
Joseph B. Kluttz
David Line Batty
V. Nicole Nichols

Follow this and additional works at: http://scholarship.law.unc.edu/ncbi
Part of the Banking and Finance Law Commons

Recommended Citation
Available at: http://scholarship.law.unc.edu/ncbi/vol4/iss1/8

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Banking Institute by an authorized administrator of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.
HOW TO BE SECURE WHEN YOUR COLLATERAL IS A SECURITY:  
A GUIDE TO THE CREATION AND PERFECTION OF SECURITY INTERESTS IN INVESTMENT PROPERTY  
UNDER THE 1994 REVISIONS TO THE UNIFORM COMMERCIAL CODE

JOSEPH B. C. KLUTTZ  
DAVID LINE BATTY  
V. NICOLE NICHOLS†

I. INTRODUCTION

In 1994, the National Conference of Commissioners on Uniform State Laws and the American Law Institute proposed a revised Article Eight and corresponding amendments to Article Nine of the Uniform Commercial Code (collectively, the “1994 Revisions”). Because the laws regulating liens on investment se-
curities "are one of the most important aspects of the commercial law rules concerning investment securities," one of the primary purposes of the 1994 Revisions was to clarify the rules governing the use of investment securities as collateral, including the process of creating and perfecting such security interests.  

Additionally, the 1994 Revisions simplified the rules applicable to the clearance and settlement of securities transfers to lessen the risk that such rules would threaten liquidity in times of turmoil in the financial markets. Because of the success of the 1994 Revisions in achieving these goals, the 1994 Revisions have been enacted by forty-eight states, Puerto Rico and the District of Columbia.

2. Id. at 1473.
3. See id. at 1434-37, 1450-51.
The long-running bull market of the 1990s has attracted a great deal of attention to investment securities as a source of collateral for many different types of lending transactions. Because the 1994 Revisions simplified the law of secured transactions relating to investment securities, lenders can more readily take advantage of this valuable pool of collateral.

The 1994 Revisions largely succeeded in demystifying the law of secured transactions as it relates to investment securities by creating a new class of collateral called "investment property" and by replacing the cumbersome requirement of transfer and possession with the simpler concept of "control" as the preferred method for creating and perfecting a security interest in investment property. Nevertheless, as with other parts of the Uniform Commercial Code, there are pitfalls for the unwary in the 1994 Revisions.

What follows is a practical guide to the revised rules governing the creation, attachment and perfection of security interests in investment property that will assist lenders and their counsel in taking advantage of the 1994 Revisions.

II. SECURITY INTERESTS IN INVESTMENT SECURITIES

Prior to the 1994 Revisions, the rules governing secured transactions involving investment securities were contained in Article Eight. Because the laws relating to all other secured transactions are contained in Article Nine, the 1994 Revisions expanded the scope of Article Nine to include the creation and per-
fection of security interests in investment securities. As a result, taking a security interest in investment securities now "follows the familiar pattern of defining and describing the relevant collateral category and then specifying rules on attachment, perfection, and priorities in a fashion appropriate to that form of collateral." 

To simplify the classification of collateral consisting of investment securities and related rights, a new category of collateral called "investment property" has been created by the addition of section 9-115. Article Eight and Article Nine are now linked by section 9-115, which includes within the definition of investment property the defined term "security" under Article Eight. Section 8-102 in turn defines a "security" as the obligation of an issuer or an ownership interest in an issuer which (a) is

7. See Cisar & Turner, supra note 6, at 1, 6-7. See also James Gadsden & Austin D. Keyes, Revised Article 8 of the Uniform Commercial Code: Investment Securities, 115 BANKING L.J. 346, 352 (1998); Rogers, supra note 1, at 1473-74.
8. Rogers, supra note 1, at 1474.
9. U.C.C. § 9-115 (1999) (including definitions relating to the rights and assets comprising investment property as well as the rules relating to attachment and perfection of security interests in investment property). Although most of the components of investment property are clearly described in the 1994 Revisions, one area of potential uncertainty remains when classifying ownership interests in partnerships and limited liability companies. The general rule under the 1994 Revisions is that ownership interests in partnerships and limited liability companies are general intangibles pursuant to Section 9-106. See §§ 8-103(c), 9-106. Despite this general rule, an ownership interest in a partnership or limited liability company will be treated as a security or a financial asset (and will therefore be investment property rather than a general intangible) if (a) the terms of the partnership and limited liability company interest expressly provide that the provisions of Article Eight govern the interest, (b) the partnership or limited liability company is an investment company, (c) the interest is, or is of the type, dealt in or traded on a securities exchange or in the securities market or (d) the interest is held in a securities account. See § 8-103(c). See also Gadsden & Keyes, supra note 7, at 354 (discussing interests in partnerships and limited liability companies in relation to Article Eight); Prefatory Note to U.C.C. Revised Article 8, at 669 (West 1999) [hereinafter Prefatory Note] (discussing the opt-in provision). Because facts giving rise to the application of these exceptions may not be easily verifiable by a secured party or such exceptions may become applicable after a security interest has attached and been perfected, the careful secured party should treat ownership interests in partnerships and limited liability companies as both investment property and general intangibles. For a table setting forth examples of collateral classification and the means by which a secured party can create and perfect security interests in the various types of investment property see ANNEX A.
evidenced by a certificate in bearer or registered form (a "certificated security"), or, if uncertificated, the transfer of which may be registered on the books of the issuer (an "uncertificated security"), (b) is part of a series or class (or is divisible into a class or series) of rights and (c) is, or is of the type, dealt or traded in securities markets or is expressly governed by Article Eight. Additionally, section 9-115 incorporates the terms "securities intermediary" (defined as a third party, such as a bank or a broker, that maintains securities accounts for others) and "security entitlement" (the bundle of rights of an entitlement holder in financial assets held by a securities intermediary) from section 8-102. Although the term investment property, as defined in section 9-115, relies heavily on certain terms and concepts from Article Eight, it also includes commodity accounts and commodity contracts, even though those assets are excluded from Article Eight.

A. Creation of Security Interests in Investment Property

Under the 1994 Revisions, section 9-203 of Article Nine allows a secured party to create a security interest in investment property in a fashion similar to the creation of a security interest in other forms of personal property. Therefore, assuming that the secured party has "given value" to the debtor and the debtor has "rights in the collateral", a security interest in investment property will "attach" once the secured party has (a) obtained possession or control of the collateral pursuant to an agreement or (b) the debtor signs a written security agreement that satisfies

11. See § 8-102.
14. See §§ 8-102, 9-115. See also Cisar & Turner, supra note 6, at 7; Rogers, supra note 1, at 1474.
15. See Cisar & Turner, supra note 6, at 7-9. See also U.C.C. § 8-106 (1999). Because the 1994 Revisions treat commodity contracts similarly to security entitlements and commodity intermediaries similarly to securities intermediaries under Article Nine, this paper does not discuss these terms separately.
the requirements of section 9-203(1)(a). Once a security interest has attached, it must be perfected to afford the secured party the protection of the priority rules set forth in Article Nine.

B. Perfection of Security Interests

Pursuant to section 9-115(4) of the 1994 Revisions, a secured party can perfect its security interest in investment property (a) by obtaining "control" of the investment property through physical possession or pursuant to an express agreement granting such control (in either case attachment and perfection would be simultaneous) or (b) by filing a financing statement in accordance with Article Nine. While physical transfer or physical delivery of investment property is no longer required to create or perfect a security interest, the requirement of "delivery" remains essential to protection of the collateral from adverse claims if the control option is used for perfection.

1. Perfection by Control

Perhaps the most important change to the law of secured transactions in the 1994 Revisions is the introduction of the concept of perfection through control. The essential requirement for obtaining control in the context of a secured transaction is that the secured party "has taken whatever steps are necessary, given the manner in which the securities are held, to place itself in a position where it can have the securities sold, without further action by the owner." Although the concept of control hinges upon the secured party's ability to sell or transfer the securities without additional action by the debtor, Article Eight does not

---

20. See Prefatory Note, supra note 9, at 661.
22. See Rogers, supra note 1, at 1474-75.
require that the secured party have the sole and exclusive right to sell or transfer such securities.24

For certificated securities that are held directly by the debtor and not indirectly through a broker or other intermediary, a secured party has control once the debtor delivers the certificate to the secured party together with any necessary indorsements to enable the secured party to transfer the certificates without further involvement of the debtor.25 For purposes of the 1994 Revisions, delivery is not limited to actual physical delivery and possession, but rather also occurs when (a) a person other than a securities intermediary acquires the certificate on behalf of the secured party or acknowledges that it holds the certificate for the secured party, or (b) a securities intermediary acting on behalf of the secured party acquires possession of a certificate in registered form that the debtor has specifically and effectively indorsed to the secured party.26

For certificated securities held by the debtor in an account maintained with a securities intermediary acting on behalf of the debtor, a secured party may obtain control in three ways. First, the secured party may obtain control by becoming the entitlement holder27 and having the record ownership of the securities entitlement transferred from the debtor to secured party on the

24. See § 8-106 cmt. 7. For instance, a secured party may allow the debtor to "retain the right to make substitutions, or to direct the disposition of the uncertificated security or security entitlement." Id. Thus, the concept of control rests on the secured party's dispositive powers, rather than the powers retained by the debtor. See id.

25. See U.C.C. §§ 8-106(a), (b), (e), 9-115(1)(e), (4)(a) cmt. 2 (1999). Although Section 9-115(6) indicates that an indorsement is not required for perfection of a security interest in a security certificate in registered form that is physically delivered to the secured party, such indorsement remains necessary under Article Eight if the secured party wishes to transfer the security certificate as a means of foreclosure. See id. at § 9-115 cmt. 2.

26. See § 8-301(a).

27. See § 8-106(d)(1). See also § 9-115 cmt. 4. For purposes of revised Articles Eight and Nine, "entitlement holder" is defined as "a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary." § 8-102(7). This designation also includes those persons acquiring a security entitlement through sections 8-501(b)(2) or (3). See id. A secured party has control over a securities account if it has obtained control over all security entitlements carried in the account. See § 9-115(1)(e).
books of the securities intermediary. Second, the securities intermediary, the debtor and the secured party can enter into an account control agreement evidencing the security intermediary's agreement to "comply with entitlement orders originated by the secured party without further consent by the entitlement holder." Finally, a secured party may obtain control over the securities account itself by obtaining control over all of the securities entitlements held in that account.

In the case of an uncertificated security that is held directly by the debtor, a secured party obtains control over the security when the issuer agrees to follow the instructions of the secured party without further consent from the registered owner pursuant to a control agreement, or when the uncertificated security is delivered to the secured party. Delivery of an uncertificated security occurs when (a) "the issuer registers the secured party as the registered owner," (b) a person other than a securities intermediary becomes the registered owner on behalf of the secured party or acknowledges that it holds the uncertificated security for the secured party, or (c) the issuer registers the "pledge" of the collateral whereby the debtor remains the registered owner but the secured party controls all right to transfer.

28. U.C.C. § 8-106(d)(2) (1999). Notwithstanding the directive of the entitlement holder to do so, the securities intermediary is not required to enter into this agreement. See § 8-106(g). For a model form of account control agreement, see Howard Darmstadter et al., A Model "Account Control Agreement" Under the New Article 8 of the Uniform Commercial Code, 53 Bus. LAW. 139 (1997).


30. One of the most common examples of this type of uncertificated security is an interest in a mutual fund.

31. See U.C.C. § 8-106(c) (1999). The issuer may enter into this type of "issuer control agreement" only with the consent of the registered owner. See § 8-106(g). Notwithstanding the directive of the registered owner to do so, the issuer is not required to enter into this agreement. See id.

32. See id. § 8-106 cmt. 3. One of the major drawbacks of the old rules was the requirement of "registered pledges" to establish security interests in uncertificated securities. See U.C.C. §§ 8-108, 8-207, 8-306(8) (1999). Although the 1994 Revisions allow issuers to offer such a program, the 1994 Revisions do not require registered pledges. See U.C.C. § 8-106 cmt. § (1999).
2. Special Rules Applicable to Securities Intermediaries

Special rules that govern priorities among entitlement holders, securities intermediaries and their respective secured creditors can cause unpleasant surprises for the entitlement holder's lender.

For example, a securities intermediary will routinely require an entitlement holder to grant a security interest in the securities entitlements it holds to secure margin loans to the entitlement holder.33 A securities intermediary has control of a security entitlement only if the entitlement holder affirmatively grants to the securities intermediary a security interest in the security entitlement.34 Under the 1994 Revisions, however, once a security interest is granted to a securities intermediary, it is automatically perfected,35 and unless the securities intermediary expressly agrees to subordinate its claim, the security interest of a securities intermediary has priority over any security interest granted by the entitlement holder to another secured party, pre-existing or otherwise.36 In other words, in the absence of a subordination agreement by the securities intermediary, a lender that thinks it has a prior claim to its borrower's securities in the hands of a broker could find itself subject to a later-granted security interest in the same securities, securing the broker's margin claim against the borrower.

An even more startling result could occur in the case of a conflict between a lender's claim against its borrower's securities held in "street name" by a broker and a conflicting claim by the broker's secured creditor against the same securities.

The general rule is that if a securities intermediary does not have a sufficient amount of a financial asset to satisfy claims of its own creditors and claims of its entitlement holders to the same type of asset, the claims of the entitlement holder (and

33. See U.C.C. § 8-106 cmt. 6 (1999).
34. See id. § 8-106(c).
35. See id. §§ 8-106(e), 9-115(1)(e), (4)(a).
36. See id. § 9-115(5)(c).
claims of the entitlement holder's secured creditors against such assets) must be satisfied first. The rule changes, however, if a secured creditor of the securities intermediary obtains control of such financial assets – in that case, the claims of the securities intermediary's secured creditors to the assets in question will take priority over claims of the entitlement holder, unless control was obtained through fraud or collusion with the securities intermediary. That was the result in the Drage case, discussed later in this article.

3. Perfection by Filing and Priority Rules

A secured party may also perfect a security interest in investment property by filing a financing statement. However, while filing is a permissible means of perfection under Article Nine and will prevail against a claim of the trustee in bankruptcy, control is the preferred method of perfection because a secured party that perfects by control has priority over a secured party that perfects by filing, even if the financing statement was filed prior to perfection by control. Despite the fact that perfection by filing can be “trumped” by perfection through control, the careful secured party should always perfect by filing in addition to perfecting through control. As discussed in the First National case discussed below, in the event a court were to determine that the secured party's control were somehow deficient, perfection by filing a financing statement would provide “belt and suspenders” protection to the secured party. Additionally, as discussed in Part II.B.3 infra, filing a financing statement will ensure that the secured party will be fully perfected in proceeds of investment

37. See id. §§ 8-503, 8-511.
38. See id.
39. See infra Part III.C.
43. See infra Part III.B.
property that take the form of additional securities. Finally, given the classification issues presented by partnership and limited liability company interests discussed in note 9 supra, perfection by filing a financing statement would protect the secured party from a misclassification of collateral.

The 1994 revisions create another exception to the general Article Nine rule of “first in time, first in right” set forth in section 9-312(5)(a). Section 9-115(5)(a) provides that, subject to the special priority rules applicable to securities intermediaries described above, conflicting security interests in the same investment that are perfected by control will “rank equally.” Notably, the comments to section 9-115 recognize that given the nature of perfecting by control, it is unlikely that two or more secured parties would ever obtain control over the same investment property at the same time. Nevertheless, because section 8-106 does not require a securities intermediary to reveal the existence of a prior executed control agreement, there is a possibility that multiple secured parties could obtain control through control agreements relating to the same investment property.

As a practical matter, about the only thing a secured party can do to protect itself against the execution of subsequent control agreements relating to the same collateral is to include a provision in the original control agreement which prohibits the execution of subsequent control agreements by the securities intermediary. Such a provision is of limited usefulness, however, since the only recourse for breach of the prohibition would be a claim against the intermediary for breach of contract. The Proposed 1998 Revisions would reduce the risk of multiple control agreements by conforming investment property priority rules to existing Article Nine priority principles, and replacing the “rank equally” rule applicable to perfection by control

---

45. § 9-115(5)(b). This section does not, however, provide any guidance as to what “rank equally” means.
46. See § 9-115 cmt. 5.
47. See § 8-106(g) (1999).
48. For a model form of account control agreement, see supra note 28.
49. See infra Part IV.
equally” rule applicable to perfection by control created by the 1994 Revisions with the rule that conflicting security interests in the same investment property will “rank in the order in which that control was obtained.”

In summary, to protect the priority of a secured party’s claim, secured parties should always perfect their security interests in investment property by taking control of the investment property. As discussed above, however, absent a contractual agreement to subordinate, a security interest in favor of the debtor’s securities intermediary is accorded a higher priority than security interests granted in favor of the debtor’s other secured parties even if such security interests are previously perfected by control. If the secured party obtains control through a control agreement, it is imperative that the control agreement include an agreement of the debtor’s securities intermediary to subordinate any security interest it might have or subsequently take to the security interest of the secured party.

C. Security Interest in the Proceeds of Investment Property

Article Nine defines “proceeds” as “whatever is received upon the sale, exchange, collection, or other disposition of collateral or proceeds.” Any payments or distributions received in connection with investment property are proceeds. Article Nine further provides that a security interest in proceeds is continuously perfected if the secured party perfected its security interest in the original collateral; however, as a general rule the

51. See id. § 9-115(5)(c).
52. For reference to a model form of account control agreement, see supra note 31. In the event the securities intermediary refuses to subordinate any security interest it may now or in the future obtain, the secured party may choose to obtain control in a different manner—such as registering the certificates in the name of the secured party—which would foreclose the debtor’s ability to pledge such securities to secure margin loans.
54. See id.
security interest in proceeds becomes unperfected ten days after
the debtor receives the proceeds unless (a) the secured party has
filed a financing statement covering the original collateral and
proceeds and (b) the proceeds are of a type that may be perfected
by filing.\footnote{55}

In the case of investment property, however, the 1994 Re-
visions create a carve-out from the general rule regarding perfec-
tion of proceeds. More specifically, section 9-306(3)(c) expressly
provides that perfection of a security interest in proceeds of in-
vestment property does not lapse at the expiration of the ten-day
period if "the original collateral was investment property and the
proceeds are identifiable cash proceeds."\footnote{56} Note that the carve-
out applies only to identifiable cash proceeds. A security interest
in other types of proceeds—namely distributions issued in the
form of additional securities—must be separately perfected, such
as by filing a financing statement or by taking control of the secur-
ities. Therefore, the prudent secured party should always sup-
plement perfection through control by also perfecting through
filing a financing statement.

D. Choice of Law Provisions in Revised Article Eight\footnote{57}

The 1994 Revisions contain a mechanical set of rules for de-
termining the law applicable to transactions involving invest-
ment property.\footnote{58} First, the law of the place where a certificated
security is physically located governs a transfer of rights through
the sale or pledge of a certificated security.\footnote{59} In contrast, a trans-
fer of rights in connection with an uncertificated security is gov-

\footnote{55. See id. § 9-306(3).
57. Although the widespread adoption of the 1994 Revisions makes choice-of-
    law determinations somewhat academic, two states (including South Carolina)
    have not yet adopted the 1994 Revisions, and as evidenced by the U.S. Physicians
    case, local common law can affect even uniform laws.
58. For a brief discussion of the choice of law rules, see Cisar & Turner, supra
    note 6, at 10-11; Gadsden & Keyes, supra note 7, at 356; Rogers, supra note 1, at 1457-
    60.
59. See U.C.C. § 9-103(6)(b) (1999). See also § 8-110(c) (clarifying the powers of
    the jurisdiction in which the certificate is located).}
erned by the local law of the issuer's jurisdiction. With respect to a security entitlement, the local law of the securities intermediary governs a transfer of rights through the sale or pledge of a security entitlement. Finally, the law of the jurisdiction where the debtor is located governs automatic perfection of security interests granted by a securities intermediary and perfection of security interests by filing.

III. POTENTIAL PITFALLS

Although 1994 Revisions are still relatively new, a few courts have had the opportunity to construe the 1994 Revisions. The following summary highlights several of the more notable decisions.

A. Stock in a Closely-Held Corporation

A July 1999 decision by the Bankruptcy Court for the Eastern District of Pennsylvania placed in question whether stock held in a closely-held corporation is a "security" within the meaning of the 1994 Revisions. In the case of In re U.S. Physicians, Inc., the court held that stock in a closely-held professional corporation was not a "security" for purposes of Article Eight because the stock was not publicly traded. Because the stock was...

---

60. See § 9-103(6)(c). See also §§ 8-110(a), (d) (clarifying the rights of the issuer and defining "issuer's jurisdiction").

61. See § 9-103(6)(d). See also id. § 8-110(b), (e), (f) (clarifying the rights of the securities intermediary and defining "securities intermediary's jurisdiction"). Identifying the local law of the securities intermediary's jurisdiction is complicated by the provisions of section 8-110(e)(1) which permit the securities intermediary and its entitlement holder to designate the law of a particular jurisdiction to govern the transaction. See U.C.C. § 8-110(e)(1) (1999). Therefore, because a secured party would be unaware of this agreement between a securities intermediary and an entitlement holder, a secured party should require the entitlement holder to disclose such a designation to the secured party.

62. See § 9-103(6)(f).


64. See id. at 518-22. In this case, several physicians who had sold stock in their practice to the debtor, U.S. Physicians, Inc., claimed that an option to reacquire such stock was a security interest that had been perfected by attempting to exercise such option and thus taking "control" of the stock. See id. at 518-22.
not a security, the court reasoned that the stock could not be investment property under section 9-115. Instead, the court concluded that stock in a closely held corporation is an "instrument". Because the collateral was an instrument, the court concluded that the secured party's security interest could be perfected only through physical possession and not merely by control.

The court's reasoning in U.S. Physicians cannot be reconciled with section 8-103, which sets forth specific rules that supplement the definitions contained in section 8-102 and guides the interpretation of those definitions. Section 8-103(a) states, simply, that "a share or similar interest issued by a corporation, business trust, joint stock company, or similar entity is a security." The plain meaning of section 8-103(a) is confirmed in the Official Comment to section 8-103, which states that, "[s]ubsection (a) establishes an unconditional rule that ordinary corporate stock is a security. This is so whether or not the particular issue is dealt in or traded on securities exchanges or in securities markets." Thus, shares of closely held corporations are Article 8 securities.

The inclusiveness of the definition of security is further confirmed by section 8-103(c), which expressly provides that certain types of uncertificated partnership and limited liability company interests are securities regardless of trading status. Several commentators have rejected the conclusion that public trading is a prerequisite for equity interests to qualify as securities within the meaning of the 1994 Revisions. Ultimately, the decision should not be followed because it runs counter to the

---

65. See id. at 527.
66. See id. at 527-28.
67. See id. at 528-29. The court further reasoned that even if the stock at issue was a security, the physicians had failed to perfect their alleged security interest because they never obtained control of the stock. See id. at 529-30.
69. Id. § 8-103.
70. Id. § 8-103 cmt. 2 (emphasis added).
71. See id.
72. See id. § 8-103(c).
73. See Nutter & Pratt, supra note 41, at 331-32 (concluding that stock in a closely held corporation is a security).
expressed intent of the 1994 Revisions to develop simple and consistent rules governing security interests in investment securities.

Secured parties should nevertheless be mindful of the court's decision in *U.S. Physicians* and the risk it represents. If stock in a closely held corporation is a meaningful component of the collateral securing a loan, the secured party should consider perfecting its interest by taking possession of the actual stock certificates in lieu of other means of establishing "control."

**B. Importance of a Written Control Agreement**

A secured party seeking to perfect a security interest in investment property should be aware that under the 1994 Revisions, the failure to obtain an express written control agreement will likely be fatal to a claim of perfection of a security interest by control. In *First National Bank of Palmerton v. Donaldson, Luften & Jenrette Securities Corp.*, the United States District Court for the Eastern District of Pennsylvania held that the course of dealing between a secured party and a securities intermediary was not, by itself, sufficient to give rise to an implied control agreement. Therefore, the court concluded that the securities intermediary did not owe any duty to the secured party to prevent the debtor from liquidating the collateral of the secured party held in an account with the securities intermediary.

In *First National*, the debtor granted the secured party a security interest in the debtor's securities that were held by a securities intermediary. Although the secured party initially took actual physical possession of the stock certificates, the secured party later returned them to the securities intermediary, specifying that the debtor would be allowed to trade the securities provided that the aggregate value of the securities held in the

74. 38 U.C.C. Rep. Serv. 2d 564 (E.D. Penn. 1999) [hereinafter *First National*].
75. See id. at 573-74.
76. See id. at 574.
77. See id. at 565.
debtor's securities account would remain the same. When the secured party advanced additional loans to the debtor, the secured party requested that the securities intermediary return a signed acknowledgement to the secured party agreeing that the secured party would have the sole right to make withdrawals from the securities account. Despite the request, the securities intermediary did not return the acknowledgement to the secured party. When the debtor later defaulted on the loans and the secured party attempted to seize the securities, the secured party learned for the first time that the debtor had already liquidated its account. The court held that the secured party's security interest was not perfected because the secured party had failed to maintain physical possession of the collateral, the securities intermediary did not enter into a written control agreement with the secured party regarding the collateral, and the secured party did not file a financing statement covering the collateral.

C. Conflicts with the Secured Party of a Securities Intermediary

In Nathan W. Drage, P.C. v. First Concord Securities, Ltd., a New York court confirmed the result of sections 8-503 and 8-511 by addressing the question of priority between a person (who was an "entitlement holder") depositing stock in a securities ac-

78. See id.
79. See id. at 565-66.
80. See id.
81. See id. at 566.
82. See id. at 570. (citing § 8-106, cmt. 5). Comment 5 to Section 8-106 of the U.C.C. states in relevant part:
   [f]or a purchaser to have "control" under subsection (c)(2) or (d)(2) [of Section 8-106], it is essential that the...securities intermediary actually be a party to the agreement....[If the] securities intermediary does not specifically agree to the arrangement [whereby a debtor gives a secured party a power of attorney to act in the name of the debtor], the secured party does not have "control" within the meaning of subsections (c)(2) and (d)(2) because the...securities intermediary is not a party to the agreement.

85. See supra Part II.B.2.
count with a broker (who was a "securities intermediary") and the broker's lender, to which the broker had granted a security interest in the pool of securities that included the entitlement holder's stock. When the broker defaulted under the agreement with its lender, the secured party seized and began liquidating the securities held by the securities intermediary including the stock deposited by the entitlement holder. Subsequent to liquidation, the plaintiff brought suit, alleging various claims, including conversion and breach of contract, against the broker and the broker's lender.

Although the court recognized that the securities intermediary had violated section 8-504(b) when it granted a security interest in a financial asset it was obligated to maintain on the plaintiff's behalf, the court observed that the Official Comment to that section 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." Moreover, the court also noted that the Official Comment to section 8-511 states that the plaintiff, as an entitlement holder, cannot assert claims against third party creditors to whom the securities intermediary wrongfully grants a security interest in the securities account unless the entitlement holder can prove collusion between the securities intermediary and the third party creditor. In addition, the court held that because the secured party had obtained control over the investment property, the secured party perfected its security interest and its claim had priority over the plaintiff's claim.

Since a secured lender's rights against its borrower's col-
lateral are subject to any conflicting rights against the same collateral, the result of the Drage decision should be of some concern to lenders where collateral is shares of stock held in "street name" by a broker. Read literally, Drage could stand for the proposition that the claim of the broker's secured creditor could take priority over the claim of the depositor's secured creditor, even where the security interest was granted to the broker's secured creditor in violation of section 8-504(b).

It should be of some comfort that the securities intermediary in Drage was an offshore brokerage company, not subject to the comprehensive federal regulatory scheme that governs domestic broker-dealers; and that the court in Drage expressly referred to the Official Comment to section 8-511, which in turn states that the federal regulatory scheme affords protection to depositors against risks such as the result in Drage, by prohibiting, as a matter of federal securities law, registered broker-dealers from granting security interests to third parties in securities held for its customers. What is not clear, however, is whether the prohibition under federal law would prevent the result of the Drage decision by preempting state law in the form of section 8-511, or whether violation of the federal prohibition would merely subject the broker to regulatory enforcement independent of state law implications.

Ultimately, the risk of lending against securities in a brokerage account otherwise subject to a properly executed control agreement may be fairly low, at least where the borrower's broker is reputable and is a registered broker-dealer otherwise subject to federal securities law. As a matter of underwriting, however, lenders should consider the risk – however remote – that a security interest in investment property perfected by execution of a control agreement with a securities intermediary could be trumped by a security interest granted by the securities intermediary to its own creditor – even if the security interest was "wrongfully" granted.

91. See Drage, 39 U.C.C. Rep. Serv. 2d at 858-59.
IV. PROPOSED 1998 REVISIONS TO ARTICLE NINE

In 1998, the National Conference of Commissioners on Uniform State Laws and the American Law Institute proposed a wholesale revision of Article Nine of the Uniform Commercial Code (the "Proposed 1998 Revisions"). The revisions would make a number of substantive changes to Article Nine, and would renumber most of its sections.

While section references to Article Nine provisions governing creation and perfection of security interests in investment property would be changed and conforming changes would be made to Article Eight, because most of the guiding principles enacted by the 1994 Revisions are in Article Eight, except for the limited changes discussed in Part II above, the Proposed 1998 Revisions under consideration should have no substantive effect on the issues discussed in this article.\(^\text{92}\)

V. CONCLUSION

The 1994 Revisions clarified and simplified rules for creation and perfection of security interests in investment property, including "securities," and in so doing made an important pool of potential collateral more accessible to lenders and other secured parties.

The key to the 1994 Revisions is to understand the importance of the concept of control. Although the 1994 Revisions allow for perfection of security interests in investment property by filing, a secured party that has perfected its security interest through control will have priority over a secured party that has perfected by filing. Therefore, to protect the priority of its security interest in investment property, a secured party should take control of the investment property by (a) taking physical possession of all certificated securities (together with any necessary endorsements to enable the secured party to transfer the certificates

---

without further involvement of the debtor), (b) entering into an account control agreement with any securities intermediary holding security entitlements pledged as collateral (which should include an express subordination of the securities intermediary's lien on such securities entitlements), or (c) entering into an issuer control agreement with the issuer of uncertificated securities pledged as collateral. Finally, to ensure continued perfection in the proceeds of investment property, the secured party should file a financing statement covering investment property and all proceeds of such investment property as collateral.
**ANNEX A**

**SUMMARY OF 1994 REVISIONS**

**RELATING TO PERFECTING SECURITY INTERESTS IN INVESTMENT PROPERTY**

<table>
<thead>
<tr>
<th>Type of Asset</th>
<th>Classification</th>
<th>Method of Perfection and Priority Rule</th>
<th>Other forms of Control (each ranks pari passu with the others, but will lose to automatic control)</th>
<th>Filing-will lose to any perfection by control (§9-115(5)(a))</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Certificated bonds, shares of capital stock,</td>
<td>“certificated security” pursuant to §§8-102(a)(4) and (15) and §8-103(a) and therefore, “investment property” pursuant to §9-115(f)</td>
<td>N/A</td>
<td>Control by Delivery: Delivery to secured party (§8-301(a)(1) or a third party acting on behalf of secured party (§8-301(a)(2))) in bearer form (§8-</td>
<td>Yes (§9-115(4)(b))</td>
</tr>
<tr>
<td>closed end fund shares or mutual fund shares in</td>
<td></td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>possession of owner/pledgor or a third party that</td>
<td></td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>is not a “securities intermediary.”</td>
<td></td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

1 The Proposed 1998 Revisions to Article Nine replace the “rank equally” rule applicable to perfection by control with the rule that conflicting security interests in the same investment property will, for priority purposes, rank in the order in which control was obtained over the investment property.
<table>
<thead>
<tr>
<th>Type of Asset</th>
<th>Classification</th>
<th>Method of Perfection and Priority Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 Uncertificated bonds, shares of capital stock, closed end fund shares or mutual fund shares titled in name of owner/pledgor, but not held by a “securities intermediary.”</td>
<td>“uncertificated security” pursuant to §§8-102(a)(15) and (18) and §8-103(a) and therefore “investment property” pursuant to §9-115(f)</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Control by Delivery: Delivery upon registration of transfer (§8-301(b)(1)) or third party acting on behalf of secured party becomes the registered owner (§8-301(b)(2)) or issuer agrees to comply with instructions from secured party without further consent of registered owner (§8-106(c))</td>
</tr>
<tr>
<td>Type of Asset</td>
<td>Classification</td>
<td>Method of Perfection and Priority Rule</td>
</tr>
<tr>
<td>----------------</td>
<td>----------------</td>
<td>----------------------------------------</td>
</tr>
<tr>
<td>3 Certificated or uncertificated partnership or LLC interest which is: (a) an investment company security (not held by &quot;securities intermediary&quot;) (b) traded in the markets (not held by &quot;securities intermediary&quot;) (c) governed by Article 8 pursuant to Issuer &quot;opt-in&quot; (not held by &quot;securities intermediary&quot;) (d) held in a brokerage or similar securities account</td>
<td>(a), (b) and (c) &quot;security&quot; pursuant to §§8-102(a)(15) and §8-103(c), and therefore &quot;investment property&quot; pursuant to §9-115(1)(f) (d) &quot;financial asset&quot; pursuant to §§8-102(a)(9) and 8-103(c) and therefore &quot;investment property&quot; pursuant to §9-115(1)(f)</td>
<td>(a)-(c) N/A (d) (see rules for &quot;security entitlement&quot; in Rows 5 &amp; 6) Control by Delivery: (a) – (c) Yes If certificated see Row 1 above. If uncertificated see Row 2 above. Control by Agreement: (see rules for &quot;security entitlement&quot; in Rows 5 &amp; 6)</td>
</tr>
<tr>
<td>4 All other certificated or uncertificated partnership or LLC interests not held by a &quot;securities intermediary&quot;</td>
<td>&quot;general intangible&quot; pursuant to §9-106. See also §8-103(c) (partnership interests and LLC interests not &quot;securities&quot;)</td>
<td>N/A</td>
</tr>
<tr>
<td>Type of Asset</td>
<td>Classification</td>
<td>Method of Perfection and Priority Rule</td>
</tr>
<tr>
<td>---------------</td>
<td>----------------</td>
<td>----------------------------------------</td>
</tr>
</tbody>
</table>
| 5  
“security entitlement” or “financial asset” held by “securities intermediary” (each as defined in §8-102) other than the secured party (includes the Types of Assets referred to in Rows 1-4 above if in possession of a “securities intermediary”) | “investment property” pursuant to §9-115(f) | Yes by debtor's own “securities intermediary” if security interest is granted thereto (§8-106(e) and §9-115(4)(a))  
Control by Agreement: Secured party becomes the entitlement holder (§8-106(d)(1)) or the securities intermediary enters into an account control agreement (§8-106(d)(2)) | Yes (§9-115(4)(b)) |
| 6  
“security entitlement” or “financial asset” held by the secured party as “securities intermediary” (each as defined in §8-102) | “investment property” pursuant to §9-115(f) | Yes by secured party as “securities intermediary” if security interest is granted thereto (§8-106(e) and §9-115(4)(a)) | N/A | Yes (§9-115(4)(b)) |
<table>
<thead>
<tr>
<th></th>
<th>Type of Asset</th>
<th>Classification</th>
<th>Method of Perfection and Priority Rule</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>“commodity contracts” or “commodity accounts” held by “commodity intermediary” other than the secured party (each as defined in §9-115)</td>
<td>“investment property” pursuant to §9-115(f)</td>
<td>Yes by debtor’s own commodities intermediary (§9-115(1)(e) and (4)(a))</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Control by Agreement: (§9-115(1)(e))</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Yes (§9-115(4)(b))</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>“commodity contract” or “commodity accounts” and held by secured party as “commodity intermediary” (each as defined in §9-115)</td>
<td>“investment property” pursuant to §9-115(f)</td>
<td>Yes by secured party as commodity intermediary (§9-115(1)(e) and (4)(a))</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Yes (§9-115(4)(b))</td>
<td></td>
</tr>
</tbody>
</table>