

**Permanent Editorial Board for the Uniform Commercial Code**

**PEB COMMENTARY NO. 18**

**July 2014**

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## PREFACE TO PEB COMMENTARY

The Permanent Editorial Board for the Uniform Commercial Code acts under the authority of the American Law Institute and the Uniform Law Commission (also known as the National Conference of Commissioners on Uniform State Laws). In March 1987, the Permanent Editorial Board resolved to issue from time to time supplementary commentary on the Uniform Commercial Code to be known as *PEB Commentary*. These *PEB Commentaries* seek to further the underlying policies of the Uniform Commercial Code by affording guidance in interpreting and resolving issues raised by the Uniform Commercial Code and/or the Official Comments. The Resolution states that:

A *PEB Commentary* should come within one or more of the following specific purposes, which should be made apparent at the inception of the Commentary: (1) to resolve an ambiguity in the Uniform Commercial Code by restating more clearly what the PEB considers to be the legal rule; (2) to state a preferred resolution of an issue on which judicial opinion or scholarly writing diverges; (3) to elaborate on the application of the Uniform Commercial Code where the statute and/or the Official Comment leaves doubt as to inclusion or exclusion of, or application to, particular circumstances or transactions; (4) consistent with U.C.C. § 1-102(2)(b),<sup>1</sup> to apply the principles of the Uniform Commercial Code to new or changed circumstances; (5) to clarify or elaborate upon the operation of the Uniform Commercial Code as it relates to other statutes (such as the Bankruptcy Code and various federal and state consumer protection statutes) and general principles of law and equity pursuant to U.C.C. § 1-103;<sup>2</sup> or (6) to otherwise improve the operation of the Uniform Commercial Code.

For more information about the Permanent Editorial Board for the Uniform Commercial Code, visit [www.ali.org](http://www.ali.org) or [www.uniformlaws.org](http://www.uniformlaws.org).

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<sup>1</sup> Current U.C.C. § 1-103(a)(2).

<sup>2</sup> Current U.C.C. § 1-103(b).

## PEB COMMENTARY NO. 18

**Issue:** Does an obligation of an issuer which satisfies the requirements of subparagraphs (ii) and (iii) of U.C.C. § 8-102(a)(15), and is represented by a certificate that is not in bearer form and that specifies a person entitled to the obligation, qualify as a “security” if (a) the certificate lacks any statement about registration of transfer, and (b) no books are maintained by the issuer for registration of transfers?

**Background:** The 2010 Amendments to Article 9 of the Uniform Commercial Code, approved and promulgated by the American Law Institute and the Uniform Law Commission, contain an Appendix adding a new paragraph to Comment 13 to U.C.C. § 8-102. That comment addresses the definition of “registered form” in U.C.C. § 8-102(a)(13), which is an important element of the definition of “security” in U.C.C. § 8-102(a)(15). This issue is quite important, and the amendment to the Comment affects matters beyond those governed by Article 9. Accordingly, the Permanent Editorial Board for the Uniform Commercial Code has determined that the promulgation of this Commentary will be useful in explaining, in somewhat greater depth than possible in the amended Comment, the importance of the issue and the circumstances that gave rise to its addition to the Uniform Commercial Code.

Depending on their nature, rights to the payment of money may fit into a number of different categories of personal property defined in the Uniform Commercial Code. For example, a right to payment may be evidenced by a “note” (which is a type of “negotiable instrument”) governed by Article 3 of the Uniform Commercial Code; it may be a “security” governed by Article 8 of the Uniform Commercial Code; or it may be one of several different types of personal property identified in Article 9 of the Uniform Commercial Code. Within Article 9, the right to payment may be an “account,” “chattel paper,” a “payment intangible,” or a “promissory note” (which is a type of “instrument”); if the right to payment is a “security” (as defined in, and governed by, Article 8) it is also “investment property” under Article 9. Each of these types of property that encompass a right to the payment of money is governed by a different set of rules in the Uniform Commercial Code. Accordingly, a misapplication of the rules governing one property type to a right that is actually a different property type will yield an erroneous answer; thus, the definitions of each of the property types are quite important.

The opinion of the New York Court of Appeals in *Highland Capital Management LP v. Schneider*, 866 N.E.2d 1020, 834 N.Y.S.2d 692 (2007), raised important questions about application of the definition of “security” to certain rights to the payment of money. Because of the importance of accurately categorizing payment rights in order to determine correctly the legal rules governing those property rights under the Uniform Commercial Code, the opinion is worthy of attention. More particularly, in *Highland Capital* the court interpreted U.C.C. § 8-102(a)(15)—the definition of “security”—as including an obligation “the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer” even if such books do not exist and are not maintained, so long as the issuer would, as a practical necessity, eventually have to maintain books upon which such transfers were recorded. Because the reasoning in this opinion could be determinative of whether an obligation is a “security” in a large number of factual contexts and because the definition of “security” has broad effects

throughout the Uniform Commercial Code, both the Permanent Editorial Board and the Joint Review Committee that prepared the 2010 Amendments to Article 9 concluded that the matter should be addressed explicitly in the Official Comments to the Uniform Commercial Code.

## I. Importance of the Issue

Among the effects of concluding that a monetary obligation constitutes a “security” rather than another type of personal property such as a “note” or “negotiable instrument” governed by Article 3, or an “account,” “chattel paper,” “instrument,” “promissory note,” or “payment intangible” governed by Article 9 are the following:<sup>1</sup>

- (i) The statute of frauds in former Article 1 of the Uniform Commercial Code does not apply if the obligation is a security.<sup>2</sup>
- (ii) The protections available to good-faith purchasers of securities for value are different than those available to similar purchasers of negotiable instruments. In the case of securities, such a purchaser may qualify for protection against certain defenses under U.C.C. § 8-202 and may qualify as a “protected purchaser” under U.C.C. § 8-303 and thereby take the security free of any adverse claim. In the case of negotiable instruments, such a good-faith purchaser may qualify as a “holder in due course” and take free of certain defenses and claims in recoupment under U.C.C. § 3-305 and take free of claims to the instrument under U.C.C. § 3-306. The criteria for qualifying for these protections, and the details of the protections, differ as between Article 8 and Article 3, however.<sup>3</sup>
- (iii) The non-temporal priority rules in U.C.C. § 9-330(d) that apply to instruments are inapplicable.
- (iv) The issuer would have the duties described in Article 8 rather than those described in Article 3 (if the obligation would otherwise qualify as a negotiable instrument) or contract law.
- (v) The obligations of an indorser would be those set out in Article 8 rather than in Article 3 (in the case of a negotiable instrument) or the common law. For example, under Article 3 an indorser is responsible if the maker of a note does not pay the note; this is not the case under Article 8.<sup>4</sup>
- (vi) Certain automatic perfection rules and priority rules that govern “investment property” under Article 9 would apply.<sup>5</sup>
- (vii) The provisions of U.C.C. §§ 9-406 and 9-408 that limit the effect of restrictions on assignment would be inapplicable.

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<sup>1</sup> See also Official Comment 2 to U.C.C. § 3-102 for further discussion of this point.

<sup>2</sup> U.C.C. § 1-206 (1962).

<sup>3</sup> Compare U.C.C. § 8-202 (2012) (issuer’s limited defenses against purchaser of security), and *id.* § 8-303 (“protected purchaser” of a security takes free of any adverse claim) with *id.* § 3-302 (defining “holder in due course” of a negotiable instrument), *id.* § 3-305(b) (issuer’s limited defenses against a holder in due course), and *id.* § 3-306 (holder in due course of a negotiable instrument takes free of any adverse claim).

<sup>4</sup> Compare U.C.C. § 8-304(f) (2012) with *id.* § 3-415.

<sup>5</sup> U.C.C. § 9-309(10) (2012) (automatic perfection); *id.* § 9-328 (priority of competing security interests).

## II. The *Highland Capital* Case

In *Highland Capital*, the plaintiff alleged that the defendant had entered into an oral agreement to sell some promissory notes and had breached that agreement. The defendant both denied the existence of the agreement and asserted the statute of frauds in former U.C.C. § 1-206(1) as an additional defense. In response, the plaintiff asserted that the promissory notes constituted securities and, therefore, § 1-206 was inapplicable. (Former U.C.C. § 1-206(2) provides that the statute of frauds in subsection (1) “does not apply to contracts for the sale of . . . securities . . . .”)

The facts of *Highland Capital* are complex, but they revolve around promissory notes with an aggregate face value of \$69 million issued by Norton McNaughton, Inc. (“McNaughton”) to various members of the Schneider family (the “Schneiders”) in conjunction with the acquisition of some women’s apparel companies. As described by the New York Court of Appeals:

The eight notes with an aggregate face value of \$69 million . . . , running 12 pages apiece, were each payable to one or another of the four Schneiders. The notes required McNaughton to make quarterly principal and monthly interest payments to the named payee. McNaughton was designated the maker of the notes, each of which bore the following restrictive legend: “THIS NOTE HAS NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED. IT MAY NOT BE TRANSFERRED IN THE ABSENCE OF AN EFFECTIVE REGISTRATION STATEMENT UNDER SUCH ACT OR AN OPINION OF COUNSEL TO THE MAKER THAT SUCH REGISTRATION IS NOT REQUIRED.” Each note was marked “SUBORDINATED PROMISSORY NOTE” on its face because these notes were subordinate to McNaughton’s existing bank and bond debt amounting to roughly \$350 million. Upon McNaughton’s default, the payee had the right to declare the entire amount under the note due and owing, and to elect either to receive payment in stock or to accelerate payment. The notes stated that they were “governed by and construed in accordance with” New York law.

The securities industry professionals who subsequently dealt with the notes considered them to be high-risk debt akin to junk bonds. Consequently, it was anticipated that any potential purchaser would expect a high yield or internal rate of return. Concomitantly, the notes carried a substantial, variable interest rate (initially, 9.34% on the December notes).

McNaughton did not maintain books on which the transfer of any of the promissory notes could be registered.

According to *Highland Capital*, at a time when it appeared that McNaughton would be unable to pay the full amount of the notes when due, the Schneiders retained RBC Dominion Securities to market the notes on their behalf and subsequently orally agreed to sell the promissory notes to RBC at almost 50% below their face value; RBC, in turn, entered into a contract to sell the promissory notes to *Highland Capital*. Then, according to *Highland Capital*, when McNaughton was acquired by a larger company and became able to pay the full amount of the promissory notes, the Schneiders reneged on their oral agreement.

Highland Capital brought suit against the Schneiders for breach of contract in a Texas state court, but the case was removed to federal court on diversity grounds and eventually transferred to the United States District Court for the Southern District of New York. In its ruling on a motion by the Schneiders to dismiss the suit on the basis of the U.C.C. § 1-206 statute of frauds, the court noted that if the promissory notes that were the subject of the *Highland Capital* dispute constituted “securities,” the § 1-206 statute of frauds would be inapplicable and the oral agreement, if proven, would be enforceable.<sup>6</sup> If, on the other hand, the promissory notes did not constitute securities, the court noted that the § 1-206 statute of frauds would apply and the contract would be enforceable only to the extent of \$5000.<sup>7</sup> The court held that the promissory notes did not constitute securities and granted the motion to dismiss.<sup>8</sup> The decision was appealed to the United States Court of Appeals for the Second Circuit, which certified the matter to the New York Court of Appeals, asking whether “the eight promissory notes issued by [McNaughton] to the Schneiders fall within the definition of a security as contemplated by § 8-102(a)(15) of the New York Uniform Commercial Code.”

### III. Analysis of the Issue Addressed in *Highland Capital*

Uniform Commercial Code § 8-102(a)(15) defines “security” as follows:

an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer:

- (i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer;
- (ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and
- (iii) which:
  - (A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or
  - (B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article.

Thus, in order to qualify as securities, the promissory notes in *Highland Capital* must fulfill the requirements of subparagraph (i) (transferability and registrability), subparagraph (ii) (divisibility), and clause (A) of subparagraph (iii) (investment-function test) of § 8-102(a)(15).<sup>9</sup>

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<sup>6</sup> See U.C.C. § 8-113. U.C.C. § 1-206 (1962) was deleted from the official text by the 2001 revision of Article 1, but it was in force in New York at the time of the events and decision in *Highland Capital*.

<sup>7</sup> The court did not consider the possibility that the sale of the promissory notes was governed by revised U.C.C. Article 9 and, thus, by its statute of frauds in U.C.C. § 9-203(b). While the events in the case occurred before the effective date of revised Article 9 on July 1, 2001, litigation was not commenced until after that date. See U.C.C. §§ 9-701, 9-702(c).

<sup>8</sup> Because the U.C.C. § 1-206 statute of frauds allows enforcement up to \$5000, the motion to dismiss was granted on the ground that the amount in controversy no longer met the jurisdictional standard for a diversity case.

<sup>9</sup> The promissory notes need not satisfy the investment-function test of clause (A) of subparagraph (iii) if they satisfy clause (B) of that subparagraph. However, these notes evidently did not satisfy clause (B) because they

In applying these criteria, we are guided by § 1-103(a) of the Uniform Commercial Code. That section provides that the Code “must be liberally construed and applied to promote its underlying purposes and policies.” This fundamental principle is further articulated in the Prefatory Note to Revised Article 8:

In analyzing these classification questions, courts should take care to avoid mechanical jurisprudence based solely upon exegesis of the wording of definitions in Article 8. The result of classification questions is that different sets of rules come into play. In order to decide the classification question it is necessary to understand fully the commercial setting and consider which set of rules best fits the transaction. Rather than letting the choice of rules turn on interpretation of the words of the definitions, the interpretation of the words of the definitions should turn on the suitability of the application of the substantive rules.<sup>10</sup>

The *Highland Capital* court devoted most of its analysis to the transferability/registrability test of subparagraph (i) of U.C.C. § 8-102(a)(15). It was common ground that the notes were not in bearer form. Thus, the court was required to determine whether the promissory notes were represented by security certificates in “registered form.”<sup>11</sup> (The court seems to have assumed that the divisibility and investment-function tests were satisfied. The opinion does not treat these issues in any detail, and, accordingly, this Commentary does not address them.<sup>12</sup>)

U.C.C. § 8-102(a)(13) provides as follows:

“Registered form,” as applied to a certificated security, means a form in which:

- (i) the security certificate specifies a person entitled to the security; and
- (ii) a transfer of the security may be registered upon books maintained for that purpose by or on behalf of the issuer, or the security certificate so states.

The notes in *Highland Capital* satisfied subparagraph (i) of this definition, because each specified the person entitled to be paid. The notes evidently did not satisfy the second clause of

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evidently did not provide expressly that they were securities subject to Article 8. Accordingly, the effects of such an “opt in” were not considered by the court, nor are they considered in this Commentary.

<sup>10</sup> Section III.C.14. Similarly, in the context of the indirect-holding-system rules of Article 8, Comment 1 to § 8-501 warns that “the question whether a given arrangement is a securities account should be decided not by dictionary analysis of the words of the definition taken out of context, but by considering whether it promotes the objectives of Article 8 to include the arrangement within the term securities account.” The interpretation of the term “security” in Article 8 must be approached with these principles in mind.

<sup>11</sup> Formally, an item may satisfy subparagraph (i) of § 8-102(a)(15) without being in bearer or registered form if “the transfer of [the item] may be registered upon books maintained for that purpose by or on behalf of the issuer.” That language was added in 1977 with reference to uncertificated securities, which are excluded from the definition of “registered form.” The current text of Article 8 does not expressly limit the application of that language in subparagraph (i) to uncertificated securities. However, the same language is an element of the definition of “registered form.” Hence an item that is not in bearer form must satisfy that language in order to qualify under subparagraph (i) in any case. For simplicity, this Commentary refers to the language as it appears in the definition of “registered form.”

<sup>12</sup> For analysis of these issues, see, e.g., Howard Darmstadter, U.C.C. Survey Article 8 – Investment Securities, 62 *Bus. Lawyer* 1623 (2007).

subparagraph (ii) (“or the security certificate so states”), because they apparently said nothing about registration of transfer. Accordingly, the issue in *Highland Capital* reduced to the single question of whether the notes satisfied the first clause of subparagraph (ii). That question can be restated as follows: given that McNaughton did not maintain books on which the transfer of the promissory notes may be registered but, presumably McNaughton *might have* maintained such books, was it the case that “a transfer of the [promissory notes] may be registered upon books maintained for that purpose by or on behalf of [McNaughton]”?

The court answered that question in the affirmative:

McNaughton ultimately would have been constrained to [register the transfer of the notes to a third-party at the Schneiders’ request]. McNaughton did not restrict transfer of the notes other than by the legend .... And the restrictive legend itself suggests that the parties contemplated the possibility of future transfer. As ... a practical matter, McNaughton would have to have recorded any transfer of the notes in order to protect itself and the senior debt holders. For example, in the event of default, the payee of the notes could have elected conversion of the principal to common stock, thus diluting other shareholders’ value; and because the notes called for hefty payments of principal and interest, McNaughton had to have a way to keep track of the proper payees.

The Permanent Editorial Board believes that records kept by an obligor as to the identity of the owners of its obligations are not sufficient to satisfy the definition of “registered form” unless, among other things, those records are maintained for the purpose of registering transfer. Registration of transfer of a certificated security as referred to in U.C.C. § 8-102(a)(13)(ii) entails the issuer marking its books to reflect the change in record ownership, and also entails the issuance of a new certificate in the name of the transferee and, if less than the whole amount of the security is transferred, issuance of a new certificate for the difference in the name of the transferor. Neither McNaughton nor the Schneiders seem to have contemplated that McNaughton would be obligated to take such actions. Moreover, the notes involved in *Highland Capital* were not subject to any agreement or arrangement by which McNaughton was entitled to treat as owner of a note the person identified as such in its records, as contemplated by U.C.C. § 8-207. Hence any records that McNaughton might have maintained as to the identity of the owners of the notes would not have been maintained for the purpose of registering transfer.

The *Highland Capital* opinion stated that “the proper inquiry is whether the notes *could have been* registered on transfer books maintained by McNaughton, not whether they were registered on transfer books at the time of the litigation.” The dissenting opinion took this to be the court’s argument:

[The majority] emphasizes the words “may be” [in the definition of “registered form,”] which the majority seemingly takes to mean that the notes are registrable if any books could possibly exist in which transfers of the notes could be registered. Read so broadly, the words “may be” deprive the registrability requirement of any meaning—it is always theoretically possible there could be books on which transfers of anything could be registered. The words “may be registered upon books maintained for that purpose” are much more plausibly read to mean that “books maintained for that purpose” must exist,

on which transfers may (or may not) be registered. In other words, the requirement is met whether transfers are actually registered on the books or not, but not if there are no books “maintained for that purpose” on which registration could occur.

The Permanent Editorial Board agrees with the dissenting opinion in *Highland Capital*. If an issuer of obligations not in bearer form does not maintain books on which transfer of those obligations may be registered, those obligations do not satisfy the registrability criterion and those obligations are not “securities.” A contrary reading deprives the distinction between debt obligations that are negotiable notes or Article 9 promissory notes and debt obligations that are securities of both the substantive content intended by the drafters and of the predictability and certainty needed for commercial transactions. This is because, under the *Highland Capital* majority, all such obligations in the form of negotiable notes or promissory notes might nonetheless be characterized as securities. Inasmuch as many important legal rights with respect to debt obligations (of which the existence or nonexistence of an applicable statute of frauds—the primary issue of the *Highland Capital* case—is only one) depend on the characterization of such obligations, a reading of the statute that creates uncertainty as to that characterization creates not only uncertainty as to the resolution of disputes in litigation but also transactional uncertainty that adds risk and cost to transactions.

#### **IV. Conclusion**

The definitions of “registered form” and “security” in U.C.C. §§ 8-102(a)(13) and 8-102(a)(15) should be interpreted so that an obligation of an issuer that is represented by a certificate, that satisfies subparagraphs (ii) and (iii) of § 8-102(a)(13), that is not in bearer form, and that specifies a person entitled to the security, is not a “security” unless (a) the certificate states that a transfer of the obligation may be registered upon books maintained by or on behalf of the issuer for the purpose of registering transfer, or (b) any records that the issuer maintains (or that it would eventually have to maintain pursuant to the undertaking referred to in the preceding clause (a)) do not merely record transfers of such obligations but are instead maintained for the purpose of registering transfer of such obligations.

As noted above, the 2010 Amendments to Article 9 of the Uniform Commercial Code, approved and promulgated by the American Law Institute and the Uniform Law Commission, contain an Appendix adding a new paragraph to Comment 13 to U.C.C. § 8-102 to preclude that incorrect interpretation of the definition of “registered form.” The new Comment states:

Contrary to the holding in *Highland Capital Management LP v. Schneider*, 8 N.Y.3d 406 (2007), the registrability requirement in the definition of “registered form,” and its parallel in the definition of “security,” are satisfied only if books are maintained by or on behalf of the issuer for the purpose of registration of transfer, including the determination of rights under § 8-207(a) (or if, in the case of a certificated security, the security certificate so states). It is not sufficient that the issuer records ownership, or records transfers thereof, for other purposes. Nor is it sufficient that the issuer, while not in fact maintaining books for the purpose of registration of transfer, could do so, for such is always the case.

This amendment to Comment 13 to U.C.C. § 8-102 is not limited to matters governed by the provisions of the Uniform Commercial Code that are amended by the 2010 Amendments. Accordingly, the amended Comment reflects the view of the Permanent Editorial Board for the Uniform Commercial Code of the law prior to the effective date of the 2010 Amendments as well as the law after the effective date of those amendments.