Duke Law Journal

VOLUME 50 APRIL 2001 NUMBER 6

INTERMEDIARY RISK IN A GLOBAL ECONOMY

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ABSTRACT

Worldwide financial markets increasingly depend on structures that reduce risk by interposing intermediaries between investors and the companies obligated to pay them. This reduction of risk may be offset, however, by the risk that an intermediary will fail, and its creditors then will claim against assets held by the intermediary for the benefit of investors. If the intermediary holds assets solely in a custodial capacity, this risk traditionally is addressed by agency and trust law. What is novel, however, is that intermediaries in a wide range of domestic and international dealings—including the trading of investment securities, the sale of loan participations, and securitization transactions—now hold assets in which they, as well as investors, share beneficial rights. The sharing of these rights creates significant uncertainty as to whether the intermediary's creditors can look to all

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those assets, or merely to the intermediary's interest therein, for repayment. This "intermediary risk" not only affects individual investors and increases transaction costs but also can be systemic: the failure of an intermediary may trigger a chain reaction of failures of investing institutions that contract with the intermediary. Moreover, the problem of intermediary risk raises innovative legal issues that blur the boundaries between commercial law and property. This Article analyzes how legal systems worldwide should respond to this risk. It concludes that a uniform rule is needed to regulate intermediary risk in cross-border commercial and financial transactions, and it examines how such a rule should be implemented in an international law context.

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I. THE PROBLEM

Companies need large amounts of financing to compete in a global economy. Investors that provide the financing, however, usually want to limit their risk by diversifying the source of repayment.[1] Thus, investors often invest relatively small amounts in each of many companies, including firms in other sovereign states or countries (each, a "state"), rather than investing a large amount in a single company.[2] Investors also can limit their risk by investing in future payment streams owing from a statistically large number of companies.[3] Some investors may use a combination of these techniques. In each case, the investment bargain fixes the particular assets—consisting of claims against, or future payment streams owing from, these companies—that constitute the source of repayment.

A curious pattern has evolved: regardless of the states in which they are located, markets are diversifying investment risk by interposing intermediaries to hold these assets for the benefit of multiple investors. For example, brokers are intermediaries with respect to investment securities, in which they sell fractional undivided interests ("undivided interests") to investors; banks are intermediaries with respect to loans, in which they sell undivided interests ("participations") to third parties, usually other banks; and companies are intermediaries with respect to receivables, in which they use securitization to sell undivided interests to investment vehicles. In each case, these sales are made in order to diversify and thereby reduce risk.[4]

To some extent this is old news. There is a long tradition, for example, of intermediaries (called trustees or agents) holding securities in a custodial capacity on behalf of multiple investors.[5] What is novel,

1. *See infra* Part II (explaining how this is accomplished).

2. This pattern of investment diversification, known as "portfolio theory," applies for both domestic and international investments. *See generally* RICHARD DOBBINS & STEPHEN F. WITT, PORTFOLIO THEORY AND INVESTMENT MANAGEMENT 13-14 (1983) (discussing the theoretical underpinnings of modern portfolio theory); GLOBAL PORTFOLIO DIVERSIFICATION: RISK MANAGEMENT, MARKET MICROSTRUCTURE, AND IMPLEMENTATION ISSUES 1-2 (Raj Aggarwal & David C. Schirm eds., 1995) (reporting "increasing evidence of international diversification of investment portfolios").

3. This is called securitization. *See infra* Part II.C (explaining securitization).

4. Intermediaries thus act as a link between diversified investors and issuers.

5. Trust indentures, which are "contract[s] entered into between a corporation issuing bonds or debentures and a trustee for the holders of the bonds or debentures which delineate[ ] the rights of the holders and the issuer," exemplify this tradition. 69 AM. JUR. 2D *Securities Regulation – Federal* § 872 (1993). As early as 1934, approximately $40 billion in corporate debt securities were issued under trust indenture agreements. JOEL SELIGMAN, THE

however, is that in a wide range of international commercial and financial transactions, intermediaries hold assets in which they, as well as investors, share rights that entitle them to some direct beneficial or equitable interest in these assets ("beneficial rights").[6] This typically occurs where the owner of an asset sells undivided interests therein to investors, retains an undivided interest for itself, but continues to hold, as intermediary, the entire asset for itself and the other investors.[7]

Even though this use of intermediaries reduces investment risk, part of the reduction may be offset by the separate risk ("intermediary risk") that, in the event of an intermediary's failure, creditors of the failed intermediary can claim against assets held by the intermediary for the benefit of investors. If the intermediary has no beneficial rights in those assets, intermediary risk traditionally is addressed by agency and trust law and, I will show, is minimal.[8]

There is, however, no clearly established body of law that addresses intermediary risk where the intermediary and investors share beneficial rights in assets held by the intermediary. For example,

> [S]ecurities today are generally held indirectly through multiple tiers of intermediaries. Cross-border investment requires not only tiering of intermediaries, but also involvement by intermediaries in different countries, with each tier being subject to a different country's laws. Existing national laws contain unnecessary ambiguities when applied to such multi-tiered securities holding systems.[9]

TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 194 (rev. ed. 1995). Also, the purchase of locomotives, railcars, and other forms of rolling stock has long been financed by mortgaging the equipment to a trustee who holds the mortgage on behalf of investors. CHARLES J. WOELFEL, ENCYCLOPEDIA OF BANKING & FINANCE 345 (10th ed. 1994).

6. An intermediary therefore would have beneficial rights in an asset only if it were entitled to some direct benefit from that asset, as opposed to holding the asset solely in a custodial capacity for investors and receiving a fee or other compensation for acting in that capacity.

7. *See infra* Part II (describing transaction patterns). This differs from the simple pattern in which an intermediary occasionally holds the same type of asset for investors and itself beneficially but is able (and, indeed, usually required by law) to segregate the holdings. JOANNA BENJAMIN, INTERESTS IN SECURITIES § 2.2.3.1, at 51 (forthcoming 2001) (June 15, 2000 draft at 51, on file with the *Duke Law Journal*).

8. *See infra* Part III.A. The term "custody risk" sometimes is used to describe intermediary risk in this context. Custody risk is therefore a subset—indeed, I will show it is the trivial case—of intermediary risk.

9. Morgan Guaranty Trust Co. of New York, Brussels Office, as Operator of the Euroclear Sys., Cross-Border Clearance, Settlement and Custody: Beyond the G30

This legal void creates significant uncertainty as to whether the intermediary's creditors can look to all those assets, or merely to the intermediary's interest therein, for repayment.[10] That uncertainty in turn increases the costs for parties engaging in these transactions and may discourage certain of these transactions altogether.[11]

This Article focuses on intermediary risk. As a practical matter, intermediary risk is important not only because it affects individual investors but also because it can be systemic. The failure of an intermediary can cause a chain reaction of failures of institutions that have invested in assets held by the intermediary.[12] Indeed, because of the international tiering of intermediaries, such a chain reaction, if it involved an intermediary holding a large enough quantity of assets, could threaten the very stability of the global financial system.[13] For this reason, one of the primary purposes of financial regulation is to manage systemic risk.[14]

As a theoretical matter, intermediary risk is important because it raises complex and unique legal issues that blur the boundaries between commercial law and property, requiring innovative legal solu-

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Recommendations xiii (June 1993) (unpublished manuscript, on file with the *Duke Law Journal*); *see also* Richard Potok, *Legal Certainty for Securities Held as Collateral*, INT'L FIN. L. REV., Dec. 1999, at 12, 12:

> [I]t is no wonder that financial institutions are paying more attention to the legal risk associated with taking securities held through multiple tiers of intermediaries . . . . [because] in the last decade there has been a sharp increase in the number of arrangements within the financial services industry . . . involving a cross-border element.

10. Dr. Joanna Benjamin wryly notes that the "Roman term for the mixing together of assets which belong to different persons and which are not divided into distinct units is *confusio*." BENJAMIN, *supra* note 7, § 2.2.3.2, at 54.

11. *Cf.* Michael J. Whincop, *Conflicts in the Cathedral: Towards a Theory of Property Rights in Private International Law*, 50 U. TORONTO L.J. 41, 44-45 (2000) (arguing that property cannot be efficiently traded unless the parties know the applicable law).

12. *See infra* notes 50-59 and accompanying text (analyzing systemic risk).

13. *Cf.* Charles W. Mooney, Jr., *Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries*, 12 CARDOZO L. REV. 305, 413 (1990) (noting the primary importance of the issue of intermediary risk); James Steven Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 U.C.L.A. L. REV. 1431, 1450 (1996) (arguing that the first element of the "core of the package of rights and duties that define the relationship between a securities intermediary and a person . . . who holds a securities position through that intermediary" is that such person "does not take the credit risk of the intermediary's other business activities; that is, property held by the intermediary is not subject to the claims of the intermediary's general creditors").

14. JOHN EATWELL & LANCE TAYLOR, GLOBAL FINANCE AT RISK 19, 197 (2000).

tions.[15] Moreover, the analysis of intermediary risk yields insights into resolution of the broader issue of whether rights of one party in assets, in which a second party also shares rights, will be subject to claims of the second party's creditors.

This Article analyzes how legal systems worldwide should respond to intermediary risk. The analysis depends, of course, on a clear understanding of this risk. Three transaction patterns dominate: the indirect holding system for debt and equity investment securities ("securities"), in which intermediary risk is addressed, at least in the United States, by newly revised Article 8 of the Uniform Commercial Code; the sale of bank loan participations; and the securitization of receivables.[16] I introduce each in turn to provide a perspective for the analysis that follows.

The analysis then shows that the issue of intermediary risk is generally unresolved under existing legal systems. Although some states resolve it by statute in the context of a single transaction pattern, there has been no attempt to examine intermediary risk in a larger context. I attempt to do so by starting from first principles. Part III argues that, for each of the foregoing transaction patterns, a creditor of the intermediary should only be able to reach the intermediary's, and not an investor's, interest. Part IV examines how this normative rule should be implemented into law, taking into account that many of these transactions cross national borders and, therefore, any law would have to bind parties in different states. Part IV.C concludes that the rule should be implemented as a uniform model law. Finally, Appendix A proposes a draft of that law.[17]

II. PATTERNS OF INTERMEDIARY RISK

This part examines the three dominant transaction patterns in order to provide a perspective for the analysis in Part III. No state has yet attempted to address intermediary risk beyond the context of in-

15. For an argument that much of commercial law is property law, carrying the same ideological freight that is taken for granted in property law but rarely acknowledged in commercial law, see generally Carl S. Bjerre, Commerce and Community: The Redistributionist Streak in American Commercial Law (Dec. 20, 2000) (unpublished manuscript, on file with the *Duke Law Journal*).

16. The similarities of these transaction patterns implicitly challenge the claim by drafters of Article 8 of the Uniform Commercial Code that the legal relationship between intermediaries and investors under the indirect holding system for securities is "sui generis." U.C.C., Prefatory Note to art. 8, part III.B (amended 1994).

17. *See infra* Appendix A (Proposed Model Law to Regulate Intermediary Risk).

dividual transaction patterns. I show, however, that from the standpoint of intermediary risk, the intrinsic structure of each of these patterns is identical: a financing in which money flows through an intermediary. A unified approach to resolving this risk may well be appropriate.

A. *Indirect Holding System for Securities*

The first of these three transaction patterns arises from the decline of the traditional system for direct holding of securities. Under the traditional system, individual securities were issued to investors that in turn had the right to trade those securities to other investors.[18] An indirect holding system has evolved in its place, under which intermediary entities—which I will refer to as "securities intermediaries"[19]—not only hold the securities on behalf of investors but also frequently own beneficial rights in those securities. Investors are concerned, however, that creditors of a failed intermediary may assert their rights against the investors' interests in those securities.

Under the indirect holding system, issuers generally record ownership of their securities as belonging to one or more depository intermediaries.[20] Although securities held through a depository intermediary are often evidenced by physical certificates,[21] these

18. The traditional securities holding system evidenced investor ownership of securities either by physical possession of certificates or by book ownership, i.e., marking the issuer's (or its transfer agent's) books and records. JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 5-7 (5th ed. 2000). The analysis in my Article applies irrespective of which of these methods is used to evidence investor ownership.

19. *See* U.C.C. § 8-102(a)(14) (1994) (using this same definition).

20. U.C.C., Prefatory Note to art. 8, part I.D (amended 1994). In the United States, the depository is ordinarily The Depository Trust Company, or DTC. With limited exceptions, however, DTC itself "does not normally take a position in securities. It serves only as a custodian." E-mail from Stephen Letzler, Director, Corporate Communications, Depository Trust Company, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (June 30, 2000) (on file with the *Duke Law Journal*). Hence, the intermediary risk discussed in this Article would not ordinarily apply to DTC as intermediary but would (absent Article 8 of the UCC) apply to "lower-tier" intermediaries of DTC. *See infra* note 42 and accompanying text (restating the same definition of intermediary risk). The author also appreciates the helpful comments of DTC's Carl H. Urist on notes 20-29 and accompanying text.

21. In this context, it should be noted that students of the indirect holding system sometimes confuse that system with the "book entry" system for transferring uncertificated securities. These systems are only coincidentally related. If securities exist in tangible form, it sometimes might be necessary to physically transfer them to evidence change of ownership. More commonly, however, such transfers are simply noted in the securities intermediary's books. Recording a transfer instead of physically transferring a tangible certificate reduces both transaction costs and the risk of loss associated with such a transfer. HAL S. SCOTT & PHILIP A.

certificates remain in that intermediary's possession and are never delivered to third parties.[22] The depository intermediary records the identities of other intermediaries, such as brokerage firms or banks, that purchase interests in these securities.[23] Those other intermediaries in turn record the identities of investors that purchase interests in the intermediaries' interests.[24]

To illustrate how this works, consider an investor that wishes to invest in 500 shares of ABC Corporation's stock. In theory, that investor could purchase 500 individual shares of ABC stock from a brokerage firm; however, for reasons discussed below, the broker may not directly hold individual shares.[25] Companies often issue securities in very large, indivisible blocks.[26] For purposes of this example, assume that ABC issued a certificate for 1,000,000 shares of its stock to a depository. If a broker then wishes to purchase 50,000 shares of ABC stock, some perhaps for its own account and some for customers, it would pay the depository for those shares.[27] In return, the broker would receive a 5% undivided, or pro rata, interest in the 1,000,000 share certificate.[28] If the investor then seeks to purchase 500 shares of ABC stock from that broker, the investor would pay the broker for those shares and, in return, would receive a 1% undivided interest in the broker's 5% undivided interest.[29]

WELLONS, INTERNATIONAL FINANCE 803 (6th ed. 1999). Whether or not the securities exist in tangible form, however, the legal risk on which this Article focuses is the same.

22. U.C.C., Prefatory Note to art. 8, part I.D.

23. *Id.*

24. *Id.*

25. *See infra* notes 29-32 and accompanying text (showing that the indirect holding system reduces the costs and lowers the risk of loss of direct holding).

26. Especially in the case of debt securities, a single certificate referred to as a "global" or "jumbo" certificate may evidence these securities.

27. The depository then would turn over that payment to ABC. Although the actual payment mechanics sometimes might work differently (e.g., in underwritten securities offerings), the differences would not be relevant to this Article's analysis of intermediary risk.

28. 1,000,000 shares (held by depository) x 5% (broker's interest) = 50,000 share equivalent.

29. 1,000,000 shares (held by depository) x 5% (broker's interest) x 1% (investor's interest) = 500 share equivalent. There are two clarifications to the foregoing example. In practice, the broker is most likely to buy equivalent shares in order to accommodate a simultaneous sale to the investor. Also, at least under Article 8, the actual records would reflect the flat number of shares (in my example, 500) to avoid any confusion if the broker's undivided interest in the certificate later increases. E-mail from Carl S. Bjerre, Professor of Law, University of Oregon, and co-author of THE ABCS OF THE UCC, ARTICLE 8: INVESTMENT SECURITIES (1997), to Steven L. Schwarcz, Professor of Law, Duke University School of Law (July 17, 2000). These technicalities, however, are irrelevant to my arguments.

The rationale for indirect holding. The indirect holding system is decisively replacing direct holding because it reduces the overall costs and complexities of record-keeping and lowers the risk of loss occasioned by physically transferring securities. Investors, for example,

> obtain expert safekeeping services rather than running the risk of keeping physical possession of their own certificates, assure themselves of the ability to transfer securities rapidly in settlement of trades, and obtain professional services in the complex record keeping involved in tracking their investments, distributions, calls, and the like.[30]

Thus, in the United States, institutional investors such as insurance companies, mutual funds, and pension funds "almost invariably use the indirect holding system."[31] In fact, the "[s]ettlement of market trading . . . is now effected primarily through some form of" indirect holding system in most of the major U.S. securities markets, including virtually all markets for publicly traded corporate equity, corporate debt, and municipal debt securities.[32]

Cross-border use of indirect holding. For these same reasons, indirect holding is also "widely used in global trading" of securities.[33]

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30. James S. Rogers, *Revised UCC Article 8: Why It's Needed, What It Does*, ALI-ABA COURSE OF STUDY: THE EMERGED AND EMERGING NEW UNIFORM COMMERCIAL CODE 285, 288 (1994). The UCC also notes that:

> [t]ransfer of securities in the traditional certificate-based system was a complicated, labor-intensive process. Each time securities were traded, the physical certificates had to be delivered from the seller to the buyer, and in the case of registered securities the certificates had to be surrendered to the issuer or its transfer agent for registration of transfer. As is well known, the mechanical problems of processing the paperwork for securities transfers reached crisis proportions in the late 1960s, leading to calls for the elimination of the physical certificates and development of modern electronic systems for recording ownership of securities and transfers of ownership.

U.C.C., Prefatory Note to art. 8, part I.A (amended 1994).

31. Rogers, *supra* note 30, at 288.

32. U.C.C., Prefatory Note to art. 8, part I.A. Commercial paper, mortgage-backed securities, and U.S. Treasury securities trading markets also have instituted indirect holding systems. *Id.*

33. Roy Goode, *The Nature and Transfer of Rights in Dematerialized and Immobilized Securities*, *in* THE FUTURE FOR THE GLOBAL SECURITIES MARKET, LEGAL AND REGULATORY ASPECTS 107, 110 (Fidelis Oditah ed., 1996); *see also* SCOTT & WELLONS, *supra* note 21, at 806:

> [T]here are three principal models for clearing and settlement in the world's major stock markets. . . . The second model . . . is one in which there is a central depository structure, with trade matching and confirmation services provided by the exchanges. . . . There are variations on this model with differing degrees of settlement services provided by the depository. . . . The third model has not only a stock market and a central depository, but also a clearinghouse that stands between the stock market and depository to reduce risk.

Sometimes the securities intermediaries are transnational organizations. For example, securities traded through Euroclear, the world's largest securities intermediary for internationally traded securities,[34] are held by local depositories that are members of the Euroclear depository network.[35] Other times, the securities intermediaries are national entities that have created linkages

> through which a non-resident of the country of issue of a security could effect settlement of a cross-border trade: (1) through direct access to (membership in) the [securities intermediary] in the country of issue, e.g. DTC in the United States; (2) through a local agent [that is a member of the securities intermediary in the country of issue]; (3) through a global custodian that employs a local agent as sub-custodian; (4) through a [securities intermediary] in the non-resident's own country that has established a link [to the securities intermediary] in the country of issue; or (5) through an [international securities intermediary], e.g. Euroclear or [CEDEL], that has established a direct or indirect (through a local agent) link to the securities intermediary in the country of issue.[36]

For example, if an investor wants to purchase shares of a company from State X whose stock is also listed on a foreign stock exchange in State Y, the exchange's securities intermediary in State Y would account for the trade through its link with a securities intermediary in State X that holds those shares.[37] If there is no such link, the securities

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(quoting U.S. CONGRESS, OFFICE OF TECH. ASSESSMENT, TRADING AROUND THE CLOCK: GLOBAL SECURITIES MARKETS AND INFORMATION TECHNOLOGY, ch. 5 (1990) [hereinafter OFFICE OF TECH. ASSESSMENT]); Goode, *supra*, at 107 (observing that in order to promote cross-border investment and trading in securities, international securities markets have moved from a direct holding system to an indirect holding system "through one or more tiers of custodian[s] [in which] internationally traded securities [are immobilized] by deposit with the international central securities depositories [and in which] permanent global notes [are issued] instead of individual definite certificates"); Potok, *supra* note 9, at 12 (stating that in the last decade there has been a sharp increase in cross-border trading).

34. Euroclear, *About the Euroclear Group*, *at* http://www.euroclear.com/eoc/default.asp (last visited March 25, 2001) (on file with the *Duke Law Journal*). Euroclear is operated by Euroclear Bank, S.A., a market-owned Belgian bank that assumed the operation of the Euroclear System on December 31, 2000, from Morgan Guaranty Trust Company of New York, which had created and operated the system since 1968. *Id.* Euroclear Participants are firms engaged professionally in the securities markets that meet admission criteria based on, among other things, financial soundness and reputation in the market. *Id.*

35. SCOTT & WELLONS, *supra* note 21, at 845.

36. *Id.* at 839-40.

37. *See id.* at 840 (giving as an example the purchase of IBM shares listed on the Tokyo Stock Exchange). The underlying certificate usually would be held by a securities intermediary

first would have to be delivered to a securities intermediary in State X that had such a link before the securities intermediary in State Y could account for the trade.[38] This pattern avoids the transaction costs and risk of loss caused by physically moving the securities from State X to State Y.[39]

States are only now beginning to grapple with the intermediary risk raised by indirect holding.[40] Investors want to know that their

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in the company's home state because that is where most of the trades with respect to those securities would be expected to occur.

38. *Id.* at 840.

39. *See id.* (explaining that without these linkages, "[s]ecurities would [have to] be constantly moved in and out of the trading country").

40. Although there are numerous legal risks associated with indirect holding of securities, only intermediary risk is unique to an indirect holding system; other legal risks arise in any securities holding system and are addressed by traditional legal disciplines, such as the laws of contract, agency, corporations, and securities regulation. To understand why, consider

> the differing roles of the broker in a typical securities transaction, in which the broker acts as agent for the customer. When a customer directs a broker to buy or sell securities for the customer, and the broker executes that trade on a securities exchange or in the over the counter market, the broker is entering into a contract for the purchase and sale of the securities as agent of the customer. The rules of the exchange, practices of the market, or regulatory law will specify when and how that contract is to be performed.

U.C.C., Prefatory Note to art. 8, part III.B (1994). This Article need not review these established bodies of law:

> Article 8 is in no sense a comprehensive codification of the law governing securities or transactions in securities . . . [and] is not, and should not be, a comprehensive body of private law governing the relationship between brokers and their customers, nor a body of regulatory law to police against improper conduct by brokers or other intermediaries.

Id. My analysis therefore focuses on intermediary risk. In this context, I also note that there are non-legal risks associated with indirect securities holding which this Article does not address. These risks result from the differences between the clearance and settlement processes of the selling investor's and buying investor's markets—a problem that becomes particularly acute when those markets are in different countries. SCOTT & WELLONS, *supra* note 21, at 805. For example, an investor in the United States may believe it is protected from these risks by government guaranties, minimum capital requirements imposed on members of the securities intermediary, or guaranties provided by the securities intermediaries themselves. *Id.* at 803. A securities intermediary may guaranty, for example, that an investor paying for securities will receive the securities and that an investor transferring ownership of securities will receive payment therefor. *Id.* at 804. These protections do not always exist, however, for foreign securities intermediaries. *Id.* at 803. Also, differences in the settlement processes may create trading inefficiencies, such as where settlement is expected to occur the third day after a trade in the selling investor's jurisdiction but later or earlier than that date in the buying investor's jurisdiction. *Id.* at 805-06. These nonlegal risks, however, may have practical solutions. For example, U.S. investors can be educated that local protections may not be available in foreign markets. Also, investors can limit their risk by knowing their trading partners or contractually limiting the duration of the settlement process. *Cf. id.* at 803 (noting the variation among members of the international community on the goals of clearing and settlement). In any event, as securities intermediaries adapt to investor demands in order to attract cross-border trading, fractional undivided interests in securities held by failed securities intermediaries are not subject to the claims of creditors of those intermediaries.[41] Securities intermediaries, such as brokers that themselves own undivided interests in securities held by failed intermediaries, want to know that those interests are not subject to the claims of creditors of the failed intermediaries. More generically, any entity—whether an investor or itself an intermediary—that owns undivided interests in securities held by a failed securities intermediary wants to know that those interests are not subject to the claims of creditors of the failed intermediary.

To clarify the following analysis, I will use certain simplifying terminology when discussing a transaction with more than one securities intermediary. First, the term "investors" generally will be deemed to include not only investors but also intermediaries that have rights in securities held by other intermediaries. Second, when necessary to avoid confusion, I will refer to a holder of an interest in securities through an intermediary that itself holds an interest in the securities through an intermediary as a lower-tier holder, and to that holder's interest as lower-tier rights.[42] Thus, in the example used earlier in which a broker holds a 5% interest in 1,000,000 shares of ABC stock held by a depository and an investor holds a 1% interest in that 5% interest,[43] the investor would be a lower-tier holder (and its interest would constitute lower-tier rights) with respect to both securities intermediaries, whereas the broker would be a lower-tier holder (and

the differences between jurisdictions ultimately will be minimized, in turn minimizing these risks. *See also id.* at 828 (discussing proposals by the Group of Thirty that, among other things, call for "[e]ach country [to] have an effective and fully developed central securities depository, organized and managed to encourage the broadest possible industry participation"); *cf. id.* at 803 ("[A]s markets become global, one could expect that investment capital will flow toward markets that are most attractive on a risk-return basis, and that also have efficient and reliable clearing and settlement systems.") (quoting OFFICE OF TECH. ASSESSMENT, *supra* note 33, ch. 5).

41. As a matter of terminology, this Article has been referring to a fractional undivided interest as an undivided interest. The fraction also could be expressed, of course, as a percentage. *See supra* notes 24-29 and accompanying text (discussing the purchase by a broker of a 5%, or in fractional terms 5/100, undivided interest in a 1,000,000 share certificate of ABC stock, and the subsequent purchase by an investor of a 1%, or in fractional terms 1/100, undivided interest in the broker's 5% undivided interest).

42. My analysis of the intermediary risk of investors as against creditors of an intermediary therefore should be construed more generally, because of this simplifying terminology, as applying to the intermediary risk of any lower-tier intermediary as against creditors of an upper-tier intermediary.

43. *See supra* notes 24-29 and accompanying text.

its interest would constitute lower-tier rights) only with respect to the depository.

Status of indirect holding intermediary risk. The issue of intermediary risk in the indirect holding system appears to be resolved only in the United States and perhaps a handful of other countries.[44] This limited resolution, however, may reflect the complexities of the issue more than lack of concern. Federal Reserve Board Chairman Alan Greenspan has urged other nations to follow the lead of the United States in eliminating legal uncertainties by modernizing their legal

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44. *See, e.g.*, CHRISTOPHE BERNASCONI, THE LAW APPLICABLE TO DISPOSITIONS OF SECURITIES HELD THROUGH INDIRECT HOLDING SYSTEMS 3 (Nov. 2000, Prelim. Doc. No. 1) (Report of the First Secretary of the Permanent Bureau, Hague Conference on Private International Law, to the Working Group of January 2001) (observing in a report on the taking of investment securities as collateral that "[i]n most jurisdictions, neither the substantive laws governing securities transactions nor the rules determining the law applicable to such transactions have been updated adequately to reflect this [risk]") (on file with the *Duke Law Journal*). Only a handful of countries appear to have addressed this risk. For example, Japan has adopted a law providing that parties are presumed to have joint ownership in deposited stocks according to the records of their account books. Kabukento no Hokan to Furikae ni Kansuru Horitsu [Law Concerning Keeping of Shares and other Securities], Law. No. 30 of 1984, art. 24. Korea enacted legislation similar to the Japanese law. Chunggwonkoraebop [Securities and Exchange Act], Act No. 2920 of 1976, art. 174-4, *translated in* 11 KOREA LEGIS. RES. INST., STATUTES OF THE REPUBLIC OF KOREA 720 (1997). German law gives investors preference, in certain circumstances, over creditors of an insolvent custodian with respect to securities owned by the custodian. BERND RUSTOR, 4 BUSINESS TRANSACTIONS IN GERMANY (FRG) § 39.16[1][e] (1987); Gesetz über die Verwahrund und Anschaffung von Wertpapieren (Depotgesetz – DepotG) v. 4. Februar 1937 (RGBI. I 171). And Belgian law gives investors title to their share of dematerialized or immobilized securities. Royal Decree No. 62 Facilitating the Circulation of Securities (Nov. 10, 1967, as amended Apr. 7, 1995) (Belgium); *see also* Nina Hval, *Credit Risk Reduction in the International Over-the-Counter Market: Collateralizing the Net Exposure with Support Agreements*, 31 INT'L LAW. 801, 815-16 (1997) (explaining Royal Decree). Canada also is considering adopting provisions similar to UCC Article 8. *See* BERNASCONI, *supra*, at 21-24 (describing certain provisions in English, Luxembourgian, French, Italian, and Brazilian law); Eric Spink, *Tiered Holding System – Uniform Legislation Project*, Report of the Production Committee (Apr. 30, 1997) (reviewing the Canadian laws governing securities transactions and proposing significant changes to those laws), *available at* http://www.law.ualberta.ca/alri/ulc/current/etiered.htm (on file with the *Duke Law Journal*); Gilles Thieffry & Julie Lynch Bridson, *Minimising Legal Uncertainty in Cross-Border Collateral Transactions*, BANKING 2000, *at* http://www.bankingmm.com/sexc/sexc11.html (last visited March 25, 2001) (reporting that "Belgium and Luxembourg, the places of organisation respectively of the depositories Euroclear and Cedelbank . . . have adopted legislation [intended to reduce] some of the uncertainty associated with conflict of law issues governing the transfer and pledge of securities held through financial intermediaries," and that the European Union adopted a Directive on Settlement Finality in Payment and Securities [Settlement] Systems [referring to the European Parliament's Directive 98/26/EC of May 19, 1998] that is intended to clarify the conflict of law rules governing collateral transactions in European Union settlement systems) (on file with the *Duke Law Journal*).

rules on indirect securities holding.[45] In May 2000 the Hague Conference on Private International Law placed the conflicts of law aspects of this issue on its priority agenda,[46] to be studied in collaboration with other international organizations including the United Nations Commission on International Trade Law (UNCITRAL) and the International Institute for the Unification of Private Law (UNIDROIT).[47] And UNIDROIT recently announced its intention to address the "need for substantive [law] harmonisation in this area."[48]

45. *See* Rogers, *supra* note 13, at 1438 (quoting Chairman Greenspan's March 3, 1995, remarks to this effect at the Financial Markets Conference of the Federal Reserve Bank of Atlanta).

46. E-mail from Christophe Bernasconi, First Secretary, Hague Conference on Private International Law, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (June 15, 2000) (on file with the *Duke Law Journal*). The Hague Conference, by its mandate, *The Hague Conference on Private International Law*, *available at* http://www.voc.net/nl/hc/#Operation (last visited Feb. 11, 2001) (on file with the *Duke Law Journal*), is focusing on the narrower topic of applicable law rules, as opposed to the unification of substantive law rules, which this Article addresses. *See* SPECIAL COMMISSION ON GENERAL AFFAIRS AND POLICY OF THE CONFERENCE 8-12 (May 2000) (providing a link to the Hague Conference's "Conclusions of the Special Commission of May 2000 on General Affairs and Policy" which, at 25, explains in the context of the indirect holding system that "[b]ecause securities have become computerised and because of the multiple levels of intermediaries, the traditional rule of *lex situs* is no longer appropriate in this situation," and therefore recommends the clarification of "applicable law rules for securities held through intermediaries [as] a basis for the world-wide adoption of consistent principles"), *available at* http://www.hcch.net/e/workprog/genaff.html (last visited Feb. 11, 2001) (on file with the *Duke Law Journal*); *see also* BERNASCONI, *supra* note 44, at 1 (stating the Special Commission on General Affairs and Policy of the Hague Conference's recommendation to include collateral securities as a priority issue in the Conference's agenda). For an analysis of the differences between the approaches of this Article and the Hague Conference, see *infra* Appendix B.

47. *See* BERNASCONI, *supra* note 44, at 4, 61 (noting that although the Hague Conference's "proposed Convention will be confined to *conflict of laws issues*," harmonizing "the *substantive* law relating to the nature of interests in respect of securities held through intermediaries is a major undertaking that may be considered by UNCITRAL or UNIDROIT in the near future"); *see also* E-mail from Harold S. Burman, U.S. Department of State, Office of Legal Adviser (Private International Law), to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Aug. 7, 2000) (summarizing an August 3, 2000 teleconference of the Global Electronic Policy Subcommittee in which there was a consensus that "it may be timely to pursue unification of substantive rules[, which] has already been suggested as a topic for UNCITRAL within its secured interest working group") (on file with the *Duke Law Journal*).

48. UNIDROIT Secretariat, Comments on the Proposed Hague Convention on the Law Applicable to the Dispositions of Securities Held Through Indirect Holding Systems 1 (Jan. 2001) (on file with the *Duke Law Journal*). UNIDROIT stated that it may address substantive law harmonization in the context of "the clearing-and-settlement unit of [its] capital markets projects." *Id.* at 1-2; *see also* E-mail from Herbert Kronke, Secretary General of UNIDROIT, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Oct. 10, 2000) (stating that "clearing and settlement issues (including the 'intermediary risk') are on the UNIDROIT

The most comprehensive law on this issue is Article 8 of the Uniform Commercial Code (UCC),[49] which was recently revised to address concerns that intermediary risk in the indirect holding system would become systemic.[50] The failure of intermediaries is not merely theoretical. Brokers sometimes fail, and even the failure of clearinghouses is not unknown.[51] If investors in securities held by a failed intermediary do not have priority over the claims of the intermediary's creditors, those investors may be unable to recoup their investments, leading to their failure and the chain reaction failure of other institutions to which the investors are obligated.[52]

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work programme as one problem area of the item 'Transactions on Transnational Capital Markets'") (on file with the *Duke Law Journal*).

49. The UCC is a uniform law intended for separate enactment by each state of the United States. *See* Steven L. Schwarcz, *A Fundamental Inquiry into the Statutory Rulemaking Process of Private Legislatures*, 29 GA. L. REV. 909, 915-27 (1995) (discussing the status of the UCC and other uniform state laws in the United States). Article 8 has been enacted in almost all of those states. Professor Fred Miller reports that:

> Revised Article 8 has not only been adopted as the standard for government securities in the Treasury TRADES Regulation ([31 C.F.R. § 357]) and also in regulations by UD and the Federal Housing Finance Board, but has gained almost a universal state enactment as well. To date, 50 jurisdictions have adopted revised Article 8 and a bill is currently being prepared in the U.S. Virgin Islands.

Fred H. Miller, *The State of the Uniform Commercial Code—1999*, 39 UCC BULL. 2 (1999).

50. *See* Rogers, *supra* note 13, at 1437-38 (stating that systemic risk was the motivating force behind revising Article 8, and giving the example of a firm making bad guesses about the price movements of a security; if the firm enters into large trades based thereon and then fails, other firms that hedged their risk with that firm will lose the benefit of their hedging and, if their hedged positions are large enough, also may fail); Rogers, *supra* note 30, at 3 (discussing Article 8's main purpose as controlling systemic risk); c*f. id.* at 1 (adding that the revision also was motivated by the desire to eliminate the "inordinate amount of legal time which, of course, means cost, [that was] required to fit modern securities transactions into the conceptual scheme of a prior era"). *But see* Francis J. Facciolo, *Father Knows Best: Revised Article 8 and the Individual Investor*, 27 FLA. ST. U. L. REV. 615, 626 (2000) (arguing that "in most respects," the revisions are unrelated to concerns of systemic risk). Professor Rogers was the Reporter for the Article 8 revision.

51. *See* SCOTT & WELLONS, *supra* note 21, at 807 (discussing the failure in 1995 of Adler, Coleman Clearing Corp.); *see also Fourth-Biggest Brokerage House in Japan Is Considering Closing*, N.Y. TIMES, Nov. 22, 1997, at D1 (describing the collapse of Yamaichi Securities); *Hong Kong Brokerage Chark Fung Goes Bust*, SEC. INDUSTRY NEWS, June 1, 1998, at 8 (describing the largest brokerage firm failure in the history of the Hong Kong Stock Exchange); *Major Japanese Bank Seeks Nationalization*, N.Y. TIMES, Oct. 23, 1998, at C24 (describing the collapse of the Long-Term Credit Bank of Japan); *Trader Linked to Collapse of British Bank*, WASH. POST, Feb. 28, 1995, at A1 (describing the collapse of Barings Bank).

52. *See* SCOTT & WELLONS, *supra* note 21, at 805 (discussing systemic risk); Rogers, *supra* note 30, at 3 (discussing the systemic "risk that a failure of one securities firm might cause others to fail"). Professor Rogers suggests that to avoid systemic risk, it also is necessary to clarify the rights of intermediaries, their creditors, and investors: "'That's an interesting question' is not an acceptable answer to questions about the legal rights of securities market participants at a time

Revised Article 8 resolves intermediary risk by clarifying that investors have property rights in the securities (or interests therein)[53] held for them by intermediaries, not merely in personam claims against the intermediaries.[54] Accordingly, these securities and interests "are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary,"[55] except in specific cases that should not pose the threat of systemic risk.[56]

Article 8, however, only resolves intermediary risk for the indirect holding system within the United States.[57] Unfortunately, there is

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when the prospect of the collapse of the financial system is a matter of more than theoretical concern." Rogers, *supra* note 13, at 1449. Part of the reason that intermediary risk has become particularly troublesome is the increasing trend toward more complex and interwoven corporate structures. Thomas W. Joo, *Who Watches the Watchers?: The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1091 (1999) (noting that although businesses were traditionallly conducted like partnerships, they are now "usually incorporated and owned through . . . structures of increasing complexity").

53. Such an interest would arise where an investor owns an interest in a securities intermediary's interest in securities held by another intermediary. For example, in the earlier illustration, an investor would own a 1% interest in a broker's 5% interest in the 1,000,000 share certificate held by a depository. *See infra* note 28 and accompanying text.

54. U.C.C. § 8-503 (2000). One commentator described this provision as setting "the ground rules for implementing transfers and resolv[ing] disputes that may arise when different people claim conflicting interests." Rogers, *supra* note 30, at 1.

55. U.C.C. § 8-503(a).

56. *See infra* Part III.B (analyzing whether investors should have priority over creditors of the intermediary); *infra* Part IV.B (analyzing whether Article 8's exceptions should be incorporated absent a comprehensive regulatory scheme to ensure that investors are protected against the risk that their ownership interests in securities held by a failed intermediary will be impaired); s*ee also infra* note 157 (noting that stockbroker liquidation in the U.S. may be governed by special federal distributional rules).

57. Article 8's choice of law rules are nonetheless helpful to some extent in providing guidance for cross-border securities transactions. Section 8-110 provides that the local law (i.e., the law other than conflict of law rules) of the intermediary's jurisdiction governs:

> (1) acquisition of a security entitlement from the securities intermediary; (2) the rights and duties of the securities intermediary and entitlement holder [investor] arising out of a security entitlement; (3) whether the securities intermediary owes any duties to an adverse claimant to a security entitlement; and (4) whether an adverse claim can be asserted against a person who acquires a security entitlement from the securities intermediary.

U.C.C. § 8-110(b). An intermediary's "jurisdiction" is defined flexibly, though awkwardly, to include the governing law contractually chosen by the intermediary and the relevant investor. U.C.C. § 8-110(e)(1). The Official Comment 3 to this section clarifies that, in order to "enable parties to determine, in advance and with certainty, what law will apply to transactions governed by this Article [8], the validation of selection of governing law by agreement is not conditioned upon a determination that the jurisdiction whose law is chosen bear a 'reasonable relation' to the transaction." U.C.C. § 8-110 cmt. 3. Thus, an investor in the United States and an intermediary in a foreign state, and arguably even a foreign investor and a foreign intermediary, could choose Article 8 as the governing law. *Cf.* Rogers, *supra* note 30, at 4 (arguing that Section 8-110 "[a]ccommodates globalization of securities markets by establishing clear choice little resolution of this risk for the indirect holding system *outside* the United States.[58] In that broader context, there remains grave concern that intermediary risk may become systemic and that a "failure of a major player will have a domino effect on the market as a whole."[59]

B. Sale of Loan Participations

The central legal issue raised by the sale of loan participations is the same as that raised by the indirect holding system: what risk arises when an intermediary and investors share beneficial interests in assets held by the intermediary?

A "loan participation is an undivided interest in a loan. The bank that made the loan sells the participation to [a third party (usually] another bank[)],[60] thereby diversifying the lending bank's credit

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of law rules to facilitate planning of international custody and clearing arrangements"). Article 8's choice of law rules, however, are clearly only the beginning of a solution. Foreign parties are unlikely to choose U.S. law to govern their relationship. Even if they did, a non-U.S. court might not enforce their choice of law where the intermediary's creditors, whose rights would be affected, are located in the foreign jurisdiction. Furthermore, in examining the rights of a lower-tier holder, one must consider the rights for each intermediary—otherwise, the lower-tier holder's rights, even if safe as against creditors of its intermediary, may be cut off by creditors of another intermediary. Finally, Article 8 only applies to the indirect holding system, not to participation or securitization transactions. These choice of law rules are therefore no substitute for uniform international regulation. *But see infra* Appendix B (discussing the Hague Conference on Private International Law's proposed applicable rule approach).

58. *See supra* note 44 (indicating the limited number of states that have attempted to address this problem to date). *But see* E-mail from Randall Guynn, Partner, Davis, Polk & Wardwell, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Jan. 5, 2001) (arguing from his experience that, at least in a "properly structured global custody network," there "is very little risk" that investors would have a mere contractual claim instead of a property right to securities credited to their accounts) (on file with the *Duke Law Journal*).

59. Goode, *supra* note 33, at 108; *see also* GROUP OF THIRTY, CLEARANCE AND SETTLEMENT SYSTEMS IN THE WORLD'S SECURITIES MARKETS iii (1989) (arguing, in the context of the indirect holding system, that "the intersection between local practice and growing volumes and values could, under adverse circumstances, represent a very serious risk to the world's financial network"). The potential for systemic risk can be limited by resolving the issue of intermediary risk in states where the largest intermediaries, such as depositories and clearinghouses, are located. These tend to be located in states where issuers of securities are located, irrespective of where such securities might be traded, because the issuer's home jurisdiction "is where most of the trades with respect to that security occur." SCOTT & WELLONS, *supra* note 21, at 840. At least at present, there are only a relatively limited number of states in which multinational corporations, whose securities are likely to be traded internationally, reside. To limit systemic risk, those states could attempt to agree on how to resolve the intermediary risk. Nonetheless, even the potential failure of smaller intermediaries, such as brokers, creates potential for systemic risk. *See* Rogers, *supra* note 30, at 3 (discussing systemic risk of broker failures).

60. Over the past several years, however, the market for "non-traditional" loan participations sold by banks to non-bank investors, such as insurance companies, mutual funds,

risk."[61] For example, if a bank lends $2 million to a borrower and thereafter sells 25% participations in that loan to three other banks for $500,000 each, the lending bank will continue to hold the entire loan but has diversified its risk by reducing its credit exposure to this borrower to only $500,000.[62] The lending bank, which sells the participation, is therefore the intermediary; the bank or other party buying the participation (customarily referred to as a "participant") is the investor.

Concern arises where the bank selling the participation fails. If the participant owns its underlying interest in the loan, it will be repaid from payments that the borrower makes under the loan. If, however, the participant does not own that underlying interest, it merely has a contract claim against the bank from which it bought the participation, which will rank at best *pari passu* with claims of the bank's other creditors. The participant's claim therefore will be impaired if the bank is insolvent.[63] In this Article's terminology, the risk that the selling bank's failure will impair the participant's claim is the intermediary risk.

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and other institutional investors, "has increased to the point where it has become a multi-billion dollar business." HOWELL E. JACKSON & EDWARD L. SYMONS, JR., REGULATION OF FINANCIAL INSTITUTIONS 157 (1999).

61. Steven L. Schwarcz, *The Parts Are Greater Than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies*, 1993 COLUM. BUS. L. REV. 139, 151 n.41 (1993); *see also* Patrick J. Ledwidge, *Loan Participations Among Commercial Banks*, 51 TENN. L. REV. 519, 521-22 (1984) (observing that loan participations are used to disperse credit risk among banks). On the need for diversification of loan credit risk, see W. Crews Lott et al., *Structuring Multiple Lender Transactions*, 112 BANKING L.J. 734, 734 (1995) (observing that, during the past decade, the "number, size, and complexity of multiple lender transactions have grown explosively as lenders have shifted their focus [toward] more prudent risk diversification"). *See also* Memorandum from William F. Kroener, III, General Counsel et al., Federal Deposit Insurance Corporation ("FDIC"), to the FDIC's Board of Directors 5 (July 26, 2000) (observing that "loan participations remain an important method for insured banks and thrifts to diversify their credit risks") (on file with the *Duke Law Journal*).

62. The lending bank's original credit exposure after making the loan is $2 million. It reduces that exposure by $1.5 million by selling the three 25% participations in the loan: $2,000,000 loan x three 25% undivided interests (i.e., 75% aggregate undivided interest) sold = $1,500,000 aggregate purchase price of the participations. The lending bank thus has reduced its $2 million exposure by $1.5 million, to $500,000.

63. Joseph J. Norton, *International Syndicated Lending: The Legal Context for Economic Development in Latin America*, NAFTA: L. & BUS. REV. AM., Summer 1996, at 21, 67 ("Participating banks can incur substantial problems if the lead lender becomes insolvent."); Robert O. Wienke, *Loan Syndications and Participations: Trends and Tactics*, COM. LENDING REV., Spring 1994, at 4, 13-14 (same).

Resolution of this intermediary risk can have real and significant consequences. Participants want to know that if the selling bank fails, their right to be repaid from payments that the borrower makes under the loan will have priority over claims of the bank's creditors. Furthermore, the consequences are not only to these parties. If participants do not have priority, the failure of a selling bank would impair their repayment, in turn threatening them with failure and causing a chain reaction of failures to the extent the participants are then unable to pay their obligations to third parties (including, in the case of participant banks, their obligations to depositors).[64] Again, there is potential for systemic risk.

Status of loan participation intermediary risk. The issue of intermediary risk for loan participations is unresolved even in the United States, where loan participations are most common.[65] In *In re Yale Express System, Inc.*,[66] for example, a bank made a loan to Yale Express and then sold a 40% participation therein to Marine Midland Trust Company ("Marine").[67] In Yale Express' subsequent bankruptcy, the court held that the purchase of the participation made

64. There is much greater potential for systemic risk where the selling bank fails than where the borrower on the loan fails because banks, as a matter of law and practice, ordinarily diversify their lending risk to borrowers but do not always diversify their intermediary risk to banks selling participations. *See, e.g.*, 12 U.S.C. § 84 (1995) (stating that a bank's total loans to a person "shall not exceed 10 per centum of [the bank's] unimpaired capital"); Eunhangbop [Banking Act], Act No. 5499 of 1998, arts. 35, 36, *translated in* 11 KOREA LEGIS. RES. INST., STATUTES OF THE REBUBLIC OF KOREA 64-66 (1997)(discussing lending limits imposed on banks in Korea); 12 C.F.R. §§ 32.3, 32.5(f) (1991) (imposing lending limits on banks in the United States); PHILIP N. HABLUTZEL, [1997] 2 INT'L BANKING L. (CBC) app. 21 F, at 89-90 (discussing in Section 13 the large-scale lending limits imposed on banks in Germany); *id.* ch. 26, at 14-15 (§ 26:08 Regulation of Lending) (discussing lending limits imposed on banks in New Zealand); *id.* ch. 10, at 28 (§ 10:16 Lending Regulation) (discussing lending limits imposed on banks in Canada); *id.* app. 3, at 47 (No. 38 of the U.K. Banking Act of 1987) (discussing lending limits imposed on banks in the United Kingdom); *id.* ch. 24, at 12 (§ 24:04 Commercial Banks) (discussing lending limits imposed on banks in Japan). Thus, even though a participant's exposure to the credit risk of a particular borrower may be limited, the participant may have purchased multiple participations (each for a different borrower) from the selling bank. If the selling bank fails, the participant would be subject to intermediary risk with respect to the aggregate amount of participations so purchased. The law could require such additional diversification, but that would address the issue of intermediary risk only in the context of loan participations.

65. For a discussion of the use of loan participations in international finance, see Norton, *supra* note 63, at 28-31 (observing that "loan participations should continue to be important financing vehicles"); David Z. Nirenberg, Note, *International Loan Syndications: The Next Security*, 23 COLUM. J. TRANSNAT'L L. 155, 159 (1984) (stating that while syndicated loans are more common in international finance, "[p]articipation loans are more popular domestically").

66. 245 F. Supp. 790 (S.D.N.Y. 1965).

67. *Id*. at 791.

Marine a creditor of the selling bank, not an owner of an interest in the underlying loan.[68] As a result, Marine would be subject to the selling bank's intermediary risk.[69] Other cases, however, suggest an opposite result. In *FDIC v. Mademoiselle of California*,[70] for example, a bank sold an 80% participation in one of its loans.[71] After its subsequent insolvency and takeover by the Federal Deposit Insurance Corporation, the selling bank made a substantial recovery on the loan.[72] The participant then claimed ownership of 80% of that recovery.[73] The court reasoned that the participant would own, and therefore would be entitled to, that undivided interest but for the fact that the recovery was obtained by way of setoff, which does not constitute a payment made by the debtor.[74]

It nonetheless has been observed that

> [m]any loan participants believe that [the] problems [of intermediary risk] can be avoided by specifically providing in the loan participation agreement that [the] participation arose as a result of [the] "absolute sale" of the loan and that the lead holds the loan participants' interest in the loan as trustee.[75]

It is, however, "questionable whether this alternative will be fully recognized."[76] The continuing legal uncertainty is instead likely to en-

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68. *Id*. at 792.

69. Some commentators have observed that "[t]he absence of privity underscores the U.S. view that no legal assignment of contract rights or obligations occurs when a loan participation is purchased." Francis D. Logan et al., *The Securitization of U.S. Bank Activities in the Eurodollar Market—Issues for U.S. Counsel*, 11 N.C. J. INT'L L. & COM. REG. 539, 545 n.19 (1986).

70. 379 F.2d 660 (9th Cir. 1967).

71. *Id.* at 661.

72. *Id.* at 662.

73. *Id*. at 664.

74. *Id.* at 665. *Accord In re* Drexel Burnham Lambert Group Inc., 113 B.R. 830, 842 n.15 (Bankr. S.D.N.Y. 1990) ("In *Mademoiselle*, the Ninth Circuit acknowledged with approbation the general rule that a loan participation passes legal title in the proceeds of the fund to the participants.").

75. Wienke, *supra* note 63, at 13.

76. *Id.* at 13-14 (citing case law in which the "court refused to hold that the participation agreement constituted a trust relationship between the parties, even though the agreement contained language that the lead 'shall be a trustee for the benefit of and accountable' to the participant"). Therefore, Wienke concludes, "these problems [of intermediary risk] are likely to persist." *Id.* at 14; *see also* Robert S. Rendell, *Current Issues in Participation and Other Co-Lending Arrangements: An American Viewpoint*, *in* INTERNATIONAL BANKING OPERATIONS AND PRACTICES: CURRENT DEVELOPMENTS 189, 207-08 (J.J. Norton et al. eds., 1994) (concluding that "[d]espite a number of recent cases in this area, the law remains unsettled" with respect to the legal consequences of the lead bank's failure); *cf. infra* notes 88-97 and

courage litigation by receivers for insolvent selling banks, which "will often argue that participating banks are merely general unsecured creditors of the lead lender, rather than owners of interests in the loans themselves, thus allowing them to subordinate the interests of participating banks."[77]

C. *Securitization of Receivables*

In securitization transactions, an intermediary also may hold assets in which it and investors share beneficial interests. Securitization is "by far the most rapidly growing segment of the U.S. credit markets,"[78] and its "use is rapidly expanding worldwide."[79] In a typical transaction, a company, usually called the "originator," transfers rights to payment from income-producing assets such as accounts receivable, loans, or lease rentals (collectively, "receivables")—or frequently undivided interests in such rights[80]—to a special purpose vehicle, or "SPV." The SPV, in turn, issues securities to capital market

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accompanying text (discussing the analogous problem of determining whether a transfer of an undivided interest in receivables is a true sale).

77. Norton, *supra* note 63, at 67. Although Professor Norton refers to arguments advanced by U.S. receivers, foreign receivers of selling banks are likely to make the same arguments if intermediary risk is unresolved in their jurisdictions. *Cf.* Wienke, *supra* note 63, at 13 (observing that "receivers of the insolvent lead have often argued that participants are merely general creditors of the lead rather than owners of an interest in the loans themselves, thus allowing the receivers to subordinate the interests of the participants").

78. Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 24 (1996).

79. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 133 (1994); *see also* Memorandum from William F. Kroener, III, et al., *supra* note 61, at 3 (noting that "asset-backed securitization has developed into one of the most significant funding sources for American and international corporations").

80. 1 SECURITIZATION OF FINANCIAL ASSETS § 3.09, at 3-52, 3-53 (Jason H.P. Kravitt ed., 2d ed. Supp. 2000) (articulating the advantages of the undivided interest structure). The rationale for selling undivided interests is that it maximizes the statistical diversification of the receivables sold to the SPV and also permits the SPV to invest in newly arising receivables by simple readjustment of the SPV's fractional interest. Undivided interests are widely used, for example, in collateralized loan obligation and bank credit card securitizations. Interview with Henry Morriello, Partner, Structured Finance and Asset-Based Transactions Group, Kaye, Scholer, Fierman, Hays & Handler, in New York, N.Y. (May 8, 2000); *see also* 1 SECURITIZATION OF FINANCIAL ASSETS, *supra*, § 3.03[A], at 3-13 (noting that the advantage of the undivided-interest structure when securitizing pools of medium term receivables "is that one may avoid the transaction costs associated with numerous separate purchases"); *id.* at 3-14 (observing that "mortgage-backed securitizations are generally handled using the [undivided interest] structure"); *id.* at 3-14, 3-16 (observing that securitization of credit card receivables also generally uses the undivided interest structure); *id.* at 3-17 (observing that "[t]he most practicable structure [for securitization of trade receivables] has been the purchase of an undivided, fractional interest in a pool of receivables").

investors[81] and uses the proceeds of the issuance to pay for the receivables. The investors, who are repaid from collections of the receivables, buy the securities based on their assessments of the value of the receivables.[82]

Perhaps the most critical analysis in a securitization is whether the SPV and its investors will continue to be repaid in the event of the originator's bankruptcy.[83] If the SPV owns the receivables, the SPV and its investors will continue to be repaid; if not, their right to be repaid will be suspended and subject to possible impairment.[84] The SPV will gain ownership of the receivables only if the transfer of those receivables from the originator to the SPV constitutes a sale under applicable bankruptcy law.[85] Irrespective of the criteria governing this sale analysis, however,[86] there is concern that an SPV that purports to purchase only an undivided interest in, as opposed to whole, receivables may be unable to gain an ownership interest in the underlying receivables.[87]

The originator is therefore the intermediary, and the risk that the originator's failure will prevent the SPV and its investors from being repaid from the receivables is the intermediary risk. Resolution of this risk is important because capital market investors want to know that their right to receive repayment from the receivables will not be affected in the event of the originator's bankruptcy.

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81. The term "capital markets" refers to any market where debt, equity, or other securities are or may be traded. Actual capital markets can be formal or informal. *See* JOHN DOWNES & JORDAN GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 59 (5th ed. 1998) (defining capital markets).

82. *See* Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 STAN. L. REV. 1, 6 (1999); *see also id.* at 6 n.21 (citing basic sources on securitization).

83. Schwarcz, *supra* note 79, at 151.

84. STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION 29-30 (2d. ed. 1993). Thus, in cases where the SPV owns the receivables, the investment decisions often can be made without concern for the originator's financial condition. *See* Schwarcz, *supra* note 82, at 6.

85. Schwarcz, *supra* note 79, at 135.

86. For a discussion of those criteria, see SCHWARCZ, *supra* note 84, at 28-35.

87. Interview with Eric P. Marcus, Partner and Chair, Structured Finance and Asset-Based Transactions Group, Kaye, Scholer, Fierman, Hays & Handler, in New York, N.Y. (May 8, 2000) (noting that even rating agencies have this concern); *see also* 1 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 80, § 3.09, at 3-52 (observing that "[i]t is also possible to argue that a court will more likely find a sale of a discrete group of receivables than a sale of an undivided interest in a pool to be a true sale, though there is no obvious analytical reason that this must be so").

Status of securitization intermediary risk. The law is unsettled as to whether the transfer of an undivided interest in receivables can constitute a sale of such interest.[88] The confusion stems partly from uncertainty about the ability to transfer such a partial interest, partly from uncertainty about what criteria define a sale of intangibles.[89] This Article focuses on the former.[90]

At least one case holds that the transfer of an undivided interest in receivables can constitute a sale, thereby avoiding intermediary risk. In *Angeles Real Estate Co. v. Kerxton*,[91] a company assigned one-half of the proceeds of a promissory note as payment for a prior debt.[92] In the company's subsequent bankruptcy case, the assignee sued for its half share of those proceeds.[93] The court held for the assignee, reasoning that the partial assignment was sufficient to transfer legal title.[94] In contrast, however, the bankruptcy court in *Fireside Credit, Inc. v. Dubuque Bank & Trust Co.*[95] invalidated the transfer for security of an undivided interest in a pool of promissory notes.[96]

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88. *See, e.g.*, Schwarcz, *supra* note 61, at 150 (referring to the "unfounded perception that the transfer of only a partial interest in a future payment stream . . . cannot be a true sale"). A recent congressional bill, however, proposes a safe harbor in which transfers of receivables, *including interests therein*, in securitization transactions will be deemed to constitute true sales provided certain conditions are met. *See* Bankruptcy Reform Act of 2001, S. 220, 107th Cong. § 912 (2001).

89. *See, e.g.*, Peter V. Pantaleo et al., *Rethinking The Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 159-63 (1996) (analyzing the uncertainty surrounding the criteria for a sale).

90. Accordingly, I ask whether a transfer that otherwise would constitute a sale of intangibles should fail because only a partial interest is being transferred. For an analysis of whether a transfer of intangibles generally should constitute a sale, see SCHWARCZ, *supra* note 84, at 31-35.

91. 737 F.2d 416 (4th Cir. 1984).

92. *Id.* at 418.

93. *Id.*

94. *Id.* at 419 (following the RESTATEMENT (SECOND) OF CONTRACTS § 326(1) (1981), which provides that an "assignment of a part of a right, whether the part is specified as a fraction, as an amount, or otherwise, is operative as to that part to the same extent and in the same manner as if the part had been a separate right").

95. Fireside Credit, Inc. v. Dubuque Bank & Trust Co. (*In re* Fireside Credit, Inc.), Bankr. No. 86-02357D, Adv. No. 87-0173D (Bankr. N.D. Iowa Sept. 4, 1987).

96. *Id.* at 10. Fireside Credit made loans secured by notes receivable equal to 200 percent of the outstanding balance of the loans. *Id.* at 2. Thus, if the amount of its loans at any given time is $\$X$ and the outstanding balance of the notes at that time is $\$Y$, Fireside Credit then would be secured by a $2X/Y$ fractional undivided security interest in the notes. *See id.* at 6 (computing that fractional undivided interest as "less than 15 percent"). This case is not directly on point because it involves the transfer for security, not ownership, of an undivided interest; in the author's experience, however, the case has been viewed by leading bankruptcy attorneys as evidencing the difficulty of generally transferring an undivided interest.

Confusion therefore remains in domestic as well as international securitization transactions.[97] As a result, parties are incurring significant, and arguably unnecessary, transaction costs.[98]

D. The Need for a Unified Approach to Intermediary Risk

The foregoing examination of transaction patterns shows that the issue of intermediary risk is treated piecemeal, if at all. Although certain states may resolve it by statute in the context of a particular transaction pattern,[99] there is no attempt, even in those states, to examine intermediary risk in a larger context.

Yet, a unified approach to this problem not only is necessary to avoid cost, inefficiency, and confusion, but also is appropriate because the commonality of intermediary risk to each of these patterns reflects a relationship among them. If each such pattern were viewed from outside of a black box, an observer would only see investors putting in money at one end and companies[100] (to which the investors look for repayment) repaying the money at the other end:

97. For a discussion of these and other unresolved issues in international securitization, see generally Symposium, *International Issues in Cross-Border Securitization and Structured Finance*, 8 DUKE J. COMP. & INT'L L. 229 (1998).

98. *See supra* note 87 (noting that rating agency concerns drive the structuring of securitization transactions). These same rating agency concerns discourage use of the divisible interest structure for securitizations, which not only represents "a less cumbersome transactional structure than that which is currently used" but also "promise[s] to expand the capital markets to now-excluded middle-market companies" by reducing transaction costs. Schwarcz, *supra* note 61, at 167.

99. For example, states may enact Article 8 of the UCC in the United States.

100. More technically, an observer would not see companies, but instead would see investors' claims against or future payment streams owing from these companies.

TABLE 1

	ISSUER		INTERMEDIARY		INVESTORS
INDIRECT HOLDING SYSTEM:		*sale of securities→*		*sale of undivided interest in the securities→*	
	Securities Issuer		**Securities Intermediary(ies)**		**Investors**
		←payment $		*←payment $*	
SALE OF LOAN PARTICIPATIONS:		*Promissory note→*		*sale of undivided interest in the loan→*	
	Borrower		**Lending Bank**		**Participants**
		←loan		*←payment $*	
SECURITIZATION TRANSACTIONS:		*Receivables, due to→*		*sale of undivided interest in the receivables→*	
	Receivable Obligors		**Originator**		**Special Purpose Vehicle and its Investors**
		←goods, services or other value		*←payment $*	

Each transaction pattern is therefore effectively a form of financing in which the money flows through an intermediary. More generally, any form of financing in which money flows through an intermediary is inherently subject to intermediary risk—that the intermediary will fail and its creditors will attempt to seize the cash flow. To the extent, therefore, that market innovation spurs new forms of financing through intermediaries, a unified conceptual approach to regulating intermediary risk also should apply to future transaction patterns.[101]

I next attempt to derive such a unified approach.

III. DERIVING A UNIFIED CONCEPTUAL APPROACH TO INTERMEDIARY RISK

I begin the analysis of intermediary risk by examining the simple case in which an intermediary holds assets in which it has no beneficial rights. I then build on that examination by analyzing the more difficult case, associated with the transaction patterns and generic financing pattern discussed above, in which an intermediary holds assets in which it shares beneficial rights. These examinations reveal,

101. Future transaction patterns may even replace existing patterns. The Internet, for example, ultimately may allow investors to opt out of using securities intermediaries. *See, e.g.*, Charles W. Mooney, Jr., *Property, Credit, and Regulation Meet Information Technology: Clearance and Settlement in the Securities Markets*, 55 LAW & CONTEMP. PROBS. 131, 155 (Summer 1992) (arguing that technology would permit investors to connect directly to issuers, thereby avoiding intermediary risk).

however, that there is no reliable precedent for the treatment of intermediary risk. I therefore next look to first principles, comparing the consequences to an intermediary's creditors and investors that would result from the externalities of intermediary risk with the consequences to those parties that would occur in the absence of that risk. This analysis suggests that investors should be protected from intermediary risk. Finally, I analyze how international law can provide that protection.

A. *Intermediary Risk Where the Intermediary Has No Beneficial Rights*

In this case, the intermediary would hold assets in which it either has rights *other than* beneficial rights, or has no rights at all. I analyze these scenarios in turn.

The scenario where the intermediary holds assets in which it has rights other than beneficial rights. The common law tradition has evolved the concept of a trust to cover this scenario. A trust is "a fiduciary relationship with respect to property, arising as a result of a manifestation of an intention to create that relationship and subjecting the person who holds title to the property [the trustee] to duties to deal with it for the benefit of" third parties.[102] The theory is that the trustee holds "legal" title to the asset, whereas the third parties hold "equitable" title.[103] The significance of this distinction is that equitable title gives beneficial rights in an asset whereas legal title does not—the same distinction that I am attempting to analyze in this scenario.[104]

102. RESTATEMENT (THIRD) OF TRUSTS § 2 (Tentative Draft No. 1, 1996) [hereinafter RESTATEMENT (THIRD) OF TRUSTS]. Some caution should be advanced, however, because the Restatement of Trusts does not necessarily deal with commercial trusts. *See id.* § 1 cmt. b, § 5 cmt. l. Comment b explains that although many rules of trust law also apply to commercial trusts, many do not; instead, "other rules are drawn from other bodies of law that are specially applicable to those activities even when conducted in trust form." *Id.* § 1 cmt. b.

103. *Id.*, Reporter's Notes on § 2 (observing that "there is probably general agreement in the United States today that a trust involves a division of legal and equitable ownership"). Historically, this distinction between legal interests (held by trustees) and equitable interests (held by beneficiaries) is traceable to the separation of judicial functions in English courts of common law and chancery. *Id.*, Introductory Note.

104. *See, e.g.*, Mont. Catholic Missions v. Missoula County, 200 U.S. 118, 127-28 (1906) ("The expression, beneficial use or beneficial ownership or interest, in property is quite frequent in the law and means in this connection such a right to its enjoyment as exists where legal title is in one person and the right to such beneficial use or interest is in another."); XL/Datacomp, Inc. v. Wilson (*In re* Omegas Group, Inc.), 16 F.3d 1443, 1449 (6th Cir. 1994) ("A debtor that served prior to bankruptcy as trustee of an express trust generally has no right

Whether or not this distinction is necessary for the creation of trust law,[105] I will use trust law, which reflects this distinction, as paradigmatic of the scenario where an intermediary holds assets in which it has rights other than beneficial rights.

It is reasonably well established in common law states that the beneficiary of a trust is not subject to intermediary risk. If the intermediary, i.e., the trustee, goes bankrupt, the beneficiary's claim against trust assets should not be subject to claims of the trustee's creditors because the beneficiary is deemed to have property rights in those assets:

> Our contention is that [the question whether a beneficiary has property rights, instead of a mere chose in action,] should be answered in the affirmative. The beneficiary of a trust has a property interest in the subject matter of the trust. He has a form of ownership. He has much more than a mere claim against the trustee, a mere chose in action.[106]

This does not mean, however, that the issue was always seen as free of doubt. "Scholars have long debated whether the beneficiary of a trust has a property interest in the trust or merely a personal right against the trustee."[107] This debate has its origin in the historical evo-

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to the assets kept in trust, and the trustee in bankruptcy must fork them over to the beneficiary.").

105. The Restatement of Trusts itself acknowledges that this distinction "has not been one of universal acceptance." RESTATEMENT (THIRD) OF TRUSTS, *supra* note 102, Reporter's Notes on § 2. It states, for example, that "although the provisions of the Japanese Trust Law as a whole closely parallel trust law principles set out in the Restatement, Second, of Trusts, trust concepts in that country are based on and discussed in terms of obligation rather than legal and equitable property rights." *Id.*; *see also* Shintaku Ho [Trust Law], Law No. 62 of 1922, art. 1, *translated in* EIBUN-HOREI-SHA, 6 EHS LAW BULLETIN SERIES JAPAN, at CD1 (1994) ("The trust within the meaning of this Law shall signify to transfer or otherwise dispose of a property right and cause another person to administer or dispose of the property in accordance with a specific purpose.").

106. 2 WILLIAM F. FRATCHER, SCOTT ON TRUSTS § 130 (14th ed. 1987); *see also* Austin W. Scott, Jr., *The Importance of the Trust*, 39 U. COLO. L. REV. 177, 178 (1967) ("[I]t is generally agreed in England as well as in the United States that the beneficiaries of a trust have a proprietary interest in the subject matter of the trust and not merely a personal claim against the trustee.").

107. Chem. Bank N.Y. Trust Co. v. S.S. Westhampton, 358 F.2d 574, 584 (4th Cir. 1965) ("The courts have had less trouble with this question. The Supreme Court has held that beneficiaries of a trust have an interest in the property to which the trustee holds legal title."); *see also* GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 1 (2d ed. 1984) (observing that "[w]hether the right which the beneficiary has is a property right in the subject-matter of the trust (a right in rem), or merely a personal right against the trustee (a right in personam), is a question much debated"); 5 PATRICK J. ROHAN, POWELL ON REAL

lution of trust law because "the chancellors at the beginning gave [the beneficiary of a trust] no more than a claim against the trustee, and only gradually gave him proprietary rights."[108] Thus, even though trust law has evolved to the point where there is little doubt about the nature of a beneficiary's interest,[109] there has been historical doubt.

It likewise appears to be the case in civil law states, notwithstanding opinions to the contrary,[110] that trust concepts exist and that the beneficiary of a trust may not be subject to intermediary risk.[111] At least one noted civil law scholar even claims that "the trust belongs to the civil law, whence it was imported in England during the formative period of the Chancellor's jurisdiction over trusts."[112] In his view, the widespread belief that trusts are inconsistent with civil law reflects the failure of common and civil law scholars to seriously address the basis of trust law:

> The mere fact that trusts exist in civil law countries should prove the point that there is no basic incompatibility with civil law structures. Why, then, is the opposite view held so unanimously? The simple answer is that common law scholars have not attempted a comparative study of the civil law institutions, while civil law scholars have not attempted a comparative study of trusts.[113]

PROPERTY ¶514[1] (1999) (arguing that a beneficiary of a trust only has a limited cause of action coupled with certain protective rights against third party interference).

108. FRATCHER, *supra* note 106, § 130; *see also id.* (noting that "[t]he growth of the trust has been a process of evolution," and even courts were slow in recognizing the proprietary interest of the beneficiary as against third parties).

109. *See* RESTATEMENT (THIRD) OF TRUSTS, Reporter's Notes on § 49 (Tentative Draft No. 2, 1999) (stating that beneficiaries have a property interest in trust assets and not merely a claim against the trustee, and noting that the United States Supreme Court and the House of Lords in England have accepted the "principle that a beneficiary of a trust has a proprietary interest in the subject matter of the trust"); *see also* E-mail from Joanna Benjamin, Senior Lecturer, Centre for Commercial Law Studies, University of London, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Oct. 15, 2000) (arguing that although some conceptual confusion may remain, there is little doubt under English law that trust interests are proprietary *for the purposes of the insolvency of the trustee*) (on file with *Duke Law Journal*).

110. *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS, *supra* note 102, Introductory Note (observing that the trust is "peculiarly a product of the Anglo-American system").

111. *See* Maurizio Lupoi, *The Civil Law Trust*, 32 VAND. J. TRANSNAT'L L. 967, 968 (1999) (aruging that trusts are not incompatible with civil law systems). *But cf.* Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. REV. 434, 456 (1998) (arguing that absent legislative changes to continental European law, the beneficiary may be subject to intermediary risk).

112. Lupoi, *supra* note 111, at 969.

113. *Id.* at 976. Professor Lupoi indeed goes on to argue that

According to this scholar, it is a "fundamental [civil law] rule that the creditors of the trustee . . . cannot attack the assets bequeathed to him [in trust]."[114] Indeed, "[a]ll civil law systems have long known instances in which assets owned by someone [e.g., a trustee] are not available to his creditors because they are to be handed over to someone else."[115]

Civil law states also have been moving legislatively to resolve any lingering doubt. For example, every European state has enacted legislation shielding trust property from claims against mutual fund intermediaries and investment firm intermediaries that operate as portfolio managers.[116] Japan and Korea also have adopted trust laws that eliminate intermediary risk.[117]

Hence, even under the civil law, the beneficiary of a trust should not be subject to intermediary risk. Therefore, under both common and civil law systems, if an intermediary holds assets in which it has only nonbeneficial rights, those assets should be immune from claims of the intermediary's creditors, thereby eliminating intermediary risk.

The foregoing analysis indicates that this conclusion has not always been free of doubt, however. In common law states, there has been historical uncertainty about the evolution of trust law; in civil law states, there has been ambiguity about the very permissibility of trust concepts. These doubts at least raise the question in the more difficult case, where the intermediary and investors share beneficial rights,[118] whether the investors' interests constitute property or merely an in personam claim against the intermediary.

> [civil law scholars] led astray by the unguarded language of common law scholars—who should think twice before uttering the magic words "equitable ownership" in front of civil law practitioners—claim that trusts subvert the framework of real rights, or that the unity of patrimony becomes fragmented. Not one ounce of truth is found in those pronouncements.

Id. at 977 (footnote omitted).

114. *Id.* at 975.

115. *Id.* at 978; *see also id.* at 979 (illustrating that assets held by an undisclosed agent for his principal cannot be seized by the agent's creditors even though "the agent purchased them in his own name, and for all intents and purposes he is their sole owner").

116. Hansmann & Mattei, *supra* note 111, at 458-59; *see also* D.J. HAYTON ET AL., PRINCIPLES OF EUROPEAN TRUST LAW 11-20 (1999) (examining ways of incorporating the common law trust into European law).

117. For Japan, see Shintaku Ho [Trust Law], Law No. 62 of 1922, art. 16, no. 1, *translated in* EIBUN-HOREI-SHA, 6 EHS LAW BULLETIN SERIES JAPAN, at CD1 (1994). For Korea, see Sintakbop [Trust Act], Act No. 900 of 1961, art. 22, *translated in* 3 KOREA LEGIS. RES. INST., STATUTES OF THE REPUBLIC OF KOREA 365 (1997).

118. *See infra* Part III.B (analyzing that situation).

An economic analysis of trust law raises similar doubts. Scholars have raised two rationales for limiting intermediary risk in the traditional trust context; neither applies, though, to the sharing by intermediaries and investors of beneficial rights. The first rationale is that trustees signal their lack of ownership of the trust property:

> [S]imple accounting measures [such as using the words "in trust" when registering or otherwise dealing with property] can easily signal to the [trustee's] potential creditors which of the properties in the [trustee's] possession is held in trust and therefore is unavailable to satisfy the creditors in case of the [trustee's] insolvency.[119]

These creditors, in turn, can adjust their credit terms accordingly.[120] Where the intermediary and investors share beneficial rights, however, the signaling mechanism breaks down.[121]

The second rationale for limiting intermediary risk in the traditional trust context is that "the law apparently presumes that the [trustee's] creditors are in a better position than the [beneficiary] to look out for themselves."[122] Accordingly, even when the trustee negligently or intentionally fails to signal,[123] thereby misleading its creditors, "the law of trusts nonetheless favors" the beneficiary.[124] Although this rationale is persuasive for gratuitous trusts where the beneficiary is passive,[125] it is less persuasive in the transactional contexts described in this Article where the transaction is a bargained-for exchange and the investors are relatively sophisticated.[126]

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119. Hansmann & Mattei, *supra* note 111, at 455.

120. *Id.*

121. Indeed, the signaling rationale implicitly assumes that the trustee segregates and does not commingle trust property with its own property. *See also* Lupoi, *supra* note 111, at 970 (defining a trust in comparative law terms to require "the lack of commingling between [the property transferred to the trustee or declared to be so transferred] and other elements of the trustee's estate (segregation)"). It is, however, impossible to segregate assets and prevent commingling when the intermediary shares undivided interests in the same assets.

122. Hansmann & Mattei, *supra* note 111, at 455 (observing that in "Calabresian terminology, [the creditors] are the cheapest cost avoiders").

123. For example, by failing to use the words "in trust" in dealings with trust property.

124. Hansmann & Mattei, *supra* note 111, at 455.

125. *See id.* (considering "the classic situation" in which the beneficiary is incompetent or a child).

126. *But cf. infra* note 129 and accompanying text discussing how, under agency law, an intermediary's creditors cannot attach assets that the intermediary is merely holding as an agent for an undisclosed principal. The rationale for this rule cannot be signaling, and the rationale that the agent's creditors are in a better position than the principal to look out for themselves is likewise problematic.

The scenario where the intermediary holds assets in which it has no rights. It is well established that there is no intermediary risk when an intermediary holds assets in which it has no rights. Thus, it is "the general rule that a bailor may reclaim property it entrusts to a bailee who subsequently files for bankruptcy"[127] and that a trustee in bankruptcy cannot bring property merely held by the debtor into the debtor's bankruptcy estate.[128] Likewise, an intermediary's creditors cannot attach assets that the intermediary is merely holding as an agent for an undisclosed principal, even though the intermediary appears to own such assets.[129]

This result is not surprising. A creditor only should be able to seize assets to the extent of its debtor's rights therein.[130] The absence of intermediary risk is also consistent with the prior scenario: if an intermediary has no rights in assets that it holds, its creditors should have even less of a basis to seize those assets than if the intermediary had rights therein. Examination of this second scenario therefore does not appear to yield additional insight.[131]

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127. Eastman Kodak Co. v. Harrison, 639 F.2d 1213, 1215 (5th Cir. 1981).

128. *See, e.g.*, *In re* Clemens, 472 F.2d 939, 942 (6th Cir. 1972) (holding that a bankrupt son's estate had no claim to one-half of his mother's property where the court determined that he merely held the property interest in trust); Sonnenschien v. Reliance Ins. Co., 353 F.2d 935, 935 (2d Cir. 1965) (holding that where trust funds "cannot be sufficiently identified or traced in a bankruptcy proceeding," the trust beneficiary must proceed as a general creditor); City of Dallas v. Crippen, 171 F.2d 526, 529 (5th Cir. 1948) (holding that creditors of bankrupt have no claim to traceable trust property); Glynn Wholesale Bldg. Materials, Inc. v. Skelton, No. 276-96, 1978 WL 1229, at *2 (S.D. Ga. Apr. 12, 1978) (concluding that "[t]he beneficiary of a valid pre-existing trust may enforce his interest in the trust property in the possession of a trustee in bankruptcy").

129. RESTATEMENT (SECOND) OF AGENCY § 420 (1958); Lupoi, *supra* note 111, at 978-79. A related issue is whether the commingling by third parties of their assets affects, in and of itself, such parties' property rights. It has been observed, for example, that "[a]ccording to traditional principles which applied under both *common law* and *civil law* legal systems, and whose origins are rooted in Roman law," the commingling of fungible property terminates direct property rights of persons owning such property. BERNASCONI, *supra* note 44, at 19 (emphasis in original). Even if this principle continues in some jurisdictions, however, its "consequences will depend on the precise terms on which [the] deposits are made." *Id.* Thus, depositors can retain "some form of common or co-proprietary interest with other depositors in the commingled bulk." *Id*. This retention would eliminate intermediary risk to the extent such proprietary interest protects the deposits from claims of creditors of a failed intermediary. Nor does the aforesaid commingling principle yield any normative insight into the question of intermediary risk.

130. *Cf. infra* note 135 and accompanying text (discussing this proposition as a corollary of the principle of *nemo dat quod non habet*).

131. It should be noted that the difference between these scenarios—in which the intermediary has no rights or only nonbeneficial rights—is sometimes blurred. This can be illustrated by Professor Lupoi's analysis of the confusion the Hague Convention of 1984 caused.

B. Intermediary Risk Where the Intermediary Shares Beneficial Rights

The foregoing analysis has not yielded any significant insight into this more difficult case associated with the transaction patterns and generic financing pattern discussed in Part II of this Article. Indeed, there is no reliable precedent for the treatment of intermediary risk where the intermediary and investors share beneficial rights. The obvious precedent, Article 8 of the UCC, may have been influenced by interest group politics,[132] and the justifications given for its treatment of intermediary risk appear more practical than principled.[133] Although certain other legal fields such as joint tenancies in real estate and community property law arguably might provide precedents (a joint homeowner occupying a house, or a spouse in possession of and using community property, being analogized to an intermediary), these fields of law evolved in settings involving natural persons, often

See Convention on the Law Applicable to Trusts and on Their Recognition, July 1, 1985, *reprinted in* 2 INTERNATIONAL TRUST LAWS app. 51 (John Glasson ed., 1999). Professor Lupoi asserts that "[t]he Hague Convention of 1984 did its best, with considerable success, to further confuse the issues." Lupoi, *supra* note 111, at 979. That Convention defines a trust as "the legal relationships created . . . by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose." *Convention on the Law Applicable to Trusts and on Their Recognition*, *supra*, art. 2. The phrase "under the control" is ambiguous, however, because it "does not necessarily imply a transfer of title." Lupoi, *supra* note 111, at 979. A trust therefore could "exist even if the settlor is still regarded as the owner of what a common [law] lawyer would call 'trust assets.'" *Id.* at 979-80. This confusion may be compounded by the different translations of the Hague Convention; for example, the French text of Article 2 of the Hague Convention, providing that creditors of the trustee may not seize the trust assets, excludes the assets in trust from the trustee's estate by referring to a separate trust estate, whereas the English text, according to Lupoi, includes those assets but clarifies that they do not belong to the "trustee's own estate." *Id.* at 980. Thus, Lupoi observes, "a new trust concept was born at The Hague—the 'Convention trust' or 'shapeless trust.'" *Id.* at 980 (citing *The Shapeless Trust*, 1 TRUSTS & TRUSTEES 15 (1995)). For example, an arrangement in which a manager manages funds for others would be a Convention trust, and the manager's creditors could not seize the managed funds. *Id*. However, "no common law jurisdiction would regard such an arrangement as a trust." *Id.* For purposes of this Article, however, this blurring of the scenarios should be irrelevant for the same reason stated above in the text: the scenario in which the intermediary holds assets in which it has no rights offers no additional insight beyond that gained from the scenario in which the intermediary has only nonbeneficial rights.

132. *See generally* Kathleen Patchel, *Interest Group Politics, Federalism, and the Uniform State Laws Process: Some Lessons from the Uniform Commercial Code*, 78 MINN. L. REV. 83 (1993) (exploring impact of interest groups on uniform laws process).

133. That appearance may well reflect reality because the goal of Article 8 was to catch up to already established industry practices. *See* Rogers, *supra* note 30, at 287 (arguing that "[Revised Article 8] does not so much change the law as recognize the changes that have already occurred").

family members; thus, they are not necessarily good precedents for analyzing intermediary risk in commercial settings. My analysis therefore starts from first principles.

It is a fundamental axiom that a creditor *qua* creditor cannot validly claim more rights than its debtor has in property.[134] This is a corollary of the universally recognized principle of *nemo dat quod non habet*, or one who has not cannot give.[135] If, therefore, a debtor owns only a partial interest in a given item of property, its creditors in their capacity as such should be able to reach only that partial interest.[136] If this axiom holds true, it is plain that a creditor of an intermediary should be able to reach only the intermediary's undivided interest.

This axiom clearly should hold true in the context of undivided interests. Commercial law generally respects *nemo dat* (and by extension the axiom)[137] with only limited exceptions: that bona fide purchasers of goods and holders in due course of negotiable instruments are not necessarily subject to defenses and encumbrances to which the transferor is subject.[138] The rationale for these exceptions—that

134. *See, e.g.*, *In re* Kinsler, 24 B.R. 962, 967 (Bankr. N.D. Ga. 1982) ("The Debtor's creditors could not get more than that to which the Debtor is entitled."); IAN F. FLETCHER, INSOLVENCY IN PRIVATE INTERNATIONAL LAW 61-62 (1999):

> [I]t is one of the fundamental principles of English bankruptcy law that the trustee in bankruptcy takes the bankrupt's property "subject to equities," in the sense that any imperfections in that title, and any valid and subsisting claims arising from the property or any security rights previously effected in relation to it, are transmitted intact so as to be exercisable against the trustee as the new owner.

The rationale is that "the trustee is essentially a *successor* to such title as the bankrupt actually had at the time of his adjudication, including any limitations or imperfections in that title, and can enjoy no better position in relation to the property than did the bankrupt himself formerly." IAN F. FLETCHER, THE LAW OF INSOLVENCY 205 (2d ed. 1996) (emphasis in original).

135. The phrase dates back at least to Justinian's Digest, which credits the Roman jurist Ulpian with the phrase "nemo plus iuris ad alium transferre potest quam ipse habet" (no one can transfer more legal rights than he himself has). Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property and Perfection*, 84 CORNELL L. REV. 305, 333 (1999) (citing 11 THE CIVIL LAW 302 (S.P. Scott trans., 1932)); *see also* G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 229 n.1 (1965) (providing a more detailed history of the *nemo dat* principle); Spiro V. Bazinas, *An International Legal Regime for Receivables Financing: UNCITRAL's Contribution*, 8 DUKE J. COMP. & INT'L L. 315, 319 (1998) (noting recognition of this principle in civil law states).

136. That is, the creditors only should be able to satisfy their claims from that partial interest.

137. *See, e.g.*, JOHN F. DOLAN & LAWRENCE PONOROFF, BASIC CONCEPTS IN COMMERCIAL LAW 6 (1998) (arguing that the concept that transferees can enjoy greater rights than their transferors enjoyed "is an idea that offends clear thinkers").

138. *See* U.C.C. §§ 2-403, 3-305, 9-307 (1977).

the importance of free-market transferability should override *nemo dat* in these situations[139]—has been questioned, however:

> Over the past thirty years there has been debate about the importance of the holder in due course doctrine in facilitating these transactions. . . . It now appears that the [arguments that holder in due course is unimportant for facilitating the flow of credit and goods] were correct.[140]

Nor would the rationale of these commercial law exceptions—encouraging transferability—apply to the transaction patterns of this Article. Quite the contrary, any exceptions to the axiom would increase intermediary risk, thereby *discouraging* the transferability of undivided interests.[141]

Furthermore, there are no other compelling arguments for overriding the axiom in the context of these transaction patterns. The strongest such argument is that, if the axiom is respected, creditors of an intermediary may be misled into thinking that the intermediary owns all rights in the asset that it holds.[142] I later show, however, that this argument should not justify giving those creditors more rights than the intermediary.[143]

Even bankruptcy law—including the United States Bankruptcy Code,[144] which is strongly biased in favor of maximizing "debtor assets

139. *See, e.g*, Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1057 (1954) (arguing that the good faith purchaser "is protected not because of his praiseworthy character, but to the end that commercial transactions may be engaged in without elaborate investigation of property rights and in reliance on the possession of property by one who offers it for sale or to secure a loan").

140. WHITE & SUMMERS, *supra* note 18, at 508 (citations omitted) (extrapolating from the abolition of the holder in due course doctrine in consumer credit transactions, which "caused barely a ripple on the consumer credit pond").

141. In the context of the indirect holding system, however, an exception to the axiom would facilitate the transfer of security interests in the United States. I later show this exception may be unjustified absent a regulatory scheme, such as exists in the United States, protecting investors from its consequences. *See infra* notes 238-50 and accompanying text.

142. *See infra* note 167 and accompanying text (raising this argument in the context of identifying contract externalities). Perhaps this concern over misleading creditors also helps to explain the law's historical uneasiness about commingling. *See supra* note 129 (discussing traditional legal principles under which the commingling of fungible property terminates "direct" property rights of persons owning such property).

143. *See infra* notes 170-205 and accompanying text (analyzing whether to enforce contracts that purport to transfer undivided interests).

144. 11 U.S.C. §§ 101 et seq. (1994) (hereinafter the "Bankruptcy Code"). The following discussion of the Bankruptcy Code is intended to be illustrative only. Because this Article addresses international transaction patterns, the application of any particular nation's bankruptcy or insolvency laws is necessarily incomplete, no matter which laws are chosen.

for the benefit of unsecured creditors"[145] and therefore, as shown below, ostensibly inconsistent with the axiom—would appear to respect the axiom. Section 541 of the Bankruptcy Code provides that the bankruptcy estate available for the payment of unsecured creditors includes "all legal or equitable interests of the debtor in property."[146] Courts have interpreted this language still more broadly to include property in which the debtor merely has an interest.[147] This raises the possibility that a debtor-intermediary's undivided interest in an item of property, because it represents a fractional interest in the entire item, might permit a trustee in bankruptcy to incorporate the entire item and not just the debtor-intermediary's fractional interest therein into the bankruptcy estate.

Nevertheless, a review of cases and other authorities interpreting the Bankruptcy Code suggests, for two reasons, that only the debtor-intermediary's fractional undivided interest, and not the undivided interests of third parties, should be included in the bankruptcy estate. First, courts have found that a debtor's "minor" interest in an item of property is insufficient to bring that property into the debtor's bankruptcy estate.[148] It is clear, for example, that a debtor's legal title to an asset is an insufficient interest where the beneficial interest in the asset is owned by third parties.[149] In the case of an undivided interest, the fact that the debtor's fraction is applied against the entire asset is simply an arithmetic technicality and thus arguably minor.[150]

Moreover, even in the United States, many intermediaries in the indirect holding system for securities (one of the three transaction patterns discussed in this Article) are banks which are not subject to the Bankruptcy Code. *Id.* § 109(b), (d). *But cf.* JACKSON & SYMONS, *supra* note 60, at 387 (noting that bankruptcy law can sometimes even be applied to a bank's insolvency by analogy); Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 DUKE L.J. 469, 505 (1992) (arguing against the need for special bank insolvency rules, in part because some of these rules may be based more on politics than public policy).

145. David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055, 1055 (1998).

146. 11 U.S.C. § 541(a)(1) (1994).

147. *See, e.g.*, United States v. Whiting Pools, Inc., 462 U.S. 198, 204 n.8 (1983) (clarifying that although "Section 541(a)(1) speaks in terms of the debtor's 'interests . . . in property,' rather than property in which the debtor has an interest, . . . this choice of language was not meant to limit the expansive scope of the section").

148. *Id.* (excluding "minor interest[s] such as a lien or bare legal title").

149. *See* 11 U.S.C. § 541(d) (1994) (providing that "[p]roperty in which the debtor holds . . . only legal title and not an equitable interest . . . becomes property of the estate . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold").

150. *See* Carlson, *supra* note 145, at 1069-70:

The second, more substantial, reason turns on policy. In arguing that a debtor's contingent right to surplus from an under-secured borrowing should be sufficient to bring all the collateral into its bankruptcy estate, Professor Carlson has asked what "principle . . . distinguishes beneficiaries of trusts from secured creditors."[151] The distinction, he concludes,

> has to do with appreciation value. When a creditor claims any sort of lien on property that goes up in value, the creditor's immediate liquidation of such property effectively deprives the debtor, and her unsecured creditors, of any potential upside. . . . In comparison, the beneficial owners of trust property are not subject to bankruptcy jurisdiction because they, not the debtor, own the cozening hope of appreciation value. If trust property goes up in value, the fiduciary does not keep the surplus but rather the beneficiary enjoys the increase. This aspect of equitable property interests keeps it outside of bankruptcy jurisdiction.[152]

Professor Carlson maintains that "[t]his distinction captures the spirit of the Bankruptcy Code's legislative history."[153] Moreover, this distinction is consistent with the only provision of the Bankruptcy Code that explicitly addresses undivided interests. Section 363 of the Bankruptcy Code permits the trustee in bankruptcy to sell both the debtor's interest "and the interest of any co-owner in property in which the debtor [has] an *undivided interest* as a tenant in common, joint tenant, or tenant by the entirety."[154] Nevertheless, any such sale is subject to conditions that protect the co-owners,[155] and the trustee in bankruptcy is required to "distribute to the . . . co-owners of such

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> Now, if the debtor and the beneficiary of a trust are, roughly speaking, cotenants of the res of the trust, why can the debtor's bankruptcy trustee not use this trust property in speculative ventures for the benefit of the general creditors of the debtor? . . . Such a thought is monstrous, and so, in default of a good answer, it is usually asserted that the equitable part of the res is simply *dehors* the estate and cannot be used beneficially for the unsecured creditors.

151. *Id.* at 1071.

152. *Id.* at 1071-72 (citations omitted) (identifying this distinguishing principle from Judge Stephen Gerling's decision in *In re* Amodio, 155 B.R. 622, 625 (Bankr. N.D.N.Y. 1993)).

153. *Id.* at 1072.

154. 11 U.S.C. § 363(h) (1995) (emphasis added).

155. One condition, for example, is that "partition in kind of such property among the estate and such co-owners is impracticable." *Id.* § 363(h)(1). This condition may well be met where the undivided interest is in a house or similar real estate but is unlikely to be met in the commercial context of this Article, where the property is securities or cash. Another condition, which contemplates the potential for appreciation, is that the sale would realize significantly more than the sale of the partial interest. *Id.* § 363(h)(2).

property . . . the proceeds of such sale . . . according to the interests of such . . . co-owners."[156] Thus, after such sale and distribution of proceeds, the co-owners will not keep the full surplus appreciation value, but they will keep their fractional interest in the surplus.

This distinction based on appreciation value likewise supports the axiom's application to undivided interests owned by an intermediary and investors. If the underlying property goes up in value, the investors do not keep the entire surplus, but rather their fractional interests therein; likewise, the intermediary will enjoy its fractional interest of the surplus. Accordingly, the investors' fractional interests should remain outside bankruptcy jurisdiction.[157]

In summary then, the foregoing axiom—that if a debtor only owns a partial interest in a given item of property, its creditors in their capacity as such should be able to reach only that partial interest—appears to hold true in the context of the transaction patterns of this Article. Hence, a creditor of an intermediary should be able to reach only the intermediary's undivided interest.

This axiom might appear to, but does not, resolve the problem of intermediary risk. *That is because the difficult problem in analyzing intermediary risk is even more fundamental than the axiom: defining what rights the debtor should have in the property*. I do not assume—nor should one assume—that contracts that purport to allocate partial

156. *Id.* § 363(j). One could argue that the applicable provision of § 363 should be § 363(a), which governs "cash, . . . securities, . . . or other cash equivalents . . . in which the estate and an entity other than the estate have an interest." *Id.* § 363(a) (collectively defining these cash equivalents as "cash collateral"). This appears to include the securities, loans, and receivables that are the subject of the transactions discussed in this Article. Even so, however, the co-owners of cash collateral are protected. Section 363(c)(2) specifically restricts the trustee in bankruptcy from using cash collateral unless the court, after notice and a hearing, authorizes such sale, and § 363(e) then requires the court to "prohibit or condition such use . . . as is necessary to provide adequate protection of [the co-owners'] interest." *Id.* §§ 363(c)(2), 363(e). Furthermore, to the extent the undivided interest in cash collateral constitutes a tenancy in common under applicable law, "§ 363(j) explicitly would require the cash collections of the [property subject to the undivided] interest to be distributed to the [debtor-intermediary and investor-co-owners] according to their respective interests." Schwarcz, *supra* note 61, at 163. The application of § 363(a) therefore would not change the underlying point of my analysis.

157. Specific laws to the contrary nonetheless could modify this general result. *See* U.C.C. § 8-503 cmt. 1 (2000) (noting, for example, that special "distributional rules for stockbroker liquidation proceedings under the Bankruptcy Code and Securities Investor Protection Act ('SIPA') provide that all customer property is distributed pro rata among all customers in proportion to the dollar value of their total positions, rather than dividing the property on an issue by issue basis").

rights between intermediaries and investors should be enforced.[158] Contracts are not universally enforced, notwithstanding the banner of freedom of contract. The presumption of contract enforceability is rebuttable where the contract violates law, harms the contracting parties (paternalism), or materially impinges on the rights of third parties (material externalities).[159] Hence, a contract that purports to allocate partial property rights between an intermediary and investors might be unenforceable if it violates law, causes such harm, or materially impinges on third-party rights. If unenforceable, the contract would be ineffective to allocate these partial property rights. That, in turn, would expose the property to claims of the intermediary's creditors, creating intermediary risk. The issue of intermediary risk thus conceptually turns on whether contracts that allocate partial property rights between intermediaries and investors *should*, for one of the foregoing reasons, be unenforceable.[160]

There is little reason to think that such contracts should violate law, and I will therefore assume, for purposes of this Article, that they do not. Paternalistic concerns are expressed in contract law defenses based on unconscionability and can be observed in defenses based on duress or information asymmetry.[161] Information asymmetry means, in the context of this Article, that the intermediary has significantly greater information than the investor about the contractual relationship between them, or vice versa. That appears unlikely in most cases because intermediaries (depositories, clearinghouses,[162] and brokers

158. I introduce contract law here because "the law of contracts [is] concerned with facilitating the voluntary movement of property rights into the hands of those who value them the most." RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 35 (5th ed. 1998).

159. *See, e.g.*, Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 545-46 (1999) (discussing, in the context of bankruptcy, whether contract law should place additional restrictions on one's freedom to contractually override statutory provisions); *cf.* MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 58, 147 (1993) (discussing public policy limitations on freedom of contract).

160. Thus, the more interesting issue is not whether an investor's undivided interest should generally be subject to claims of an intermediary's creditors—it should not—but whether contracts that purport to divide pro rata interests between investors and intermediaries should be enforced in the first place.

161. Schwarcz, *supra* note 159, at 546. Information asymmetry, for example, is not actually a contract defense. An information asymmetry, however, may undermine some prerequisite to enforceability—for example, by casting doubt on whether there is meaningful consent. *Id.* at 547 n.185.

162. The difference between clearinghouses and depositories to some extent parallels the distinction between securities clearance and settlement. Documenting the transfer of ownership of securities, including the identity and quantity of the securities being transferred, the price payable therefor, the date of transfer, and the identity of the relevant investors, is referred to as

holding interests in securities; banks selling loan participations; or companies originating receivables for securitization transactions) as well as investors (mostly institutional investors or brokers investing in interests in securities, banks or other institutions buying loan participations from the selling bank, or capital market investors in securitizations) are generally sophisticated commercial entities.[163] Although individual investors sometimes will be unsophisticated, my analysis will focus on investors that are either sophisticated or repeat players in the transaction patterns contemplated by this Article. Duress is unlikely because, in the transaction patterns contemplated by this Article, the relationships between intermediaries and investors are entirely free and voluntary.[164] Unconscionability, which is based on the premise that there may be certain extreme situations where as a matter of equity a contracting party must be protected against its own weakness,[165] is equally unlikely where the contracting parties are so-

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"clearing." SCOTT & WELLONS, *supra* note 21, at 802. Transferring and paying for those securities is referred to as "settlement." *Id.* A clearinghouse generally keeps track of the clearance process and a depository generally effectuates the settlement. *Id.* at 802, 804, 823. The functions of clearinghouses and depositories may overlap, however. Where "clearinghouses do not exist (e.g., in some European markets), depositories may take on functions of clearinghouses," and vice versa. *Id.* at 802 (quoting OFFICE OF TECH. ASSESSMENT, *supra* note 33, at ch. 5).

163. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS, THIRD QUARTER 1999, 44, 89 (Dec. 15, 1999) [hereinafter FLOW OF FUNDS ACCOUNTS] (showing that, in 1998, net purchases of bonds by the "household sector" were only 14.2% of similar purchases by institutional investors (banks, insurance companies, and various funds) and, as of year-end 1998, household sector bond outstandings were only 18.2% of institutional investor bond outstandings). This rise of institutional investing appears to be a worldwide phenomenon, partly resulting from the shift from traditional savings vehicles to more performance-oriented vehicles such as money-market and mutual funds. *See* Hans J. Blommestein & Norbert Funke, *The Rise of the Institutional Investor*, OECD OBSERVER, June-July 1998, at 37, 38 (observing that "[i]nstitutional investors . . . have been gaining in importance in both OECD and non-OECD countries," and explaining the reasons for the trend).

164. Economic duress that merely arises out of hard bargaining is not a defense. *See* Schwarcz, *supra* note 159, at 550.

165. *Id.* at 548; *see, e.g.*, Doctor, Inc. v. Stuart, 85 F.3d 975, 980 (2d Cir. 1996) ("The 'purpose of unconscionability doctrine is to prevent unfair surprise or oppression.'" (quoting David L. Threlkeld & Co. v. Metallgesellschaft Ltd., 923 F.2d 245, 249 (2d Cir. 1991), in turn quoting Pierson v. Dean, Witter, Reynolds, Inc., 742 F.2d 334, 339 (7th Cir. 1984))). Courts have used the doctrine primarily to rescue from hard bargains those who are grossly disadvantaged in their dealings with more sophisticated parties. Jane P. Mallor, *Unconscionability in Contracts Between Merchants*, 40 SW. L.J. 1065, 1066 (1986). It therefore is questionable whether the doctrine should apply to contracts between sophisticated parties. *See* Schwarcz, *supra* note 159, at 549-51 (arguing that unconscionability is rare in commercial settings because it not only requires a finding of unequal bargaining power or unfair surprise but also of overly harsh or one-sided contract terms or unreasonable and unexpected allocations of risk).

phisticated or repeat players. Thus, in the context of this Article, paternalistic concerns are unlikely to interfere with the enforceability of contracts allocating beneficial rights between investors and intermediaries.

Accordingly, the contractual allocation of rights between an intermediary and investors should be enforceable absent the creation of material externalities. In our case, this allocation is effectuated pursuant to contracts in which intermediaries purport to sell undivided interests in their assets to investors. The potential externality is that a person extending credit to an intermediary may be misled into thinking that the intermediary owns all rights in the asset that it holds.[166] This externality is material because it goes to the very essence of the intermediary's ability to repay its creditors.[167]

Although this externality can be mitigated and made nonmaterial by disclosing the lack of ownership to potential creditors, disclosure would be ineffective against existing or involuntary creditors.[168] These creditors therefore will be unable to engage in an informed allocation of risk and the externality will remain. The law therefore must address the extent to which contracts in which intermediaries purport to sell undivided interests in their assets to investors, thereby producing this material externality, should be enforced.[169]

If these contracts are enforced, the investors would own the assets held by the intermediary to the extent of their undivided interests therein, and the intermediary would have no rights in the investors'

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166. This is the same type of externality that led to the invalidation of contracts creating undisclosed, or "secret," liens. *See* 4 COLLIER ON BANKRUPTCY ¶ 544.01, at 544-43 (Lawrence P. King ed., 15th ed. 1996) (explaining that § 544 of the Bankruptcy Code, and its predecessor section under federal bankruptcy law, are designed to "strike down secret liens"); *see also* PHILIP R. WOOD, PRINCIPLES OF INTERNATIONAL INSOLVENCY 36 (1995) (arguing that traditional civil law objections to the trust may be based on a concern that trusts are unfair to creditors of the legal owner, who believe they can claim against all assets that the legal owner appears to own).

167. Creditors normally have the right to be repaid only from property of the debtor's estate. 11 U.S.C. § 726(a) (1994).

168. *See, e.g.*, Schwarcz, *supra* note 159, at 532 n.93, 575 n.328 (acknowledging that even the UCC filing system has this defect).

169. One might argue that disclosure under the Uniform Commercial Code has this same defect. Yet security agreements are enforced notwithstanding such defective disclosure; thus, disclosure subject to this defect should nonetheless be sufficient to ameliorate externalities. The fallacy of such an argument, however, is that the existence of positive law cannot resolve a normative law debate. *See, e.g.*, *id.* at 575 (arguing that the existence of a positive law rule is merely precedent for, and cannot be used to prove the validity of, a normative result).

interests in those assets. The investors then would have priority over claims of the intermediary's creditors in accordance with the aforesaid axiom that a creditor *qua* creditor cannot validly claim more rights than its debtor has in property.[170] But if these contracts are not enforced, the investors would only be left with in personam claims against the intermediary,[171] which would be *pari passu* with other unsecured claims[172] and effectively subordinate in priority to secured claims.[173]

To determine which path the law should take, I attempt to compare the consequences of enforcement with those of non-enforcement. Comparison is appropriate because I do not focus on whether the indirect holding system, or loan participations, or securitization transactions justify their externalities. I assume they do. (If I were to assume otherwise, my analysis would have to take into account the externalities that would be caused by prohibiting each transaction pattern,[174] such as, in the case of the indirect holding system, the increased costs and complexities of record-keeping and increased risk of loss occasioned by physically transferring securities.[175]) My analysis merely focuses on which parties—an intermediary's creditors or its investors—should bear the externalities.[176]

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170. *See supra* note 134 and accompanying text.

171. Although it is possible to deny an investor even in personam claims, that result appears unnecessarily harsh. Rather than mitigating the externality to creditors, it creates an externality to investors. I therefore do not see it as a realistic option.

172. *See* 11 U.S.C. § 726(a)(2) (1994) (providing that unsecured claims generally are *pari passu* in bankruptcy).

173. To the extent of collateral covered by the security interest, a secured claim against a debtor has priority over unsecured claims, including unsecured claims that arise out of contract. U.C.C. § 9-201 (2000).

174. In order to analyze whether a proposed system justifies its externalities, an analysis would have to take into account the externalities that would arise in the presence, and absence, of that system. *See, e.g.*, Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 480-84 (1997) (analyzing whether secured financing justifies its externalities); Schwarcz, *supra* note 159, at 560-76 (analyzing whether pre-bankruptcy contracting justifies its externalities).

175. *See supra* notes 29-32 and accompanying text (maintaining that the indirect holding system reduces these costs and lowers that risk). *But cf.* Letter from Kenneth C. Kettering, Partner, Reed Smith Shaw & McClay LLP, to Steven L. Schwarcz, Professor of Law, Duke University School of Law 5-6 (June 21, 2000) (arguing that these costs and risks may be able to be minimized in states that have widespread use of personal computers and a satisfactory legal regime for issuing uncertificated securities) (on file with the *Duke Law Journal*).

176. This approach is a variant of the traditional law and economics approach of allocating risk to the lower-cost risk bearer and monitor. *See, e.g.*, JEFFERY L. HARRISON, LAW AND ECONOMICS 94 (2d ed. 2000) (explaining the traditional law and economics approach of allocating risk to the lower-cost risk bearer and monitor). The first part of the variation—comparing consequences, instead of merely comparing which parties (the intermediary's

Because comparing the consequences of enforcement and non-enforcement may be influenced by the transactional context, I make the comparison in the context of each transaction pattern.[177] In the context of an indirect securities holding system, the enforcement of contracts in which intermediaries purport to sell undivided interests in their assets to investors would give investors priority over claims of the intermediary's creditors.[178] This might appear to discourage financiers from extending credit to intermediaries to enable them to engage in margin lending[179]—the on-lending of such credit to investors to enable them, in turn, to purchase securities.[180] Whether margin lending would be discouraged, however, is doubtful: intermediaries typically require investors to pledge the purchased securities as collateral for their margin loans,[181] and financiers concerned about the credit of their borrowers will require the intermediaries to re-pledge these securities as collateral for the original credit.[182] This re-pledge

ring consequences, instead of merely comparing which parties (the intermediary's investors or creditors) are the lower-cost risk bearers—is needed because the consequences of enforcing or not enforcing contracts that purport to transfer undivided interests affect more than those parties. *See infra* notes 178-204 and accompanying text (discussing the larger societal consequences of contract enforcement in the context of undivided interest transfers). The second part of the variation—disregarding which parties are the lower-cost monitors—is merely a deferral of that analysis for the sake of clarity. I later show that the same parties who are the lower-cost risk bearers are also the lower-cost monitors. *See infra* notes 205-11 and accompanying text (showing that an intermediary's creditors are both lower-cost risk bearers and monitors). That the lower-cost risk bearers and monitors are the same parties makes the analysis of risk allocation relatively simple by avoiding the need to discount the consequences of the risk by the probability of the risk occurring ("risk" being a function of both the probability of the risk-event occurring—the term "monitoring" merely being shorthand for trying to prevent the risk-event—and the amount of loss that will result if the risk-event in fact occurs).

177. In comparing these consequences, I regard as interchangeable persons who may act as an intermediary's creditors and investors. To this extent, my approach is related to the Kaldor-Hicks standard of economic efficiency under which a transaction is efficient if, with respect to all parties affected thereby, the aggregate benefit exceeds the aggregate harm. *See* POSNER, *supra* note 158, at 14-15 (describing the Kaldor-Hicks standard). The inherent rationale is that parties who are injured in one transaction may be benefited in another, and therefore are interchangeable when viewed from a statistical perspective. *See* Schwarcz, *supra* note 159, at 562 n.262 (noting this justification for Kaldor-Hicks efficiency).

178. *See supra* notes 169-70 and accompanying text.

179. At the end of the third quarter of 1999, the total liability of security brokers and dealers on security credit from banks, for example, amounted to $122.1 billion. *See* FLOW OF FUNDS ACCOUNTS, *supra* note 163, at 81.

180. DIV. OF BANKING SUPERVISION & REGULATION, BD. OF GOVERNORS OF THE FED. RESERVE SYS., BANK HOLDING COMPANY SUPERVISION MANUAL § 3230.0.2.1, at 2 (June 1998).

181. *Id.*

182. Kenneth C. Kettering, *Repledge Deconstructed*, 61 U. PITT. L. REV. 45, 51 (1999).

effectively provides those financiers with priority over competing investor claims.[183]

In some states, it might be desirable to give even broader priority to claims of the intermediary's creditors over ownership interests of investors. As a practical matter, such priority could be achieved by statutorily subordinating investor ownership to such claims.[184] Because that could discourage investment, however, a state might not wish to impose subordination without compensating impaired investors, such as through regulatory protection of their interests.[185]

Non-enforcement, on the other hand, would leave investors with mere in personam claims against intermediaries, which would be *pari passu* with other unsecured claims and effectively subordinate in priority to secured claims.[186] The consequence then may be to discourage investors from dealing with any but the financially strongest intermediaries.[187] Moreover, even if an investor were to attempt to protect itself by dealing with a financially strong intermediary (such as a large and established brokerage house), it could not easily control the selection of upper-tier intermediaries—the investor may not, for example, even know the identity of all the upper-tier intermediaries. Yet, the failure of an upper-tier intermediary would permit that intermediary's creditors to attach securities in which the investor owns an interest. And even if the investor's intermediary were made liable, by law or contract, for upper-tier intermediary risk, an upper-tier intermediary's failure could, in an example of systemic risk, impair the ability of lower-tier intermediaries to pay their obligations. Recognizing this risk, investors may refuse to invest.[188]

The balance therefore appears to favor contract enforcement. With enforcement, investors are protected and financiers concerned

183. *Id.* at 185.

184. *See, e.g.*, U.C.C. § 8-511 (2000) (giving secured creditors in "control" of an intermediary's securities priority over owners of those securities).

185. *Cf. infra* notes 244-48 and accompanying text (arguing that the justification for U.C.C. § 8-511 is that investors in the United States are protected by a federal regulatory scheme against the risk that their ownership interests will be impaired).

186. *See supra* notes 171-73 and accompanying text. Likewise, lower-tier intermediaries themselves would merely own in personam claims to the extent their assets are undivided interests.

187. For example, the "common response" in civil law states that lack a default rule limiting intermediary risk is "to employ as [intermediaries] only large and stable institutions, such as banks, that are unlikely to go bankrupt." Hansmann & Mattei, *supra* note 111, at 458.

188. *See infra* notes 244-48 and accompanying text (discussing investor risk and noting that this risk may be less significant in states where investors are protected by regulation).

about extending credit to intermediaries can protect themselves by demanding collateral. But without enforcement, investors would be exposed.[189] Hence, in an indirect securities holding system, contracts in which intermediaries purport to sell undivided interests in their assets to investors should be enforced, notwithstanding externalities to the intermediary's creditors.[190]

This same conclusion is reached in the context of buying and selling loan participations. The consequence of enforcement, which would respect the priority of investors' (i.e., participants') rights over claims of an intermediary's (i.e., a selling bank's) creditors, might be to somewhat discourage parties from extending credit to banks that sell participations.[191] This concern is mitigated, however, for several reasons. The banking industry is heavily regulated in many, if not most, states.[192] A bank's creditors thus may be comfortable in relying on the bank's disclosure about the extent to which its assets are subject to creditor claims. Also, most banks buy and sell loan participations.[193] Creditors that worry about their ranking vis-a-vis participants thus have little choice where to invest their money unless they are prepared to lend to a different industry, which no doubt will have its own set of risks. Finally, a bank traditionally obtains a large percentage of its funding from customer deposits, and the amount of a typical deposit is insignificantly small compared to the bank's assets.[194] Cus-

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189. Only financiers would be protected, and even their protection would be at risk where the intermediary-borrower itself obtains its interest in securities through a financially weak intermediary; without enforcement, the financier's claim against its intermediary-borrower would be effectively subject to prior claims of creditors of the financially weak intermediary.

190. *But cf. infra* note 249 and accompanying text (observing that in states, such as the United States, where governmental regulation protects investors from losses caused by a failed securities intermediary, investors' rights need not have priority over creditors' rights).

191. Banks traditionally borrow (at least by taking deposits) in order to re-lend money and generally engage in the banking business.

192. *See* JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 720 (2d ed. 1997) ("As is the case in the United States, banking is a highly regulated industry throughout the world.").

193. *See* DIVISION OF BANKING SUPERVISION & REGULATION, BD. OF GOVERNORS OF THE FED. RESERVE SYS., BANK HOLDING COMPANY SUPERVISION MANUAL § 2020.2, at 1 (1997) ("It is common practice for a bank to sell to or place with other banks loans that the bank itself has made to its customers."). There is, however, anecdotal evidence that banks may be increasingly reluctant to buy loan participations precisely because of the potential for intermediary risk. Letter from Kenneth C. Kettering, *supra* note 175, at 7.

194. *See, e.g.*, Mark E. Van Der Weide & Satish M. Kini, Subordinated Debt: A Capital Markets Approach to Bank Regulation 28 (Jan. 2000) (unpublished manuscript, on file with the *Duke Law Journal*) (observing that, even in the absence of deposit insurance, depositors would not monitor bank riskiness because "each depositor would have so little at risk that it would

tomers therefore are usually prepared to make deposits irrespective of the ranking of those deposits vis-a-vis participant interests.[195] And in states where repayment of bank deposits is guarantied by the government,[196] customers should have even less reason to worry about their ranking.[197]

The consequences of non-enforcement, on the other hand, could be significant. Participants, whose rights would be merely *pari passu* with the selling banks' unsecured claims and subordinate to the banks' secured claims,[198] could try to protect themselves by buying loan participations only from financially sound banks.[199] That, however, could lead to bank failures because relatively weak but otherwise viable banks, which no longer are able to diversify risk on their loans by selling participations therein, would find it more difficult to remain in business. Weighing these consequences, the balance, although not overwhelming, appears to favor enforcement.

The same conclusion is reached even in the context of securitization transactions. The consequence of enforcement, which would respect the priority of investors' rights over claims of an intermediary's

make no financial sense for him or her to spend much time analyzing the riskiness of the bank"). They also argue that "depositors do not have the financial sophistication and acumen necessary to monitor bank activities." *Id.* Customer deposits are no more than loans made by customers to a bank and evidenced by deposit accounts or certificates of deposit. *See, e.g.*, N.Y. County Nat'l Bank v. Massey, 192 U.S. 138, 145 (1904) ("[A] deposit of money upon general account with a bank creates the relation of debtor and creditor."); Morse v. Crocker Nat'l Bank, 190 Cal. Rptr. 839, 842 (Cal. Ct. App. 1983) ("It is axiomatic that the relationship between a bank and its depositor arising out of a general deposit is that of a debtor and creditor.").

195. This does not mean, however, that customers should be uninterested in that ranking. *See, e.g.*, Kevin B. Fisher, *Loan Participations and Bank Failures: The Penn Square Decisions*, 44 SW. L.J. 753, 760 n.29 (1990) (noting that depositors with amounts in Penn Square Bank over the insured maximum lost money when the FDIC liquidated the bank).

196. *See, e.g.*, 12 U.S.C. §§ 1813, 1817, 1821 (1994) (providing federal deposit insurance).

197. For example, Van Der Weide & Kini observe:

> under the current scheme of [U.S.] federal deposit insurance, most depositors — except for those who have placed over $100,000 with a bank . . . —have no incentive to monitor or influence a bank's activities [because] [i]f a bank fails, the federal government will fulfill the bank's contractual obligation to return the depositors' principal.

Van Der Weide & Kini, *supra* note 194, at 27-28. The government guarantor, however, may worry about that ranking because it affects the likelihood that the state will be able to recover on its subrogation claim against the failed bank.

198. *See supra* note 63 and accompanying text.

199. The concern expressed in the context of an indirect securities holding system, that the failure of an upper-tier intermediary would permit that intermediary's creditors to attach securities in which the investor owns an interest, can be controlled by the participant buying participations in loans originated by the selling bank, as opposed to buying participations in upper-tier loan participations.

(i.e., an originator's) creditors, should be minimal. Creditors will not be discouraged from extending credit to originators, because the type of non-recourse financing typified by a securitization increases unsecured creditor value.[200]

The consequences of non-enforcement, on the other hand, may well be significant. If investors, whose rights to repayment would be suspended and possibly impaired in the event of the originator's bankruptcy,[201] try to protect themselves by engaging in securitization transactions only with financially sound originators, troubled, but viable, originators would be deprived of an important source of capital market liquidity. Even if those originators attempt to obtain securitization financing by restructuring investor interests as interests in whole receivables, as opposed to undivided interests in pools of receivables,[202] that would significantly and unnecessarily increase transaction costs.[203] Weighing these consequences, the balance again appears to favor enforcement of contracts in which intermediaries purport to sell undivided interests in their assets to investors.

The foregoing analysis has shown, for each transaction pattern, that an intermediary and investors *should* be able contractually to allocate their respective undivided interests in assets held by the intermediary. Stated more intuitively, if in the context of one of these transaction patterns a given transfer of assets would constitute a sale, then the fact that only an undivided interest in those assets is being transferred should not defeat sale treatment.[204] Intermediary risk thus should not arise.

Possible arguments against contract enforcement. There appear to be only two arguments, both of which fail, against this conclusion. The first argument is that, as between two parties, risk sometimes should be allocated to the lower-cost monitor of the risk.[205] In our

200. *See* Schwarcz, *supra* note 174, at 462-65 (explaining how non-recourse debt is an exception to the general rule that debtors "will not incur secured debt until they need liquidity and cannot obtain unsecured financing").

201. *See supra* note 84 and accompanying text.

202. This increases the likelihood that investor rights will have priority over creditor rights.

203. *See* 1 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 80, § 3.03[A], at 3-13 (explaining that the undivided interest structure reduces the transaction costs associated with numerous separate purchases).

204. *Cf. supra* notes 86-87 and accompanying text (addressing this perspective in the context of securitization).

205. *See, e.g.*, HARRISON, *supra* note 176, at 94 (arguing that "[f]rom an economic point of view, it makes sense to allocate . . . risk to the party who can control the event or insure against it more economically").

case, however, the intermediary's creditors *are* the lower-cost monitors because they already have an incentive to monitor the intermediary, the only party to which they can look for repayment. Investors, on the other hand, have no incentive, absent the existence of intermediary risk, to monitor the intermediary because they can only look to (and therefore only will monitor) the issuer for repayment.

Concern over intermediary risk would only increase the overall monitoring cost by imposing on investors the additional incentive to monitor their intermediaries but, because an intermediary's bankruptcy would continue to jeopardize creditor repayment, not commensurately reduce the monitoring incentive of creditors.[206] Furthermore, intermediary risk may increase more than monitoring cost if investors opt out of transactions in which this risk could arise. For example, investors faced with monitoring their immediate intermediary, as well as all upper-tier intermediaries (whose identities may not even be known),[207] may decide to shift their investments to securities that are subject to direct holding.[208] This shift, however, would further increase costs by forgoing the very real benefits that led to the creation of the indirect holding system.[209] Actual experience with loan participation and securitization transactions illustrates the cost increases from opting out. Banks frequently engage in the more complex and costly process of loan syndication in order to avoid intermediary risk from participations.[210] Parties also frequently contract out of intermediary risk in securitizations by structuring their transactions, at increased cost, as sales of whole receivables.[211]

The second argument is that divided ownership is traditionally viewed as inefficient because it would be awkward or impractical for

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206. Even though the existence of intermediary risk means that creditors may also have claims against investors' interests in securities, the creditors' primary source of recovery remains the intermediary; hence, creditors will continue to have incentives to monitor the intermediary.

207. *See supra* notes 186-87 and accompanying text.

208. This shift would occur because intermediary risk would discourage investors from investing in securities held through the indirect holding system.

209. *See supra* notes 30-32 and accompanying text (discussing the efficiencies and cost savings of the indirect holding system).

210. *See* Letter from Kenneth C. Kettering, *supra* note 175, at 7 (observing that in recent years "the participation market has largely dried up, largely on account of concerns about intermediary risk").

211. *Cf. supra* note 87 and accompanying text (noting concern that an SPV that purports to purchase only an undivided interest in, as opposed to whole, receivables may be unable to gain an ownership interest in the underlying receivables).

the market alone to determine which third-party transferees are to share possession with current owners. For example,

> [D]ivided ownership makes transfer difficult in practice even if there is no formal limitation. If 50 different people are joint tenants of a piece of property, a sale of the property will require them to agree both on the price and on the division of the proceeds among them; there will be holdout problems.[212]

This argument fails because the foregoing inefficiencies do not apply to the transaction patterns of this Article. Sharing possession of commercial intangibles, such as securities (in the case of the indirect holding system), loans (in the case of loan participations) and receivables (in the case of securitizations), is neither awkward nor impractical. Nor would sharing lead to holdout problems. The price of securities is readily determinable from the market, so each investor's undivided interest in securities at any time is simply the dollar amount of such investor's investment in such securities divided by the aggregate dollar amount of all unpaid investments in such securities. No pricing issue arises in the case of loan participations because each participant is merely entitled to its undivided fraction of the actual collections on the underlying loan. And there are usually just two parties, the originator and the SPV, that own undivided interests in receivables.[213] Accordingly, such contractual sharing of undivided interests should not, in and of itself, be inefficient.

C. Thesis

For each transaction pattern, an intermediary and investors therefore should be able to make an enforceable contract that allocates their respective undivided interests in assets held by the intermediary, notwithstanding the creation of material externalities. A creditor of the intermediary thus should not be able to reach an investor's undivided interest.

This conclusion, that there *should* be no intermediary risk, is normative. In reality, there remains uncertainty whether externalities

212. POSNER, *supra* note 158, at 86. In this context, Professor Goode observes that "ever since the 1925 property legislation English law has restricted the number of legal (as opposed to equitable) co-owners to four in order to restrict the number of people with whom the purchaser has to deal." E-mail from Roy Goode, Professor of Law, University of Oxford, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Aug. 18, 2000) (on file with the *Duke Law Journal*).

213. *See supra* notes 79-81 and accompanying text.

would prevent contract enforcement, especially given the potentially large number of national jurisdictions that may be involved. Uncertainty, in turn, increases costs and discourages transactions. I therefore next examine how this normative thesis can be implemented as positive law in order to reduce this uncertainty and enable parties to clearly understand their rights.[214]

IV. IMPLEMENTATION

In a domestic legal system, implementation of a thesis into law is relatively straightforward: articulate the thesis as a rule of law and enact the law. But intermediary risk arises in international as well as domestic transactions.[215] In an international context, it is additionally necessary—in order to minimize transaction costs[216]—to implement the rule of law in a way that binds parties in different nation-states with maximum uniformity.

In this part, I first examine how the thesis should be articulated as a rule of law. Thereafter, I examine how that rule should be implemented into law, taking into account that in many transactions involving intermediary risk, the parties—investors, intermediaries, and their creditors—may be located in diverse states. Finally, I conclude that the rule should be implemented as a uniform model law.

A. Articulating the Thesis as a Rule of Law

The thesis asserts that an intermediary and investors should be able to make an enforceable contract that allocates their respective undivided interests in assets held by the intermediary, notwithstanding the creation of material externalities.[217] Because the thesis focuses on the enforceability of contracts, the simplest way to articulate it as a

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214. *Cf.* RANDALL D. GUYNN, MODERNIZING SECURITIES OWNERSHIP, TRANSFER AND PLEDGING LAWS 60 (1996) (arguing that implementation is "perhaps the most challenging aspect of the task of modernizing the commercial law of the securities holding and transfer system").

215. *See supra* Part II (describing the international orientation of these transactions).

216. *See* Tamar Frankel, *Cross-Border Securitization: Without Law, But Not Lawless*, 8 DUKE J. COMP. & INT'L L. 255, 256 (1998) (arguing that "market and institutional intermediation are unlikely to arise, let alone flourish, without a legal infrastructure that provides uniform, predictable, stable rules of behavior"); Tamar Frankel & Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1673, 1677 (1996) (discussing the economic impact of judicially enforced social norms on markets).

217. *See supra* Part III.C.

rule of law is to restate it in contract law terms. A hypothetical contract law rule thus might state that a contract between an intermediary and investors that purports to allocate their respective undivided interests in assets held by the intermediary shall be enforceable.

Contract law, however, might be insufficient. In some states, contract law may only govern the relationship between parties to a contract, thus not binding their third-party claimants. Indeed, some have argued that this limitation is implicit even in U.S. jurisprudence.[218] In these states, contract law would be insufficient because any articulation of the thesis as a rule of law must bind the intermediary's creditors, in order to confirm that a creditor of the intermediary should not be able to reach an investor's undivided interest.[219]

Property law serves this function, and also is a more intuitive source of law for the thesis than contract law. In contrast to contract law, property law provides rights "good against the world," thereby binding non-contracting creditors.[220] Moreover, the consequence of the hypothetical contract law rule—that a contract between an intermediary and investors that purports to allocate their respective undivided interests in assets held by the intermediary shall be enforceable—is that such an allocation is effective to transfer ownership of these interests. Transferring ownership, however, is traditionally addressed by property law.[221]

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218. *See, e.g.*, Michael W. McConnell, *Contract Rights and Property Rights: A Case Study in the Relationship Between Individual Liberties and Constitutional Structure*, 76 CALIF. L. REV. 267, 289 (1988) (observing that, analytically, "contract is a right good only as against determinate persons—those with whom one has made the contract").

219. *See supra* Part III.C.

220. *See* McConnell, *supra* note 218, at 289 (observing that on the "sophisticated legal basis, expounded by Professor Wesley Hohfeld . . . the distinctive feature of property is that it is a right 'good against the world,' while contract is a right good only as against determinate persons . . . with whom one has made the contract" (citing Wesley Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 26 YALE L.J. 710 (1917))). McConnell further explains that:

> A particular object may give rise to both contractual rights and property rights. *X* may contract with *Y* for exclusive use and enjoyment of real property owed by *Y*. *X* has a contractual right as against *Y*; if *Y* enters the property he is in breach of contract. However, *X* also has obtained, by virtue of the contract, rights against the world, in the nature of property rights.

Id.

221. *See, e.g.*, Jeanne L. Schroeder, *Death and Transfiguration: The Myth That the U.C.C. Killed "Property*,*"* 69 TEMP. L. REV. 1281, 1285-89 (1996) (defining property as "the legal relationship among legal subjects concerning the possession, enjoyment, and alienation of objects"); *cf.* POSNER, *supra* note 158, at 89 (observing that "[p]roblems in the transfer of property rights are part of a larger problem, that of deciding who owns what property"). To some extent, however, this distinction between property and contract is semantic because these

The thesis therefore would have broader and more intuitive application if formulated as a rule of property law.[222] Such a rule tentatively could be articulated as follows:

> The transfer of an undivided fractional interest in property shall constitute a valid and enforceable transfer of that interest to the same extent and in the same manner as if that interest had been a separate asset.[223] The transfer shall not be affected by the fact that the property in which the interest is being transferred is itself an undivided fractional interest.[224]

The next step of this analysis is to examine how this proposed rule should be implemented into property law on an international basis. Before engaging in that examination, however, it is necessary to

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bodies of law have much overlap. *See, e.g.*, McConnell, *supra* note 218, at 287 ("If property is viewed in the sense of modern financial property—corporate shares, electronic transfers, bank deposits, and so forth . . . property is little more than a web of contractual commitments.").

222. A property-based rule also may be easier to adopt across legal systems. *See, e.g.*, Charles W. Mooney, Jr., & Atsushi Kinami, *Transfer, Pledge, Clearance and Settlement in the Japanese and United States Government Securities Markets*, 12 U. PA. J. INT'L BUS. L. 517, 567 (1991) (noting that, in the context of the Japanese indirect holding system, "changes in law that would clearly recognize and give effect to property rights in uncertificated securities controlled by intermediaries would seem to be advisable"). In the context of revising UCC Article 8, however, some scholars have opposed property-based rules. *See, e.g.*, Mooney, *supra* note 13, at 310 (arguing that "a property law construct for resolving priorities among claimants to fungible bulks of securities is a fundamentally flawed approach"); Jeanne L. Schroeder, *Is Article 8 Finally Ready This Time? The Radical Reform of Secured Lending on Wall Street*, 1994 COLUM. BUS. L. REV. 291, 357 (arguing that "traditional property tracing and bona fide purchaser rules were awkward, impracticable, or even impossible and unjust means of determining distributions of assets among rival claimants in intermediary insolvency cases"). This opposition does not mean, however, that a property-based rule must be inappropriate. These scholars appear to have been opposing the application of traditional property rules that attempt to trace property to *specific* underlying securities. *See, e.g.*, Schroeder, *supra*, at 370 (arguing that "a customer in the indirect holding system may not be treated . . . as the owner of any specific, identifiable, underlying security held by the securities intermediary"). They actually do not oppose, but rather affirm, the idea of undivided interest ownership. *See id.* at 382 (concluding that, under Revised Article 8, the investor would have a pro rata interest in the fungible bulk of all interests in that financial asset held by the intermediary, not "an exclusive property right in any specific identifiable financial asset").

223. This language is based in part on RESTATEMENT (SECOND) OF CONTRACTS § 326(1) (1981).

224. My analysis of which parties—an intermediary's creditors, or its investors—should bear the externalities was limited to the transaction patterns discussed in this Article. *See supra* note 177 and accompanying text. One therefore might argue that the foregoing rule should be limited to those types of transactions. However, because the intuitive nature of the rule suggests that it is likely to be valid in other contexts as well, I have chosen to state the rule, and to propose in Appendix A a model law to regulate intermediary risk, without this limitation.

examine whether the proposed rule should be subject to any exceptions.

B. Exceptions to the Proposed Rule

As a reality check, it is useful to compare the proposed rule to existing law that addresses intermediary risk. The most comprehensive such law is Article 8 of the UCC,[225] which conceptually is consistent with the rule subject to three exceptions. I analyze below whether these exceptions also should qualify the rule.

The exception for multiple tiers of intermediaries. A practical problem arises where there are multiple tiers of intermediaries. An investor then may not be in privity with all of the intermediaries that hold assets in which the investor owns an interest. It would be difficult for intermediaries that are not in privity to know the identity of those investors or the amount of their interests.

In the context of the indirect holding system, Article 8 responds to this difficulty by limiting the ability of investors (and their creditors) to assert rights or claims against intermediaries that are not in privity. However, limiting the assertion of rights and claims is inherently confusing because it creates a conceptual paradox: an investor is protected from intermediary risk because it has a property right in the underlying assets, yet neither the investor nor its creditors may directly reach that property right to the extent it is held by intermediaries with which the investor is not in privity.

Should the proposed rule similarly limit the assertion of rights and claims? My analysis starts by examining this limitation under Article 8. Under that Article, an investor has an undivided ownership interest in securities (or interests therein) held by the intermediary from which it purchased the interest.[226] Logically, therefore, that undivided ownership interest should constitute an ownership interest in each underlying ownership interest because a property interest in property is itself property. For example, an investor that owns a 10% undivided interest in its broker's 20% undivided interest in XYZ Company stock held by a depository should own a 2% undivided interest in that stock. This does not, however, mean that the investor may enforce its ownership interest directly against the depository, or that the investor's creditors may seek to attach that interest. Such di-

225. *See supra* note 49 and accompanying text.

226. U.C.C. § 8-503(a) (2000).

rect enforcement would conflict with "[o]ne of the basic principles of the indirect holding system," that "securities intermediaries owe duties only to their own customers."[227] This principle respects the impracticality of imposing duties on an intermediary with respect to an investor whose identity and ownership interest is not recorded on the intermediary's books.[228]

Article 8 implements this principle by providing that an investor "cannot assert rights directly against . . . intermediaries through whom the [investor's] intermediary holds the positions."[229] Thus, "[t]he interest of a debtor in a security entitlement may be reached by a creditor only by legal process upon the securities intermediary with whom the debtor's securities account is maintained."[230]

In reality, however, this limitation affects procedural rights but does not change the substantive nature of the investor's intermediary risk. Even though an investor may not enforce its ownership interest directly against upper-tier intermediaries with which it is not in privity, creditors of a failed upper-tier intermediary are prohibited from attaching interests held by that intermediary for its investors.[231] Those interests would be property of those investors, who in turn (as intermediaries) would be required to hold those interests as property of their own investors.[232] Thus, Article 8 solves the practical problem of multiple tiers of intermediaries without increasing intermediary risk.

227. *Id.* § 8-507 cmt. 3; *see also id.* § 8-102 cmt. 7 (emphasizing that "the definition of entitlement holder is, in most cases, limited to the person specifically designated as such on the records of the intermediary"); *id.* § 8-115 cmt. 4 (noting that section 8-115 "embodies one of the fundamental principles of the Article 8 indirect holding system—that a securities intermediary owes duties only to its own entitlement holders").

228. *See, e.g.*, *id.* § 8-507 cmt. 3 (observing that in the indirect holding system, "an intermediary is not required to determine at its peril whether a person who purports to be authorized to act for an entitlement holder is in fact authorized to do so"); Rogers, *supra* note 13, at 1455 (observing that an intermediary "has no way of knowing anything about its customer's customers [and,] [a]ccordingly, the realities of the marketplace dictate that an intermediary can only be held responsible to its own customers").

229. U.C.C. § 8-503 cmt. 2; *see also id.* § 8-501 cmt. 5 (stating that "the nature of a security entitlement is that the intermediary is undertaking duties only to the person identified [on its records] as the entitlement holder"); *id.* § 8-507(a) (describing the circumstances under which a securities intermediary satisfies its duty to comply with an entitlement order); *id.* § 8-507(a) cmt. 3 (providing that a securities intermediary shall comply with an order only if the order is originated by a person identified in the intermediary's records).

230. *Id.* § 8-112(c).

231. *Id.* § 8-503.

232. *Id.* This pattern would repeat for each tier of intermediaries.

This same procedural exception, which solves the practical problem of multiple tiers of intermediaries without increasing intermediary risk, appears to be equally appropriate for the proposed rule. In any indirect holding system, it is impractical for upper-tier intermediaries to maintain records about, or even to know the existence of, investors with which they are not in privity.[233] In the context of loan participations, multiple tiering of intermediaries is less likely but, where it exists,[234] the ultimate participant and the lender will not be in privity and the lender therefore may not know of the ultimate participant's existence. Multiple tiering is not, however, likely to occur in securitization transactions, so this exception would be neutral in those cases.[235]

The exception where investors do not need priority in order to satisfy their rights. The second exception arises where investors don't need priority in order to satisfy their rights.[236] This exception, however, is trivial because intermediary risk then would be nonconsequential; therefore, any intermediary risk permitted by this exception could not give rise to systemic risk.

The exception where secured creditors are in control of an intermediary's securities. The third exception arises where secured creditors are in control of an intermediary's securities.[237] This exception appears extraordinary because it subordinates a third party's ownership interest to a security interest given without consent of the owner.[238]

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233. The term "investors" being deemed to include all lower-tier intermediaries. *See supra* Part II.A at 1552 (defining the term "investors" to generally include not only investors but also intermediaries that have rights in securities held by other intermediaries).

234. Multiple tiering would exist, for example, where a participant sells an undivided interest in its own participation to another participant.

235. The foregoing discussion does not purport to address the ability of investors to enforce rights, on account of their undivided interests, directly against *issuers*. Such an ability should derive from the fact that these undivided interests are property rights in claims against the issuer. I note, however, that parties can contractually restrict such direct enforcement. For example, a lending bank that wishes to restrict participants from directly suing the borrower can impose that restriction in the participation agreement. Likewise, an originator that wishes to restrict the SPV from taking enforcement action directly against receivable obligors can impose that restriction in the securitization documentation.

236. Under the UCC, investors have property rights only to the extent needed to satisfy a lower-tier holder's rights in securities. U.C.C. § 8-503.

237. Under the UCC, secured creditors in control of an intermediary's securities have priority over lower-tier holders. U.C.C. § 8-511.

238. Thus, in the event of a dispute between investors and secured creditors of an insolvent intermediary, the investors' ownership interest would be subordinate to secured creditor claims.

One possible explanation for this exception is pragmatic: "Since securities intermediaries generally do not segregate securities in such fashion that one could identify particular securities as the ones held for customers, it would not be realistic for this section to state that 'customers' securities' are not subject to creditors' claims."[239] This explanation indirectly turns on the general precept that "a person buying an entitlement must [be able to] ascertain the owner of the entitlement and the existence of any other qualifications to or encumbrances on that interest."[240] Because secured creditors are unable to ascertain the identity of the investors or the existence of qualifications or encumbrances, the UCC creates a bright-line test making such information irrelevant. But this explanation is unconvincing because if a bright-line test is needed to address the inability to identify which securities are held for customers, the test could as easily favor ownership interests over secured claims.[241]

Another explanation is that the exception merely reflects how the market actually works: "[t]oday, in the securities industry, second-in-time purchasers, such as secured creditors and repo buyers, regularly prevail over first-in-time owners, such as customers."[242] Again, however, I do not find this explanation convincing: one should not respond to an "ought" question with an "is" answer.[243]

The official comments to Article 8 nonetheless offer a third, more compelling, explanation.[244] Investors are protected in the United States by a federal regulatory scheme against the risk that their ownership interests in securities held by a failed intermediary will be impaired.[245] This government protection thus minimizes the conse-

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239. U.C.C. § 8-503 cmt. 1.

240. Whincop, *supra* note 11, at 41, 44.

241. Moreover, the rationale is inconsistent with the qualification, which favors secured but not unsecured creditor claims. *See infra* notes 244-47 and accompanying text.

242. Schroeder, *supra* note 222, at 298; *see also* Rogers, *supra* note 13, at 1525-26 (arguing that this exception "has been the law for centuries").

243. *See, e.g.*, Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1814-15 (1998) (arguing that "the appropriate response to an 'ought' claim is an 'ought not' claim, not an 'is' claim").

244. *See* U.C.C. § 8-511 cmt. 2. Even this rationale fails to explain, however, why unsecured creditor claims are not likewise favored.

245. Under Rules 8c-1 and 15c2-1 promulgated by the Securities and Exchange Commission, a securities intermediary is prohibited from giving a security interest in customer securities without the customer's consent. *See id.* (paraphrasing those SEC Rules). Brokers are required to maintain a sufficient inventory of unencumbered securities to satisfy customer claims. 17 C.F.R. § 240.15c3-3 (2000); *see also* U.C.C. § 8-504 (mirroring that requirement). If a failed broker fails to maintain a sufficient unencumbered inventory, its customers are protected

quences of favoring secured creditors.[246] Absent this type of comprehensive regulatory protection, however, it is doubtful that Article 8 would ever favor secured claims over ownership interests.[247] Accordingly, absent similar worldwide regulatory protection, there would appear to be insufficient justification for the proposed rule to favor an intermediary's secured creditors over investors.[248] Nonetheless, on a case-by-case basis, states that have regulatory schemes protecting investors from the consequences thereof may wish to consider whether

against loss under the Securities Investor Protection Act, which established the Securities Investor Protection Corporation to pay that loss. U.C.C. § 8-511 cmt. 2; *see also* Securities Investor Protection Act, 15 U.S.C. § 78fff-1(d) (1994) (requiring the trustee to conduct an investigation of the debtor, report his findings to the court and submit a statement of his investigation to the SIPC); *id.* § 78fff-3(a) (providing that in certain circumstances the SIPC shall advance moneys to the trustee in order to "provide for prompt payment and satisfaction of net equity claims of customers of the debtor").

246. *But cf.* David A. Kessler, Note, *Investor Casualties in the War for Market Efficiency*, 9 ADMIN. L.J. AM. U. 1307, 1308-09 (1996) (arguing that there are gaps in this government protection).

247. *See* U.C.C. § 8-511 cmt. 2 (stating that "Article 8 is premised on the view that the important policy of protecting investors against the risk of wrongful conduct by their intermediaries is sufficiently treated by other law"); *see also* Schroeder, *supra* note 222, at 300-01 (cautioning that "[w]ithout [the regulatory protection provided in the United States by the SEC and SIPC], the overall preference given to the lending industry over consumers by the proposed revisions must be rethought"). *But see* Rogers, *supra* note 13, at 1539 (arguing that a highly regulated securities system is not essential to the functioning of Revised Article 8).

248. There also is a fourth, although circular, explanation. Because property is transferable, "the law must describe how competing claims for the entitlement, each of which is based on an apparently enforceable trade, are to be resolved." Whincop, *supra* note 11, at 44. The general default rule is that an owner's rights trump subsequent claims. *See, e.g.*, Schroeder, *supra* note 222, at 297 (noting that the derivation rule protecting possession is the default rule). In certain cases, however, the law favors subsequent claimants, such as bona fide purchasers of goods and holders in due course of negotiable instruments, in order to encourage participation in markets for the property. *Id.* This reflects the negotiability aspect of property. *Id.* at 296-97. This aspect of property even applies in a trust context. *See* RESTATEMENT (THIRD) OF TRUSTS, *supra* note 102, § 2 cmt. d ("[An] equitable interest in a thing is traditionally extinguished by the transfer of the legal interest in it to a bona fide purchaser when a legal interest in the thing would not be so extinguished."). It is this aspect of property, the argument goes, that justifies the favoring of subsequent secured creditors over investors required by Article 8. *See* Schroeder, *supra* note 222, at 297 (asserting that "[p]roposed Article 8 comes down firmly in favor of the negotiation principle"). The flaw in this argument, however, is that no compelling reasons have yet been advanced as to *why* the default rule should be modified in this case. To the contrary, one might argue that original owners should be protected when the default rule is modified. *See, e.g.*, U.C.C. §§ 9-306(2), 9-307(1) (noting that a buyer in the ordinary course of business takes free of a security interest but the security interest continues in the sale proceeds). Yet absent government protection (discussed *supra* notes 244-48 and accompanying text), investors would be unprotected.

it is appropriate to favor an intermediary's secured creditors over investors as an exception to the proposed rule.[249]

Restatement of the proposed rule as qualified by these exceptions. The foregoing analysis thus indicates that there should be only one general exception to the proposed rule, to address the problem of multiple tiering of intermediaries. Taking this exception into account, the rule can be restated as follows (as so restated, the "Rule"):

> The transfer of an undivided fractional interest in property shall constitute a valid and enforceable transfer of that interest to the same extent and in the same manner as if that interest had been a separate asset. The transfer shall not be affected by the fact that the property in which the interest is being transferred is itself an undivided fractional interest. Holders of property in which undivided interests have been transferred shall, to the extent of such transfers, be deemed to hold such property for their transferees, but only transferors and transferees that are in privity may prosecute rights directly against each other on account of such transfers.

In addition, states that have regulatory schemes protecting investors from the consequences thereof may wish to consider a non-uniform exception to the Rule, favoring an intermediary's secured creditors over investors.[250]

I next examine how the Rule can be implemented into law on an international basis.[251]

C. Applying the Rule to Cross-Border Transactions

In general, there are three ways that a rule can be implemented internationally. First, states can agree with one or more other states that they and their residents will observe the rule; this approach is usually referred to as a treaty or convention.[252] Second, the rule can be

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249. This exception may be useful, for example, to encourage asset-based lending to securities firms.

250. *See supra* notes 237-49 and accompanying text.

251. *Cf.* EATWELL & TAYLOR, *supra* note 14, at 197 ("If markets are to operate efficiently and the greatest social benefit is to be attained, then systemic risk must be regulated on an international scale."); Mooney & Kinami, *supra* note 222, at 568 (noting in the context of the indirect holding system that "[t]he harmonization of law and practice in the various domestic regimes could be of great benefit in the cross-border environment").

252. *See, e.g.*, THOMAS BUERGENTHAL & HAROLD G. MAIER, PUBLIC INTERNATIONAL LAW 91 (2d ed. 1990) ("The term 'treaty,' as used on the international plane, describes international agreements in general, whether they be denominated conventions, pacts, covenants, charters, protocols, etc. These different names have no legal significance; the same

formulated as a uniform model law to be enacted into national law by each state that wishes to do so. This approach might be characterized as a form of private international law.[253] Third, the rule can be expressed as model language for parties to incorporate into their contracts as they deem appropriate. In this section, I argue that the Rule should be implemented as a uniform model law.

Treaty approach. It is theoretically possible for the Rule to be implemented as a treaty, but such a formal approach is unnecessary and might raise unwarranted political hurdles. It is unnecessary because the Rule does not purport to govern transactions between states *qua* states,[254] merely transactions between residents of different states.[255] Furthermore, one of the major advantages provided by a treaty—the ability to impose an international dispute settlement mechanism[256]—is not needed in the context of the

legal rules apply to one as to the other."). In the context of United States domestic law, however, the term "treaty" has a more limited meaning. *Id.* at 91-92.

253. *See, e.g.*, BARRY E. CARTER & PHILLIP R. TRIMBLE, INTERNATIONAL LAW 19 (3d ed. 1999) (observing that "[i]n contrast to the public international law of rules between states, there has long been private international law dealing with the activities of individuals, corporations, and other private entities when their activities crossed national borders"). It should be cautioned, however, that this characterization is necessarily imprecise because "[t]he distinctions between public and private international law have become increasingly artificial as many states and their instrumentalities have entered the marketplace in a major way . . . and as commerce and foreign policy have become increasingly intertwined." *Id.* at 19-20.

254. I recognize that treaties, such as the Convention on the Recognition and Enforcement of Foreign Arbitral Awards and the United Nations Convention on Contracts for the International Sale of Goods, *can* be used for the international unification of private law. I argue, however, that there may be a simpler way to unify private law in the context of intermediary risk.

255. Although investors and creditors of an intermediary ordinarily would be private residents, some intermediaries may be quasi-governmental entities. In Korea, for example, the only depository intermediary is the Korea Securities Depository, a public corporation established and regulated by the government. *See* Chunggwonkoraebop [Securities and Exchange Act], Act No. 4701 of 1994, art. 173, *translated in* 11 KOREA LEGIS. RES. INST., STATUTES OF THE REPUBLIC OF KOREA 716 (1997). That is irrelevant to this analysis, however, so long as such intermediaries are bound by the national law of their state.

256. Ever since the days of antiquity, treaties were used by princes and states to settle international disputes. PAUL REUTER, INTRODUCTION TO THE LAW OF TREATIES 1 (José Mico & Peter Haggenmacher trans., 1989); *see also* MARK W. JANIS, AN INTRODUCTION TO INTERNATIONAL LAW 1 (2d ed. 1993) (describing treaties between the Jews and the Romans, Syrians and Spartans). Many international treaties continue to provide mechanisms to settle such disputes. For example, the International Centre for Settlement of Investment Dispute (ICSID) provides a relatively low-cost and unbureaucratic procedure for adjudicating certain disputes between a state and its creditors. Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 1024 (2000). The 1982 Law of the Sea Convention contains an elaborate system of dispute settlement, which, in most cases, will lead to a binding third-party decision. PETER MALANCZUK, AKEHURST'S MODERN

Rule.[257] Implementing the Rule as a treaty might raise unwarranted political hurdles because some states, such as the United States, require extraordinary measures to bind themselves to a treaty.[258] In practice, a rule that does not govern transactions between states *qua* states often can be more easily implemented through a uniform model law:

> Throughout the discussions [of UNCITRAL's proposal for international rules governing cross-border corporate insolvency], a significant minority of countries favored a treaty rather than a model law, in part because they favored a system based on reciprocity. However, a substantial majority, in which the United States took a leading role, favored the model-law approach as a first step that could be agreed and implemented far more quickly and more generally than a treaty.[259]

INTRODUCTION TO INTERNATIONAL LAW 298 (7th ed. 1997). The North American Free Trade Agreement (NAFTA) and the Agreement Establishing World Trade Organization (WTO) also provide dispute-settling mechanisms. *Id.* at 300.

257. The Rule deals mostly with private parties—investors, intermediaries, and their creditors. Hence, disputes under the Rule are unlikely to involve a sovereign, and the judiciary of the state whose law applies will provide the dispute settling mechanism. However, even if the intermediary involved in a dispute is state-owned, the qualified immunities doctrine of international law would not allow the intermediary to enjoy immunity on its commercial activities so long as the intermediary is a commercial entity dealing with other commercial entities. *See* MALANCZUK, *supra* note 256, at 118-19 (observing that "the prevailing trend . . . is to . . . grant immunity to foreign states only in respect of their governmental acts (acts *iure imperii*), not in respect of their commercial acts (acts *iure gestionis*)"). Thus, the judiciary of the state whose law applies would again provide the dispute-settling mechanism.

258. The United States Constitution requires, for example, that treaties be entered into only with the advice and consent of two-thirds of the U.S. Senate. U.S. CONST. art. II, § 2, cl. 2. Professor Bergsten adds that he

> found in [his] days as Secretary of UNCITRAL . . . that the biggest obstacle to getting an UNCITRAL treaty adopted in many countries was that the subject matter was one in which the Ministry of Justice was interested (being responsible for development of the domestic legal system), but the initiative had to come from the Ministry of Foreign Affairs, which had the monopoly on commencement of the bureaucratic actions leading to the submission of a treaty to Government and then to Parliament for action.

E-mail from Eric E. Bergsten, Professor of Law Emeritus, Pace University, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Aug. 18, 2000) (on file with the *Duke Law Journal*).

259. Memorandum from Jay L. Westbrook, Professor of Law, University of Texas, to National Bankruptcy Review Commission 3 (July 29, 1997) (on file with the *Duke Law Journal*). Professor Bergsten adds a practical observation:

> The overwhelming reason for not proposing your suggested text [i.e., the text in Appendix A] as a convention is that it is too short. That may sound silly, but a convention is heavy artillery. . . . Just as the army does not use a 155 mm howitzer to take out a single sniper, so one does not use a convention for a single substantive paragraph, no matter how important the rule in that paragraph.

Uniform model-law approach: States that are prepared to adopt the Rule through a treaty therefore may simply prefer to enact it into national law based on a model-law template. This sometimes is referred to as a uniform model-law approach because, whenever a rule is formulated as a model law, the intention is for states to adopt the law in as uniform a manner as possible.[260] Such an approach would be almost as effective as a treaty because, like a treaty, a model law would equally bind residents of states that have adopted it. Indeed, a model law, once adopted, is part of a state's national law, whereas treaties may have to provide that their rules be separately enacted by the state into national law in order to bind residents.[261]

Another way of thinking about this is that a model law represents parallel legislation—a uniform text that is intended to be enacted into the national law of each state—whereas a treaty or convention represents an international agreement between states. Yet the parties on which this Article focuses—investors, intermediaries, and their creditors—are not themselves states. Therefore, in order to bind these parties to the Rule, a treaty would have to require each ratifying state to enact the Rule into national law. From the standpoint of these parties, enacting a model law based on the Rule would have the same effect.

This is not to say, however, that a model-law approach is categorically better than a treaty for implementing the Rule. A treaty approach, for example, could use the negotiation process to build con-

E-mail from Eric E. Bergsten, *supra* note 258.

260. *See, e.g.*, Memorandum from Jay L. Westbrook, *supra* note 259, at 3-4 (observing, in the context of UNCITRAL's Model Law on Cross-Border Insolvency, that "[w]here the text is a model law, it is understood that it should be adopted in as uniform a manner as possible, but that some adjustments to fit each national legal system are inevitable"); *see also* UNITED NATIONS, UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY WITH GUIDE TO ENACTMENT 23 (1999) (noting that when incorporating the text of a model law into its legal system, a state may modify or leave out some of its provisions, whereas in the case of a treaty the possibility of changes being made to the uniform text—referred to as "reservations"—is much more restricted).

261. In the United Kingdom, for example, a treaty becomes effective in international law when ratified by the Queen but usually has no effect in municipal law until approved by Parliament. MALANCZUK, *supra* note 256, at 66. Most Commonwealth countries (including Canada and India) follow English tradition. *Id.*; *cf.* JANIS, *supra* note 256, at 95-99 (discussing countries in which the legislature participates in the process of ratification, so that ratification becomes a legislative act and the treaty becomes effective in international and national law simultaneously); Jordan J. Paust, *Self-Executing Treaties*, 82 AM. J. INT'L L. 760, 771-75 (1988) (explaining when a treaty is "self-executing" and may be applied by U.S. courts without further legislative action).

sensus around the Rule and increase its perceived legitimacy.[262] Any state unwilling or unable to ratify the treaty always could choose to enact national legislation consistent with the Rule. Also, a model law lacks an international oversight mechanism to ensure the consistency of each national law enacted pursuant to the template, whereas a treaty could create such an oversight mechanism.[263] The ultimate choice of whether to implement the Rule through a model law or a treaty therefore will be a political decision.

Model contract language approach. It is unrealistic, however, for the Rule to be implemented through model language for parties to incorporate into their contracts. This is because the parties primarily intended to be governed by the Rule—creditors of intermediaries—are not parties to, and therefore are not bound by, contracts between intermediaries and investors.[264] In contrast, a state that enacts the Rule into its national law thereby binds not only intermediaries and investors but also creditors of intermediaries that are resident in that state.

This Article therefore proposes that the Rule be implemented through a model law. Implementation, however, is always imperfect in international law because there is no centralized legislative or adjudicatory source of lawmaking.[265] Neither a model law nor, indeed, a treaty can bind creditors from states that choose not to participate. Nonetheless, as more states enact the Rule as a model law, more creditors will become bound thereby and its influence will increase.[266]

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262. Professor Garcimartin further argues that "a convention has more 'autoritas' than a uniform law. Politicians take more seriously a convention (signed by other states) than a model law [and therefore] are more [willing] to put it in the political agenda." E-mail from Francisco Garcimartin, Professor of Law, Autonomous University of Madrid, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Jan. 5, 2001) (on file with the *Duke Law Journal*).

263. *Cf.* Schwarcz, *supra* note 256, at 1017 n.352 (arguing for a treaty rather than uniform legislation to implement a sovereign debt-restructuring scheme).

264. Indeed, even if intermediaries separately attempted to bind each of their creditors to the Rule, they could not bind involuntary creditors, such as tort creditors.

265. *See* BUERGENTHAL & MAIER, *supra* note 252, at 19 (observing that "[v]iewed in terms of law-making, international law is a primitive legal system").

266. For example, legislation based on UNCITRAL's 1985 Model Law on International Commercial Arbitration has been enacted to date in more than thirty states. UNITED NATIONS COMM'N ON INT'L TRADE LAW, STATUS OF CONVENTIONS AND MODEL LAWS 13, *available at* http://www.uncitral.org/en-index.htm (last modified Jan. 17, 2001) (on file with the *Duke Law Journal*); *see also* JACK J. COE, JR., INTERNATIONAL COMMERCIAL ARBITRATION: AMERICAN PRINCIPLES AND PRACTICE IN A GLOBAL CONTEXT 96 (1997) (observing that this Model Law "enjoys global recognition"). Legislation based on UNCITRAL's 1996 Model Law on Electronic Commerce has been enacted to date in more than a dozen states. UNITED NATIONS

CONCLUSION

Worldwide financial markets are increasingly dependent on structures in which an intermediary and investors share beneficial rights in assets held by the intermediary. This creates uncertainty, however, whether creditors of the intermediary, in the event of its failure, can claim against all of these assets or merely against the intermediary's interest therein. The uncertainty, in turn, increases the costs for parties engaging in these transactions, and may discourage certain of these transactions altogether. Furthermore, this "intermediary risk"—that an intermediary's creditors can claim against an investor's interest in assets held by the intermediary—can be systemic: the failure of an intermediary can trigger a chain reaction of failures of investors that contract with the intermediary.

The issue of intermediary risk nonetheless remains generally unresolved under existing legal systems. Although some states have attempted to resolve it by statute in the context of a single transaction pattern, there has been no attempt to examine intermediary risk in a larger context. Resolution is important, however, not only to reduce costs and minimize systemic risk. As a theoretical matter, intermediary risk raises innovative legal issues that blur the boundaries between commercial law and property. Moreover, the analysis of intermediary risk yields insights into the broader question of whether rights of one party in assets, in which a second party also shares rights, will be subject to claims of the second party's creditors.

This Article examines intermediary risk in that larger context by starting from first principles. It shows that the issue of intermediary risk conceptually turns on whether contracts that allocate partial

COMM'N ON INT'L TRADE LAW, *supra*, at 14. Model legislation also has been influential as a basis for treaties. Thus, the Organisation for Economic Cooperation and Development (OECD) and several capital exporting states, including the United States, have formulated a model bilateral investment treaty that has been widely adopted. Memorandum from Katherine Topulos, Foreign & International Law Librarian, Duke University School of Law Library, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Dec. 19, 2000) (describing a telephone conversation on December 18, 2000, with David Renz, the Bilateral Investment Treaty Coordinator at the U.S. State Department, in which Mr. Renz informed Ms. Topulos that all recent treaties were negotiated from the 1994 Model Bilateral Investment Treaty, and many of them are very similar to the model treaty (except for the annex exceptions which are country-specific), and that of the ten treaties approved by the [U.S.] Senate in 2000, eight have been based on the Model) (on file with the *Duke Law Journal*). The OECD's Model Tax Convention has been similarly influential. ORG. FOR ECON. COOPERATION & DEV., MODEL TAX CONVENTION (noting that almost 350 treaties between OECD member countries, and over 1,500 treaties in all, are based on this model), *available at* http://www.oecd.org/daf/fa/treaties/treaty.htm (last modified Feb. 1, 2001) (on file with the *Duke Law Journal*).

property rights between intermediaries and investors should be enforceable. Then it analyzes the enforceability of these contracts, concluding they should be enforced notwithstanding externalities imposed on creditors of the intermediaries. More simply put, if in the context of one of these transaction patterns a given transfer of assets would constitute a sale, then the fact that only an undivided interest in those assets is being transferred should not defeat sale treatment. Thus, for each transaction pattern in which intermediary risk arises, a creditor of the intermediary should not be able to reach an investor's undivided interest.

This conclusion, that there should be no intermediary risk, is normative. In actuality, there remains uncertainty whether externalities would prevent contract enforcement, especially given that many transactions cross national borders. In that context, I analyze how this normative thesis can be implemented into law that binds parties in different states, concluding that a model law could best accomplish this purpose. Finally, I propose a text of such a law.[267]

267. In that context, I also discuss the relationship between this Article's model-law approach to intermediary risk and the conflicts of law approach undertaken by the Hague Conference on Private International Law. *See infra* Appendix B.

APPENDIX A
PROPOSED MODEL LAW TO REGULATE INTERMEDIARY RISK

(a) The transfer of an undivided fractional interest in property shall constitute a valid and enforceable transfer of that interest to the same extent and in the same manner as if that interest had been a separate asset.

(b) The transfer shall not be affected by the fact that the property in which the interest is being transferred is itself an undivided fractional interest.

(c) Holders of property in which undivided interests have been transferred shall, to the extent of such transfers, be deemed to hold such property for their transferees, but only transferors and transferees that are in privity may prosecute rights directly against each other on account of such transfers.[268]

268. States that have regulatory schemes protecting investors from the consequences thereof may wish to consider whether to adopt a non-uniform exception favoring an intermediary's secured creditors over investors, as discussed *supra* in Part IV.B. Also, because the consequences of enforcement and non-enforcement "may be influenced by the transactional context," *supra* note 177 and accompanying text, this Article only balances the consequences of enforcement and non-enforcement in three such contexts. *See supra* Part III.B. States may wish to consider whether to restrict enactment of the Model Law to those contexts.

APPENDIX B
RELATIONSHIP BETWEEN A MODEL-LAW AND CONFLICTS OF LAW APPROACH

In May 2000, the Hague Conference on Private International Law placed the issue of intermediary risk on its priority agenda.[269] By its organizational mandate, the Hague Conference intends to address this risk through conflicts of law rules, as opposed to a model substantive law approach such as that proposed in this Article.[270] This Appendix describes the relationship between these approaches.[271]

Before doing so, however, it should be noted that there are other differences between the way in which the Hague Conference and this Article examine intermediary risk. The Hague Conference only examines this risk in the indirect holding system for securities.[272] This Article also examines intermediary risk in securitization, loan participation, and by analogy similar transactions. Furthermore, even within the indirect holding system for securities, the Hague Conference focuses on intermediary risk primarily from the standpoint of a party (such as a lender) extending secured credit to an investor, not from the standpoint of the investor.[273] Yet the issue of intermediary risk is as important for investors as for lenders. This narrow focus might reflect that lenders have been more vocal than investors in demanding a legal solution. After all, lenders typically rely on counsel and legal opinions for assurance that their security interests in collateral have priority over competing claims, and therefore are forced to grapple with the issue of intermediary risk on a daily basis.[274] Investors, in contrast, less commonly retain counsel to advise on the legal nature of

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269. *See supra* note 46 and accompanying text.

270. *See supra* note 47.

271. The author thanks Francesco Parisi and Larry Ribstein for helpful discussions on conflict of law issues related to those discussed in this Appendix.

272. BERNASCONI, *supra* note 44, at 5-6.

273. *See id.* at 8 (claiming that, "in practice, it is normally in relation to collateral transactions that the most significant issues tend to arise").

274. This Article nonetheless addresses a collateral issue not addressed by the Bernasconi Report: whether an intermediary's secured creditors should be able to gain priority over unencumbered property interests previously sold by the intermediary to investors. *See supra* note 238 and accompanying text (observing that, although Article 8 of the UCC enables secured creditors that "control" the intermediary's interest to gain priority over the investor even though the investor has not consented to subordinate his interest, "[t]his exception appears extraordinary because it subordinates a third party's ownership interest to a security interest given without consent of the owner").

investments in securities; they therefore may be less aware of the issue.[275]

Setting aside these differences, what is the relationship between a conflicts of law approach to intermediary risk and one based on a model substantive law? From a lender's standpoint, both approaches must address the problem that intermediary risk undermines the "absolute assurance" needed by lenders that "the collateral being pledged [to them] is enforceable against third parties."[276] Such assurance requires that "[i]n the event of the insolvency of either the [investor] as collateral provider, or the financial intermediary, the [lender] has a perfected interest (either through outright ownership or a valid security interest) in the collateral, free from the grasp of the [investor's], or the financial intermediary's, other creditors."[277]

Under existing legal systems, however, a lender can rarely obtain this assurance because it will not know, without consulting counsel in the investor's, each intermediary's, the issuer's, and perhaps other jurisdictions, whether its security interest has priority over the investor's and each intermediary's creditors. This uncertainty reflects that, in an indirect holding system, a proprietary interest in securities may

> have a nexus with multiple jurisdictions—that of the issuer's place of organisation, the place where the underlying securities are physically located [in the case of securities evidenced by a certificate], the place where the register recording the interests [in securities] is maintained (assuming the securities are in registered form), the place where each intermediary maintains its records evidencing the book-entry interest and the place where the investor is located.[278]

The transaction costs of consulting counsel in so many jurisdictions can be prohibitive.

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275. Notwithstanding its focus on collateral transactions, the Hague Conference's approach might turn out to have broader applicability. *See, e.g.*, BERNASCONI, *supra* note 44, at 8 (noting that "there seems to be no reason to distinguish for this purpose title transfers under collateral transactions from ordinary transfers by way of sale"); *see also id.* at 61 (concluding that its conflict of law recommendation "should apply not only to transactions that involve the taking of collateral but to outright sales of securities that are held through tiers of intermediaries").

276. Thieffry & Bridson, *supra* note 44, at 2.

277. *Id.*; *see also* BERNASCONI, *supra* note 44, at 1 (arguing that a lender needs to know, before extending credit to an investor under the Report's typical fact pattern, "which requirements have to be fulfilled so as to ensure that the [lender] will receive an interest that will prevail over the interests of third parties").

278. Thieffry & Bridson, *supra* note 44, at 2; *see also* BERNASCONI, *supra* note 44, at 16-17 (presenting a straightforward hypothetical situation to illustrate the complexity of jurisdictional questions in an indirect holding system).

A conflicts of law approach would address this problem by imposing international rules to clarify which jurisdictions' laws are applicable, thereby reducing transaction costs.[279]

However, a conflicts of law approach cannot, by itself, fully resolve this problem. Sometimes conflict of law rules might point, for example, to a jurisdiction whose substantive law effectively subordinates the lender's security interest to rights of the investor's or an intermediary's creditors. Also, the foregoing conflict of law discussion has assumed that the lender is collateralized by a *proprietary interest* in securities. Sometimes there is uncertainty whether the collateral is a property right in underlying securities or merely an in personam claim against the immediate intermediary.[280] Then, "[n]o collateral taker would likely assume [the] intermediary insolvency risk."[281]

A model-law approach, in contrast, would conclusively solve these problems to the extent nations harmonize their substantive laws to clarify that investors in indirect holding systems hold, and therefore lenders to such investors would be collateralized by, proprietary interests in securities as to which lower-tier holders (such as investors) always have priority over upper-tier holders (such as intermediaries) and their creditors. This is the approach that I have taken in this Article.[282]

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279. BERNASCONI, *supra* note 44, at 29, 31-39. A related but lesser concern is that it also may be difficult to know under the general *lex situs* conflict of laws rule where the investor's interest is located for purposes of perfecting the investor's transfer of collateral. Thieffry & Bridson, *supra* note 44, at 2.

280. BERNASCONI, *supra* note 44, at 20, 29.

281. Thieffry & Bridson, *supra* note 44, at 3. Randall Guynn argues, however, that there is no such uncertainty in intermediary holding systems and that the "only real question that persists" is whether the nature of the investor's right is "like an Article 8 'security entitlement' or a Belgian 'co-property right in a notional pool of securities,' on the one hand, or whether it is a traditional property right that is traceable through the intermediaries to the underlying individual securities, on the other," a distinction that would influence the choice of law. E-mail from Randall Guynn, *supra* note 58. *If this is indeed the only open question*, then intermediary risk could be contained by ensuring that transfers of interests in securities are perfected under applicable law in accordance with the Hague Conference's conflicts of law approach.

282. *See* E-mail from Randall Guynn, *supra* note 58 (concluding that "[o]nly after all jurisdictions modernise, and ideally standardize[,] their laws[] will we mitigate further the risks, legal uncertainties and additional costs associated with cross-border collateral transactions"); *see also* UNIDROIT Secretariat, *supra* note 48, at 2 (arguing in support of the need to harmonize the substantive laws in this area because, even after adoption of a conflicts of law approach, "numerous legal issues (as well as issues of economic inefficiencies generated by present arrangements) will have to be addressed").