10-17-1996

Legislature Mulls Change of Article 8

Francis J. Facciolo
St. John's University School of Law

Legislature Mulls Change of Article 8; Corporate Law

By Francis J. Facciolo

Corporate Law

A major revision of Article 8 of the Uniform Commercial Code was passed by the New York Assembly on July 2, 1996, but did not receive Senate consideration prior to adjustment. In light of the strong support given Proposed Article 8 by the banking and securities industries, the New York State Legislature will probably give serious consideration to passage when the next legislative session begins.

Although the supporters of Proposed Article 8 have stoutly maintained that it is primarily a clarification of the existing Article 8 and that the proposed changes are insignificant, the proposal actually includes major changes that should be of concern to all investors in America's securities markets. Without significant amendments to Proposed Article 8, investors would be profoundly disadvantaged.

Separate Regimes

The separate legal regimes created by Proposed Article 8 for securities held directly and indirectly were described by Richard Smith and Paul Schupak in an article published in the **New York Law Journal** on May 30, 1996. The creation of separate regimes, as explicated by Smith and Schupak, is the single largest change wrought by Proposed Article 8, and one with which the author has no general quarrel.

Proposed Article 8 has added Part 5 to deal with indirectly held securities. Part 5 is based upon the newly created concept of a securities entitlement, which is not an interest in any particular security. Rather, it is the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5.

In contrast to the common law concepts underlying New York Article 8 that are based on claims to specific physical certificates, Proposed Article 8 has created a new type of property interest that is not a claim to a specific identifiable thing; [rather] it is a package of rights and interests that a person has against the person's securities intermediary and the property held by the intermediary.

The intent of Proposed Article 8 is to restrict entitlement holders in most situations to a cause of action against the securities intermediary. This creates high barriers to the assertion by an entitlement holder of property rights in any financial asset against a purchaser of the financial asset.

Proposed Article 8 does little to explain why it should be adopted. The prefatory note to Proposed Article 8 briefly mentions the legal uncertainties created by the prior version of Article 8 and the adverse effects these uncertainties have on all participants in securities trading.

Professor James Steven Rogers, the reporter for Proposed Article 8, has provided a much fuller rationale in a recent article in **UCLA Law Review.** He has identified concerns with systemic risk in the financial markets as the impetus behind Proposed Article 8. Systemic risk is [t]he risk that inability of one [financial] institution to meet its obligations [to pay funds or transfer securities] when due will cause other [financial] institutions to be unable to meet their obligations when due.

Systemic risk can arise from any cause that would lead financial institutions to fail, thus possibly triggering a domino effect. The particular systemic risks to which Proposed Article 8 is addressed are those arising from clearance and settlement of securities trades. Professor Rogers has justified Proposed Article 8 as one part of a world-wide effort to assure that the clearance and settlement system for securities trading functions in such a way that the system does not create systemic risk.

Professor Rogers starts his defense of Proposed Article 8 with an 11-page discussion of systemic risk. Nowhere in these 11 pages or in the balance of his article does he ever explain what aspects of systemic risk would be alleviated by Proposed Article 8. Nor does he give any convincing examples of systemic risk that have arisen from the prior versions of Article 8.

In fact, Professor Rogers himself reports that although there were many general expressions to the effect that prior law did not provide a sufficiently certain legal framework for transactions implemented through the modern securities holding system, there was relatively little specific description of problems.

The problem with this systemic risk argument as applied to Proposed Article 8 is the one that Professor Rogers' article exemplifies. No one has identified exactly how Proposed Article 8 alleviates systemic risk.

Professor Paul Shupack, the chair of the Working Group of the Uniform State Laws Committee of the Association of the Bar of the City of New York who authored a very influential report in favor of Proposed Article 8 (the Article 8 Bar Report), is even more blunt than Professor Rogers: The conclusion that current law creates serious risk of systemic market failure is the SEC's, not mine. I have no basis independent of the SEC studies upon which to form a judgment about the empirical claim that drastic reform of prior Article 8 is needed.

Not all writers on financial matters agree that the current system, if not reformed, engenders significant systemic risks. Even if one takes the many systemic risk studies cited by Professor Rogers and the other related studies at their word, and assumes that there are significant risks contained within the clearance and settlement systems for securities, the net result of making this assumption is to demonstrate the irrelevance in most respects of Proposed Article 8 to the concerns of these studies.

The essential concern of the many studies of systemic risk has been the gap in time between transfer of a security and payment for it. This gap exposes securities industry participants, and through them the banks that provide financing to the participants, to serious credit and liquidity risks. But these risks are not ones arising from flaws in New York Article 8.

The supporters of Proposed Article 8 maintain that it furthers a policy of finality in securities transactions, i.e., only in the most unusual circumstances should a third party be able to challenge a securities transfer. And it is true that the systemic risk studies also identify finality as a policy to be favored. But finality concerns in the studies arise out of fears of the bankruptcy of one broker that leads to bankruptcy of another broker-dealer counterparty because there has not been simultaneous delivery versus payment between the two in a major financial transaction.

The evidence from DBL Group's bankruptcy is unsupportive of the notion that problems in perfecting security interests in securities present a serious danger to America's financial markets. Richard C. Breeden, SEC Chairman at the time of the bankruptcy, gave a detailed report on the bankruptcy to a Senate committee. In Mr. Breeden's account, the reluctance of banks to make a secured loan to DBL Group was due to standard commercial considerations.

Supporters of Proposed Article 8 also often cite to the congressional reports on the Market Reform Act of 1990, adopted in part in response to the October 1987 crash, as evidence that the problem of potential and actual nonuniformity among the states [is] the major problem with the commercial law foundation of the securities clearance and settlement system.

The main legal problem actually identified in these reports was an inconsistency in state treatment of options as collateral, which does make the financing process more burdensome for prospective lenders and may create enough uncertainty to cause a prospective lender to reconsider its decision to accept options as collateral for loans.

Of course, the lack of an overarching justification for Proposed Article 8 does not mean that it should be rejected, merely that the case in its favor is weaker than its proponents would like it to be. Proposed Article 8 would make a number of major changes in New York law, however, that argue for its amendment.

Definition of Notice

For directly held securities, Proposed Article 8 substitutes the term protected purchaser for bona fide purchaser. The first change in Proposed Article 8 from the official 1977 version of Article 8 is in Proposed Article 8's narrower definition of notice. 1977 Article 8 relies on the general definition of notice in Part 1 of the UCC, which defines notice of a fact to cover both when a person (a) has actual knowledge of the fact or (b) from all the facts and circumstances known to him at the time in question has reason to know that it exists.

Proposed Article 8 creates a unique definition of notice when dealing with adverse claims. A reasonable person standard with regard to notice is rejected. Notice of an adverse claim exists only if the transferee has actual knowledge or if the transferee is willfully blind. In turn, in order to find willful blindness, two things must be established.

First, the person [must be] aware of facts sufficient to indicate that there is a **significant probability** that the adverse claim exists. It is not enough that a claim may exist; there must be a significant probability of its existence. Second, the person must deliberately avoid[ ] information that would establish the existence of the adverse claim. Mere negligence, and perhaps even gross negligence, would not meet this second prong.

New York currently has a non-uniform definition of notice of adverse claims, which supporters of Proposed Article 8 believe is comparable to the proposed new definition. In fact, the legal significance of this non-uniform addition is unclear.

There is ample precedent to support the proposition that New York's definition of notice for Article 8 purposes is not materially different from that of other states. This line of cases holds professional purchasers to a higher standard of good faith than other purchasers; therefore, with respect to such institutions as brokers and banks, New York's standard of notice does encompass more than actual knowledge or willful blindness. To be fair to the Article 8 Bar Report, there also is ample precedent to support its interpretation of New York law.

This split in the New York case law suggests that there is no legal consensus on the type of notice of adverse claims that is appropriate under Article 8. A justification for the tightening of the notice standards in Proposed Article 8 has to be found in policy arguments rather than in reliance upon precedent. Regrettably, neither Professor Rogers nor the Article 8 Bar Report explicitly addresses this issue.

It would not be appropriate to impose higher new standards requiring frequent investigation by transferees. Such standards would impede the free transferability of securities. But this does not necessarily mean that the current standards should be lowered as they are in Proposed Article 8.

Barriers to Recovery

Proposed Article 8 uses no term comparable to protected purchaser to describe a protected transferee under the indirect holding system. Rather, it provides that an adverse claim to a financial asset may only be asserted against a person if the claimant can prove that certain stringent conditions have been met. This article will refer to purchasers against whom these conditions cannot be proved as favored purchasers in order to distinguish them from the defined term protected purchasers.

In addition, a secured creditor of a securities intermediary is in a position analogous to that of a favored purchaser when the secured creditor is in control of a financial asset.

The first substantive change from prior New York law is common to proposed 8-502, 8-503 and 8-510, all of which deal with favored purchasers. The claimant alleging that the transfer is wrongful now bears the burden of proof. In contrast, under prior New York law the burden was placed on the transferee claiming bona fide purchaser status.

Beyond shifting the burden of proof on wrongful conduct to the claimant, proposed 8-502, 8-503 and 8-510 erect other substantial barriers to recovery from a transferee. Proposed 8-502 and 8-

510 require notice of the particular adverse claim that is asserted in order for a purchaser to lose his/her favored status. In contrast, New York Article 8 requires that a bona fide purchaser be without notice of any adverse claim. Therefore, knowledge of a claim other than the one being asserted against the transferee will not count in determining favored purchaser status.

An even more fundamental barrier to recovery from a transferee under Proposed Article 8 is created by the very definition of a securities entitlement. A securities entitlement is not a property interest in a particular financial asset; therefore, it is extremely unlikely that an investor in the indirect holding system will ever be able to prove that he/she has any interest in any particular financial asset. This result is explored in the comments to proposed 8-502.

As comment 2 describes and as comment 3 illustrates in a number of examples, it will normally be impossible for anyone to trace the path of any particular security that is cleared and settled in the indirect holding system. Therefore, it will usually be impossible for anyone even to make an equitable argument for recovery against a transferee.

Proposed 8-503 describes the favored purchaser status of purchasers of financial assets in comparison to that of acquirers or purchasers of securities entitlements described in proposed 8-502 and 8-510. If the barriers to disproving that a transferee is a favored purchaser would be high under proposed 8-502, they would be virtually insurmountable under proposed 8-503. Instead of requiring the claimant to prove notice, 8-503 requires the claimant to prove that the purchaser is not act[ing] in collusion with the securities intermediary in violating the securities intermediary's obligations under Section 8-504.

There is no definition of collusion in Proposed Article 8. Section 1 of the New York State Assembly bill adopting Proposed Article 8 attempts to deal with the lack of definition by stating that collusion includes not only activities done in concert but also actual knowledge by a party or a party's deliberate closing of its eyes to facts that would provide knowledge. This is a useful attempt to deal with one weakness of Proposed Article 8, but it does not address the most important issue - the priority given to control lenders over securities entitlement holders.

Securities Intermediary

Proposed 8-503(a) is one of the more radical sections of Proposed Article 8. It establishes the general principle that financial assets held by a securities intermediary are held by the intermediary for its entitlement holders to the extent necessary to satisfy such holders and are not property of the securities intermediary.

Proposed 8-511(a) carries out this general principle by providing that if a securities intermediary were to have shortfall in a particular financial asset, all claims of entitlement holders who have interests in the financial asset would have priority over any claim of a creditor of the securities intermediary.

It is especially important that such a policy choice favoring entitlement holders has been made. Under Proposed Article 8, most investors will lose the protection that they had under New York

Article 8 of being able to assert an adverse claim against a particular financial asset, as they will no longer be able to trace the asset.

By defining a securities entitlement as a bundle of rights against a securities intermediary rather than as a right in any financial asset, Proposed Article 8 would have the effect of increasing the exposure of entitlement holders to the risk of insolvency of their securities intermediaries. This insolvency risk arises from the crucial exception that proposed 8-511 makes to the policy choice to favor entitlement holders: Any claim of a creditor of the securities intermediary that has control of the financial asset has priority over any claim of an entitlement holder to the financial asset.

If one confines consideration of this issue purely to the language of New York Article 8 and ignores the approach taken by the courts in applying 1977 Article 8, one can argue that Proposed Article 8 decreases, not increases, an entitlement holder's exposure to insolvency risk.

Under New York Article 8, which on this point is identical to 1977 Article 8, most indirectly held securities are held as part of a fungible bulk in which the purchaser is the owner of a proportionate property interest. Therefore, tracing and earlier-in-time concepts, which in theory operate fortuitously, should determine whether customers or creditors receive priority. Difficult as such exercises were to justify under 1977 Article 8, such exercises would be almost impossible to justify under Proposed Article 8 with its explicit rejection of any tracing notions with respect to financial assets.

In light of the risks imposed on entitlement holders by Proposed Article 8' s approach to priority disputes, one would expect that investors might seek to opt out of the indirect holding system. The ability of any investor to opt out of the system, of which proposed 8-511 is part, however, would be limited. An investor could opt out by holding actual paper certificates, rather than holding a securities entitlement with a securities intermediary. For any investor who will be active in the marketplace, this option is not practical.

As of June 7, 1995, settlement of most security trades must be completed within three days of the trade. This short time frame makes it difficult for an investor to get the paper certificate to his/her broker in time for settlement. As the goal of the SEC is one-day settlement by the end of the millennium, this practical difficulty will only grow greater. In addition, many brokers actively discourage their customers from obtaining paper certificates.

Some supporters of Proposed Article 8 have relied upon the continued presence of other federal and state law, regulation, oversight and enforcement [concerning the relationship between investors and brokers] and the continued availability of SIPC [insurance] coverage as premises for passage of Proposed Article 8. However, reliance upon regulation in the current national anti-regulatory mood may well be unwise. In addition, insurance raises the moral risk issues so familiar from the savings and loan crisis.

Conclusion

Insofar as Proposed Article 8 rests on unproved assumptions about systemic risk, the very real changes to the bona fide purchaser rules of New York Article 8 should give one pause. In the direct holding system, the protection afforded owners against bad actors has been significantly weakened. In the indirect holding system, the protection afforded a beneficial owner against bad actors is essentially meaningless.

The only meaningful protection is the priority established by proposed 8-511(a) for entitlement holders. But a growth of control lending, which may be likely in the immediate future, would mean that the protections of this section also would be illusory, at least with respect to control creditors.

One possible solution to protecting investors would be to create a consumer carveout to proposed 8-511(b). Such a carveout, as suggested by Professor Margaret Kniffin, would provide that control lenders would have priority over entitlement holders except for entitlement holders who are consumers. A consumer would be defined as a natural person who exercises the rights that comprise a financial asset for personal, family or household use. Institutional investors acting on their own behalf or on behalf of consumers do not need such protection as they have the clout and knowledge to pursue effective contractual protections.

It remains to the states to balance the competing interests of investors and control creditors in the area of securities transfers, an area that is traditionally one of state law.