion claim against M&T Bank was the one that raised the collusion issue. Under section 8-503(e) of revised Article 8, any purchaser [M&T Bank] of a financial asset or interest therein [the Drage GS shares] who gives value [the $4.9 million loan], obtains control, and does not act in collusion with the securities intermediary [First Concord] in violating the securities intermediary's obligations under Section 8-504 is immune to any claim with respect to the financial asset, whether framed in conversion, replevin, constructive trust, equitable lien, or other theory. Section 8-504 is the section of revised Article 8 that mandates that a financial intermediary such as First Concord must hold financial assets corresponding to the security entitlements of its entitlement holders, such as Drage, and must not, unless authorized by the entitlement holder, grant any security interest in any such financial asset. Drage argued that First Concord had violated section 8-504(b) by granting M&T Bank a security interest in the GS shares and, therefore, M&T Bank had no such interest. Judge Bransten properly rejected that argument, relying upon Official Comment 2 to section 8-504. The comment states that section 8-504(b) does not determine the rights of a secured party to whom a securities intermediary wrongfully grants a security interest; that issue is governed by Sections 8-503 and 8-511.Judge Bransten then examined section 8-503(a), which provides that the property interests of entitlement holders in financial assets held by a securities intermediary are not subject to claims of creditors of the securities intermediary, except as otherwise provided in section 8-511. Section 8-511 provides for the priority rules among secured creditors of a securities intermediary and entitlement holders when there is a shortfall in the financial asset against which claims are made. Under section 8-511(a), the entitlement holder prevails unless, under section 8-511(b), the secured creditor has control over the financial asset. The plaintiff attempted to argue that M&T Bank did not control the GS shares because either, under section 8-106(d)(1), the transfer of Drage's shares to M&T Bank was

unlawful or, under section 8-106(d)(2), there was no evidence in the record that Depository Trust Company, M&T's securities intermediary, had agreed to abide by M&T's instruction with respect to the GS shares. Without discussing her reasoning, Judge Bransten held that M&T Bank had control of the GS shares. Presumably she could have been relying upon either section 8-106(d)(1), which provides that a purchaser has control of a security entitlement if ... the purchaser becomes the entitlement holder, or section 8-106(e), which provides that [i]f an interest in a security entitlement is granted by the entitlement holder to the entitlement holder's own securities intermediary, the securities intermediary has control. The argument for applying the former section would be that, as the GS shares were held by DTC in an M&T Bank account, M&T Bank was the entitlement holder with respect to DTC. The proper approach, however, would be to apply section 8-106(e) as it describes the precise situation between M&T Bank and First Concord. Once Judge Bransten had held that M&T Bank had a perfected security interest in the GS shares and was in control of the GS shares, the only remaining issue was whether plaintiff could meet the conditions imposed by section 8-503(d) in order to bring an action against M&T Bank as the purchaser of the GS shares.

M&T Bank as Purchaser

As all the other preconditions to an action by Drage as an entitlement holder under section 8-503(d) had been met according to Judge Bransten, the only issue raised by the facts in Drage was whether M&T Bank had act[ed] in collusion with the securities intermediary [First Concord] in violating the securities intermediary's obligations under Section 8-504.

Judge Bransten alluded to another condition imposed by section 8-503(d): any action brought against a purchaser has to be brought by [t]he trustee or liquidator of the financial intermediary from which the financial asset was transferred. An individual entitlement holder can bring an action with respect to a particular financial asset only [i]f the trustee or other liquidator elects not to pursue that right.

As First Concord was involved in bankruptcy proceedings in the West Indies, Judge Bransten stayed the Drage case until that proceeding was resolved and the prosecution, by the trustee in that proceeding, of plaintiff's claims against M&T Bank.

Judge Bransten could have stopped at this point, leaving the issue of collusion to be argued and tried in the West Indies litigation. She went on to hold, however, that sufficient facts suggesting collusion had been pled for M&T Bank's motion to dismiss to fail.

Judge Bransten focused on two alleged facts in finding that collusion had been satisfactorily pled. First, loans had been made by M&T Bank to First Concord that were far in excess of the amount provided for in the Secure Grid Note and Pledge Agreement (the Note and Agreement). The face amount of the Note and Agreement was $1.5 million but the total amount of the credit extended by M&T Bank to First Concord prior to M&T Bank declaring an event of default under the Note and Agreement was $4.9 million.

Drage alleged that M&T Bank extended this credit knowing that [First Concord] did not have sufficient assets to cover the increased credit. Second, Drage alleged that M&T Bank manipulated the market in GS shares in order to drive the price up so that M&T Bank could recover as much as possible of FCS's debit balance upon selling the GS shares.

Neither of these factual allegation are the types of allegation that should support a collusion claim under revised Article 8. Revised Article 8 does not define collusion, although the official comments talk about collusion arising only in extremely unusual circumstances where the third party [M&T Bank] was itself a participant in the wrong doing or where the third party's conduct rises to a level of complicity in the wrong doing.

The comments imply that even actual knowledge by a party such as M&T Bank of wrong doing by a party such as First Concord is not enough to constitute collusion. The legislative intent preamble to the bill that adopted Article 8 in New York has a slightly broader standard, stating that [t]he legislature intends collusion to include acting in concert, acting by conspirational arrangement, or acting by agreement for the purposes of violating the entitlement holder's rights or with actual knowledge that the securities intermediary is violating these rights

M&T Bank relied on the comments to revised Article 8 to argue that collusion required First Concord to adequately plead that M&T Bank (i) knew that [First Concord] did not have the authority to pledge GS Telecom shares, and (ii) took positive steps to assist [First Concord] in violating its obligations to [Drage].

This is a restrictive reading of the collusion standard that was implicitly rejected by Judge Bransten, who seems to have been concerned solely with M&T Bank's knowledge that First Concord might be violating Drage's rights rather than with whether knowledge plus joint action existed. Although Judge Bransten's reading is supported by the New York legislative history, M&T Bank's interpretation is more consistent with the Official Comments to revised Article 8.

Cause to Disagree

There may be cause to disagree with Judge Bransten on the facts concerning M&T Bank and First Concord upon which her opinion relies with respect to collusion. The first factual allegation concerning collusion, that M&T Bank extended credit to First Concord in excess of the face amount of the Note and Agreement, does not support an implication of the type of specific knowledge of actual wrongdoing by First Concord involving its entitlement holder that should have been pled to meet the burden of pleading collusion under revised Article 8.

As M&T Bank pointed out in its pleadings, the New York legislature explicitly excluded any duty of inquiry from the collusion standard. As the legislative intent preamble notes, Thus, for example, a purchaser's [M&T's] knowledge of the precarious financial situation of the financial intermediary [First Concord] coupled with rumors, allegations, or reports of suspected wrongdoing does not amount to collusion.

The facts alleged by Drage with respect to the increased credit extended by M&T Bank to First Concord do not appear to imply the type of knowledge on M&T Bank's behalf that is required by the New York legislature. The mere extension of additional credit by a secured party such as M&T Bank to a securities intermediary such as First Concord cannot support a reasonable inference the secured party knew that the securities intermediary was violating its entitlement holders' rights, much less the more specific knowledge that revised Article 8 requires, i.e., M&T Bank knew that First Concord was violating Drage's rights in particular.

Judge Bransten does appear to have implicitly adopted a duty of inquiry standard with respect to M&T Bank. Although this is consistent with one strand of New York case law under the prior versions of Article 8,[10] it is not consistent with revised Article 8.

As to the second factual allegation concerning collusion, that M&T Bank of manipulated the market in GS shares, this is even further from the types of factual allegations to support collusion that revised Article 8 requires. At the most, this allegation suggests that M&T Bank was a bad actor and that it may have acted in concert with First Concord but not that it was a bad actor with respect to Drage.

The factual standard developed by Judge Brantsen favors entitlement holders by encompassing a larger range of behavior than intended by revised Article 8. Any factual allegation against a purchaser that suggests any irregularity in the relationship with the securities intermediary (the credit that was larger than provided for in the Note and Agreement) or that suggests any bad action undertaken by the purchaser with the securities intermediary (the alleged manipulation of GS shares) will withstand a motion to dismiss.

This standard, especially on the latter point where there were almost no specific factual allegations to support Drage's speculations, is an easy one to meet.

Missing from the Drage opinion is any discussion of alleged facts that would support a possible finding that M&T Bank knew it was foreclosing upon and selling shares owned by First Concord's entitlement holders such as Drage and not by First Concord itself. Drage's pleading raises this issue but there are no factual assertions but rather only speculations about what M&T Bank might have known.

As Drage has not been appealed due to the stay imposed by Judge Bransten and may never be appealed because of the insolvency proceedings against First Concord in the West Indies,[11] we are left with an opinion on collusion that is both the only published opinion and incorrect in its interpretation of the collusion standard. The author wishes to thank Meagan Schaefer for her research assistance.

End Notes

1 Nathan W. Drage, P.C. v. First Concord Securities Ltd., NYLJ., Mar. 16, 2000, at 30 (N.Y. Sup. Ct. Mar. 16, 2000) [hereinafter Drage, Mar. 16, 2000].

2 Francis J. Facciolo, Father Knows Best: Revised Article 8 and the Individual Investor, 27 Fla. St. U. L. Rev. 615, 616 n.1 (2000).

3 See generally William D. Hawkland & James S. Rogers, Revised Article 8: Investment Securities, 7A Uniform Commercial Code Series (1996) (providing in this author's opinion, the best overview of revised Article 8) [hereinafter Hawkland & Rogers).

4 Facciolo, supra note 2, at 643-652 (describing and criticizing protections for transferees of directly held securities), 653-72 (describing and criticizing protections for transferees of indirectly held securities).

5 James S. Rogers, Policy Perspectives on Revised U.C.C. Article 8, 43 UCLA L. Rev. 1431, 1536 n. 156 (1996).

6 Association of the Bar of the City of New York, REPORT ON PROPOSED REVISIONS TO ARTICLE 8 OF THE NEW YORK UNIFORM COMMERCIAL CODE, WITH CONFORMING AND MISCELLANEOUS AMENDMENTS TO ARTICLES 1,5,9 AND 13 THEREOF AS WELL AS CONFORMING AND MISCELLANEOUS AMENDMENTS TO OTHER STATUTES 42-46 (Feb. 21, 1996).

7 Professor Rogers has opined that it seems relatively unlikely that many, or even any, litigated cases will actually rise in which courts would be called upon to interpret and apply the collusion standard due to the regulatory scheme that governs securities intermediaries. Hawkland & Rogers, supra note 3, at 630. First Concord was not a U.S. registered broker-dealer. Nathan W. Drage, P.C. v. First Concord Securities, Ltd., NYLJ, July 1, 1999 at 30 (N.Y. Sup. Ct. July 1, 1999) [hereinafter Drage, July 1, 1999].

8 Drage, July 1, 1999, supra note 7, at 30. This earlier opinion, which contains a fuller explanation of the facts than the March 16, 2000 opinion, involved a motion by the plaintiff seeking an order of attachment and preliminary injunction against the clearing broker that First Concord used, a subsidiary of M&T Bank Corporation. Id.

9 Drage, July 1, 1999, supra note 7, at 30. M&T Bank was concerned with both the size of the First Concord debt and the illiquid nature of the collateral, which consisted primarily of OTC Bulletin Board stocks.

10 See Facciolo, supra note 2, at 645-651 for a discussion of this New York case law.

11 Pleadings have been filed in the West Indies case but there have been no court hearings or decision. Telephone Interview with Alan C. Fried, Esq., Schwarzfeld, Ganfer & Shore, LLP (Dec. 12, 2000) (attorney for Drage).