Pledged Securities: The Pledgee's Duty to Preserve Value Under the Uniform Commercial Code

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PLEDGED SECURITIES—THE PLEDGEE’S DUTY TO PRESERVE VALUE UNDER THE UNIFORM COMMERCIAL CODE

Corporate stocks and bonds are quite commonly pledged as collateral for secured loans. However, problems can arise in these transactions where the pledgor’s stocks and bonds are in the possession of the secured pledgee. Action may have to be taken to convert or redeem convertible bonds or debentures in the pledgee’s possession. Common stock may fluctuate in value due to factors relating to the issuing company or because of general market conditions. The secured party in possession of the collateral may wish to act to improve or protect his position as creditor. More importantly, the borrower-pledgor may desire to sell or exchange the securities involved in order to prevent or limit his financial losses. In all these situations there may be a problem either because of the pledgee’s failure to act or because of his unwillingness to cooperate with the pledgor's wishes.

The duties of a pledgee are set out in section 9-207 of the Uniform Commercial Code. Unfortunately, the section and the accompanying official comments do not deal directly with the problems created by the use of securities as pledged collateral. The purpose of this comment is to examine the application of

1. See, e.g., 1A BENDER'S U.C.C. SERV. § 14.01[1], at 1502 (1978) [hereinafter cited as BENDER].
2. A debenture is a bond which carries with it the privilege of conversion or exchange for the common stock of the company at a fixed price. If the price of the common stock increases beyond that fixed price, the market price of the debenture will increase accordingly. Some debentures also have a redemption feature which permits the issuer to redeem the bond at face value (or at a slight premium) prior to maturity. See P. Wyckoff, Dictionary of Stock Market Terms 46, 65 (1964).
3. (1) A secured party must use reasonable care in the custody and preservation of collateral in his possession. In the case of an instrument or chattel paper reasonable care includes taking necessary steps to preserve rights against prior parties unless otherwise agreed.
   . . .
   (3) A secured party is liable for any loss caused by his failure to meet any obligation imposed by the preceding subsections but does not lose his security interest.

U.C.C. § 9-207. Unless otherwise indicated all references will be to the 1972 version of the Uniform Commercial Code.
the Uniform Commercial Code to this area of financial dealing in an effort to synthesize a formula which describes the duty of a pledgee of securities.

I. THE CODE — WHERE THE QUESTIONS ARISE

Article 9 of the Uniform Commercial Code applies to security interests created in a variety of types of personal property, including "instruments." The term "instruments," in turn, is defined to include "securities," such as stocks, convertible debentures, and stock warrants and bearer bonds. Under the 1972 version of the Uniform Commercial Code, a security interest in "instruments" can be perfected under the Code only, with one exception, if the secured party has possession. Thus, when stocks or bonds are used as collateral, the transaction must take the form of a "pledge." Section 9-207 defines the rights and duties of a secured party who has possession of the collateral. Subsection (1) states the general rule: "A secured party must use reasonable care in the custody and preservation of collateral in his possession. In the case of an instrument or chattel paper reasonable care includes taking necessary steps to preserve rights against prior

4. Id. § 9-102(1).
5. Id. § 9-105(1)(i). The 1977 version of the Code further defines a "certificated security" as follows:
   A "certificated security" is a share, participation, or other interest in property of or an enterprise of the issuer or an obligation of the issuer which is
   (i) represented by an instrument issued in bearer or registered form;
   (ii) of a type commonly dealt in on securities exchanges or exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment; and
   (iii) either one of a class or series or by its terms divisible into a class or series of shares, participations, interests, or obligations.
9. U.C.C. § 9-204(1). The exception is the 21-day period of perfection available when the instrument is delivered for sale or exchange. Id. § 9-304(5)(b).
parties unless otherwise agreed.”12 None of the more specific provisions apply to investment securities.

The first sentence contains the basic proposition of the section.13 Difficulty arises in applying this sentence because “reasonable care in the custody and preservation of collateral” is not defined in the Code.14 Further, although the standards by which it is to measured may be determined by agreement between the parties, the general duty of the pledgee to exercise “reasonable care” may not be waived.15 Thus, the duties of the pledgee will continue to depend upon what constitutes “reasonable care” and “‘reasonable care’ will continue to be what the judges say it is.”16

The second sentence of subsection 9-207(1) applies only when certain intangibles are involved. Where the collateral is an instrument or chattel paper, the pledgee must take “necessary steps to preserve rights against prior parties unless otherwise agreed.”17 Since the Code uses the words “prior parties,” which suggests a negotiable instruments situation, it is not particularly helpful when investment securities are pledged.18 It is unclear whether the sentence is meant to be exclusive in defining what “reasonable care” involves for pledgees of intangibles. Further, this express duty will not exist where it is “otherwise agreed.” Thus, a great deal of uncertainty is built into the Code section by its own terms.

The official comments to section 9-207 add further guidance, but still leave much uncertainty. Comment 1 indicates that, “Subsection (1) states the duty to preserve collateral imposed on a pledge at common law.”19 The comment also directs the reader to sections 17 and 18 of the Restatement of Security, which is an authoritative statement of the pre-Code common law.20 Section 17 provides for a general “duty of reasonable

12. U.C.C. § 9-207(1).
13. 2 G. Gilmore, Security Interests in Personal Property § 42.2, at 1129 (1965) [hereinafter cited as Gilmore].
15. U.C.C. § 1-102(3).
16. Gilmore, supra note 13, § 42.2, at 1130. See also Duty of a Pledgee, supra note 14, at 301-02 n.8.
17. U.C.C. § 9-207(1).
18. Gilmore, supra note 13, § 42.3, at 1135.
20. Gilmore, supra note 13, § 42.1, at 1129 n.4.
care” for pledgees in possession of collateral.21 One of the comments to that section defines “reasonable care” as “that which a reasonable man under like circumstances would recognize as necessary to prevent his conduct from creating an unreasonable risk of harm to the pledgor’s chattel.”22 Although another comment indicates that, “The rule of reasonable care expressed in this Section is confined to the physical care of the chattel,”23 it also indicates that the pledgee “has other duties in certain circumstances”24 and refers to section 18 of the Restatement of Security.

Section 18 provides that, “Where instruments representing claims of the pledgor against third persons are pledged, the pledgee has the duty of using reasonable diligence to preserve and collect the claims or to enable the pledgor to undertake such preservation and collection.”25 Just as with the second sentence of section 9-207, these provisions are not clearly applicable to pledges of investment securities because they use terms suggesting negotiable instruments. Furthermore, one of the comments expressly provides that, “The pledgee is not liable for a decline in the value of pledged instruments, even if timely action could have prevented such decline.”26 However, the same comment notes that the duty imposed by this section “is in addition to the rule of reasonable physical care stated in § 17”27 and the section certainly does indicate that the duty of the pledgee extends beyond mere physical maintenance.

Again drawing from the Restatement of Security,28 the comments to section 9-207 do make one specific suggestion as to how a pledgee may be able to fulfill his duty of reasonable care: “In many cases a secured party . . . may satisfy this duty by notifying the debtor of any act which must be taken and allow-

21. RESTATEMENT OF SECURITY § 17 (1941).
22. Id. § 17, Comment b.
23. Id. § 17, Comment a. This is the first line of defense for the lender who is being sued for a loss not caused by physical deterioration of the collateral. See, e.g., Dubman v. North Shore Bank, 85 Wis. 2d 819, 271 N.W.2d 148 (Ct. App. 1978).
24. RESTATEMENT OF SECURITY § 17, Comment a (1941).
25. Id. § 18.
26. Id. § 18, Comment a.
27. Id. (emphasis added).
28. RESTATEMENT OF SECURITY § 18, Comment a, reads in part: “If the pledgee makes it possible by notice and other action appropriate in the circumstances, for the pledgor to enforce pledged instruments, the pledgor cannot complain of the pledgee's non-action.”
ing the debtor to perform such act himself." Professor Gilmore suggests that this option to notify modifies both the duty to physically maintain the collateral as well as the duty to preserve actions against third parties. Presumably, it would also apply to the unique duties of the pledgee of investment securities.

It is apparent that the pledgee's duty under the Code is somewhat amorphous where investment securities are involved. The nature of the collateral may be part of the reason. Unlike tangible goods, securities have a value which is usually not closely related to their physical condition or form. The rights of the owner or holder against third parties assume a greater significance, as in the case of negotiable instruments. However, the Code makes no special provision for the preservation of these rights by the creditor-pledgee of investment securities. Thus, a party seeking to impose such a duty on a pledgee must rely on an expansive definition of "reasonable care" under section 9-207.

The issue as to the scope of the duty of a pledgee of investment securities arises in two types of situations. In both, action may be required of the pledgee in order to preserve the value of the collateral. The first type of situation involves action in the nature of an exchange, such as the conversion of bonds into stock or the exchange of stock pursuant to a reorganization or merger. The conversion or exchange may be mandatory or optional.

Section 21 of the Restatement of Security (which is not referred to in the Code comments) deals with the situation where action is required, but where there is a choice of alternatives. For example, in the case of convertible debentures called for redemption, they must either be converted or redeemed. The Restatement section provides that the pledgor may exercise the choice and that the pledgee is to "perform any act within his power which is necessary to effectuate this choice." Furthermore, where only the pledgee knows of the necessity for changes, he has a duty to notify the pledgor. However, where

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30. GILMORE, supra note 13, § 42.4, at 1136.
31. Id.
32. RESTATEMENT OF SECURITY § 21 (1941).
33. Id. § 21(1).
34. Id. § 21(2).
the pledgor refuses or neglects to choose, the pledgee’s choice of action is binding on the pledgor.\textsuperscript{35}

Section 21 does not apply where the change is merely optional; a pledgor in that situation may not compel the pledgee to act.\textsuperscript{36} The scope of the pledgee’s duty where action is permissive is unclear, because “reasonable men might differ on its advisability.”\textsuperscript{37} Pre-Code case law produced a split of authority in this regard. The apparent majority espoused the position that a creditor would not be obligated to take affirmative action “when it would require the expenditure of funds or the assumption of risks or performance of burdensome acts.”\textsuperscript{38} Other courts, however, imposed a duty to act if the very nature of the collateral required it.\textsuperscript{39} Thus, neither the Code nor pre-Code common law is clear on who has the ultimate power of decision in such situations.\textsuperscript{40}

Even in the case of actions which are required, the Code does not expressly provide whether it is the pledgor or pledgor who is to take the action called for. It is suggested that a duty on the part of the pledgor may be implied from the rule of the second sentence of section 9-207(1). “It seemes [sic] reasonable . . . to take the negotiable instrument formula of . . . § 9-207(1) as illustrative of the types of action which may have to be taken against third parties, without a nice regard to whether the particular action is well described as a step in preserving rights against a prior party.”\textsuperscript{41} Even so, the parameters of such a duty are still without definition.

As mentioned earlier, the comments to section 9-207(1) suggest that notifying the pledgor and allowing him to act can discharge the duties of a pledgee. This would seem to be a convenient method of satisfying the pledgee’s duty of reasonable care in the convertible debentures cases. However, a secured party who turns a stock or bond over to the debtor for such purposes as presentment or registration of transfer will retain a perfected interest for only twenty-one days thereafter.\textsuperscript{42}

\textsuperscript{35} Id. § 21(3).
\textsuperscript{36} Id. § 21, Comment a.
\textsuperscript{37} GILMORE, supra note 13, § 42.3, at 1134.
\textsuperscript{38} Murray, Secured Transactions—Defenses of Impairment and Improper Care of Collateral, 79 COM. L.J. 265, 270 (1974).
\textsuperscript{39} Id.
\textsuperscript{40} GILMORE, supra note 13, § 42.3, at 1134.
\textsuperscript{41} Id. § 42.3, at 1135.
\textsuperscript{42} See id. § 42.4, at 1136.
Thus, notifying the pledgor and allowing him to act may not be advisable for a pledgee of investment securities if he is not certain he will regain possession within twenty-one days.

Applying section 9-207(1) to the second type of problem situation in investment security pledges is even more difficult because there is virtually no Code language to rely upon. This is the situation where, because of a decline in the value of the collateral due to market forces, action is appropriate to limit the pledgor's losses. As mentioned earlier, under common law, the pledgee was not liable for the mere decline in the market value of the security. Where the pledgee fails to take such action, the pledgor may seek to impose liability, not for the decline in the market value of the securities, but for the pledgee's failure to assist the pledgor in limiting his losses. Courts have had difficulty in attempting to define the duty of the pledgee in this second type of situation because of the highly discretionary nature of the action.

Several of the questions raised by the two situations described above are left unanswered by the Code and the pre-Code common law. Consequently, the task of providing answers to these questions under the Code has devolved upon the courts.

II. The Courts' Answers to Some of the Questions

All of the cases decided under section 9-207 have fallen into the two types of problem categories outlined above. Most of the cases dealing with the first type of situation where action in the nature of an exchange is called for have involved convertible debentures pledged as collateral which were called for redemption. Since the price of the underlying common stock into which the debentures could have been converted exceeded the face value of the debentures, the pledgee's failure to exercise the conversion privilege resulted in an obvious financial loss to the pledgor. Because the appropriate response by the pledgee is rather clear in such cases, the arguments for finding liability for his failure to take the appropriate steps are relatively strong.

However, in the second type of situation where the pledgor requests the return of the collateral so that he can limit his

43. Restatement of Security § 18, Comment a (1941).
losses in the market, the appropriate response on the part of the pledgee is not as obvious because the results of a given choice cannot be predicted with certainty. Consequently, the reasons for imposing liability are not as strong. These differences in the factual settings of the cases may explain, in part, why the courts have arrived at diverse answers to the questions not answered by the Code.

A. More Than a Duty to Preserve Form

A prerequisite to imposing liability on the pledgee in these cases is the conclusion that his duty of "reasonable care" includes a duty to act to preserve value in some circumstances. A majority of the courts applying section 9-207 have interpreted "reasonable care" to encompass a duty to preserve value. However, the courts do not agree on how to justify this finding of duty or how to define its precise nature.

1. The Convertible Debenture Cases

The courts are divided on the basis of the duty to preserve value in the convertible debenture case. In Traverse v. Liberty Bank & Trust Co., the court recognized a duty to preserve value noting that, "[T]he holder of commercial paper on pledge was responsible for more than the physical preservation of the paper" under the common law. The court did not rely upon the second sentence of section 9-207 in finding this extended duty of reasonable care. "The process of charging endorsee . . . can result in damage to the value of the collateral. Certainly there cannot be a duty on a pledgee to convert in all cases . . . ." Relying on common law, the court applied a flexible definition of reasonable care, "taking into account all of the circumstances of the pledge and the character of the property pledged." However, the court attempted to remain close to the idea of physical preservation by relating value to form. "In the instant case, after the notice of call, it became impossible

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45. Id. at 539. See also RESTATEMENT OF SECURITY § 18 (1941).
46. 5 UCC REP. SERV. at 539 (emphasis in original).
47. Id. at 539 (citing Hibernia Bank & Trust Co. v. Turner, 156 Miss. 842, 127 So. 291 (1930)).
for the pledgee to hold the property precisely in its original form. Either the debentures had to be changed to stock . . . or to non-convertible debentures of low value . . . .”48 By finding the duty to preserve value in the general definition of reasonable care and by relating it to the duty to preserve form, the court allowed the pledgee some discretion. The court only required the pledgee to use good judgment in fulfilling his duty of reasonable care.

In another convertible debentures case, Grace v. Sterling, Grace & Co.,49 the court also found that, “Where commercial paper or other securities are placed in the custody and control of the pledgee, it is clear that his responsibility is not limited solely to the physical preservation of the same.”50 In contrast to Traverse, the court based the pledgee’s duty to preserve value on the negotiable instrument language of section 9-207.

[W]here bearer or negotiable instruments, taken as collateral, mature before the payment of the secured indebtedness, the pledgee is required . . . to take such action as reasonable prudence suggests to preserve the value of the collateral . . . . By analogy, it follows that where pledged convertible debentures are called at par . . . , he may be required in the exercise of reasonable care to do more than just stand by and wait for payment of the face value of the securities.51

Although the language of the second sentence of section 9-207 is mandatory, the court did not impose a duty on the pledgee to act in all circumstances. Instead the pledgee was only required “to take such action as reasonable prudence suggests.”

Reed v. Central National Bank52 relied on the Grace decision’s negotiable instruments rationale and adopted the same definition of reasonable care.53 However, Siedman v. Merchant’s Bank54 refused to base the pledgee’s duty in a convertible debentures case on the preservation of rights language of section 9-207. “Where other rights, such as conversion, are con-

48. 5 UCC REP. SERV. at 540.
50. 30 App. Div. 2d at 64, 289 N.Y.S.2d at 637.
51. Id. at 64, 289 N.Y.S.2d at 638.
52. 421 F.2d 113 (10th Cir. 1970) (also a convertible debentures case). See also 59 Ga. L.J. 240 (1970).
53. The rule was also noted in Brodheim v. Chase Manhattan Bank, 75 Misc. 2d 285, 347 N.Y.S.2d 394 (Sup. Ct. 1973) (pledgee held not liable on other grounds).
cerned, the duties imposed by law differ. There is no absolute duty on the part of the pledgee to make an exchange of one security for another.\textsuperscript{55} Apparently relying on the general reasonable care duty of section 9-207, the court imposed a duty to preserve value dependent upon the circumstances of each case.

Whether there is a duty on the pledgee either to make the conversion itself without notice or to make it with notice; or to advise the pledgor of the advisability of doing so, or to advise the pledgor of the circumstances, . . . which affect the value of the collateral, depends in the final analysis on the circumstances of each case.\textsuperscript{56}

\textit{Tallahassee Bank & Trust Co. v. Bryant}\textsuperscript{57} involved a fact situation analogous to the convertible debenture cases. In that case a bank had failed to return stock warrants\textsuperscript{58} to the pledgor prior to their expiration date. The court refused to find "that the Bank had any specific duty to sell or otherwise dispose of the worthless warrants"\textsuperscript{59} and held that "the provisions of the Uniform Commercial Code have not cast an absolute duty upon the Bank."\textsuperscript{60} However, the court did recognize a duty to preserve value and that the provisions of the Code were to aid "the trial court and the parties in developing the standard of care."\textsuperscript{61}

Thus, the convertible debentures cases all impose a duty to preserve value on the pledgee of investment securities. The cases are split, however, on whether to base the duty on the reasonable care language of the first sentence of section 9-207 or on an analogy to the negotiable instruments language in the second sentence of that section. In either event the courts do not impose a strict duty to act upon the pledgee in these situations, but are willing to impose liability only when the circumstances indicate that a prudent pledgee should have acted.

\textsuperscript{55} Id. at 883.
\textsuperscript{56} Id. at 883-84.
\textsuperscript{57} 271 So. 2d 190 (Fla. Dist. Ct. App. 1972).
\textsuperscript{58} A stock warrant is a "privilege granted by a corporation which gives the holder the right to purchase a specific number of shares of stock . . . at a certain price until a stipulated future date. Warrants may have a market value, particularly a speculative value, based on a possible rise in price of the stock named in the warrant." P. WYCKOFF, \textsc{Dictionary of Stock Market Terms} 264 (1964).
\textsuperscript{59} 271 So. 2d at 193.
\textsuperscript{60} Id.
\textsuperscript{61} Id.
2. The Market Decline Cases

As might be expected, in the cases involving the pledgee’s failure to take affirmative action in the marketplace, the courts display a greater reluctance to recognize and apply a duty to preserve value. In *Hutchison v. Southern California First National Bank*, the pledgor, who was in default, sought the pledgee’s consent to a complicated stock and stock option transaction. The court held as a matter of law that the pledgee’s refusal to consent did not constitute a failure to exercise reasonable care, “assuming, without deciding,” that the pledgee’s duty was as expansive as some of the earlier cases had held. On facts similar to those in *Hutchison* the federal district court in *Fidelity Bank & Trust Co. v. Production Metals Corp.* came to an almost identical conclusion. Rejecting apparently inconsistent prior state law, the district court assumed, but did not decide, that the New Jersey courts would interpret section 9-207 of the U.C.C. “to impose upon a pledgee the duty of exercising reasonable care in the preservation of the value of collateral in his possession.” However, the court found that the circumstances of the case justified the bank’s refusal to cooperate with the pledgor. The federal court’s prediction about the New Jersey court was not entirely accurate. In *New Jersey Bank v. Toffler*, the court read section 18 of the *Restatement of Security* as placing the burden of preserving value on the pledgor. The court relied on the comment to that section mentioned earlier that, “The pledgee is not liable for a decline in the value of pledged instruments, even if timely action could have prevented such decline.” On the other hand, the court concluded that, “[O]ur law does not hold a pledgee responsible for a decline in the market value of securities pledged to it as collateral absent a showing of bad faith or a negligent refusal to sell after demand.” Although the opinion is not clear, it seems to indicate

63. Id. at 582, 103 Cal. Rptr. at 822.
65. Id. at 617 (citing Franklin Trust Co. v. Goerke, 116 N.J.L. 529, 185 A. 39 (1936)).
67. Id. at 619.
70. 139 N.J. Super. at____, 353 A.2d at 118.
that there may be a duty for the pledgee to act in some cases. However, because neither exception was present in that case, the court did not explain what the duty was or what would constitute bad faith or negligence.

The Wisconsin case of Dubman v. North Shore Bank, 71 like Hutchison and Production Metals, also involved a pledgee bank’s refusal to cooperate in a complex stock transaction. This court did not follow Grace and subsequent cases recognizing a duty to preserve the value of collateral. 72 However, the facts of the case made it unnecessary for the court to decide whether the duty of reasonable care should include such a duty, because the bank’s action was reasonable, even under the proposed preservation of value analysis. 73

In Capos v. Mid-America National Bank 74 the pledgee bank had simply failed to sell pledged corporate stock when it was declining in value. The Court of Appeals for the Seventh Circuit specifically held that “a bank has no duty to its borrower to sell collateral stock of declining value.” 75 The court noted that the negotiable instrument language of section 9-207(1) and of the Restatement of Security would not “appear to have any pertinence to the mere diminution in market value of securities.” 76 However, in dicta distinguishing the Grace and Reed cases, the court did indicate that the failure to exercise conversion rights might fall within the duty of care set forth in the second sentence of section 9-207(1). 77

Although not as clear as the convertible debenture cases, the majority of cases involving the pledgor’s request for the return of his collateral certainly do not appear to reject the proposition that the duty section 9-207 imposes when securities are collateral encompasses more than the mere physical preservation of the pledged property. However, all of the cases decided under section 9-207 recognize that the pledgee must be able to exercise discretion in fulfilling his duty of reasonable care under that section. Consequently, many factors are rele-

71. 85 Wis. 2d 819, 271 N.W.2d 148 (Ct. App. 1978).
72. Id. at 824-25, 271 N.W.2d at 151.
73. Id. at 825-27, 271 N.W.2d at 151-52.
74. 581 F.2d 676 (7th Cir. 1978).
75. Id. at 680.
76. Id.
77. Id. at 681.
vant in determining whether the pledgee has breached his duty of care.

B. Effect of the Pledgor's Demand

Whether or not the pledgor had made a demand for the pledgee to perform some act to preserve the value of the collateral was central to the imposition of liability in many of the cases decided under section 9-207.

1. The Convertible Debentures Cases

In the cases involving convertible debentures the necessity for action on the part of the pledgee is brought about by the issuing corporation calling to redeem the securities. A pledgee-bank can learn of this either through announcements made by the issuer of the debentures or from the pledgor himself. Where the securities are in bearer form the issuer cannot send notification directly to a holder and the announcement is generally made in financial publications, such as the Wall Street Journal.

In the first three cases mentioned above, the pledgee was held liable for failing to convert into stock the debentures called for redemption without any apparent regard for whether the pledgor had demanded that the securities be converted. In Traverse, the evidence was in dispute as to whether the pledgor had given notice to the bank, and the court made no finding in that regard.\(^78\) In Grace the pledgor of the securities was traveling abroad when the notice of redemption was given and made no demand on the pledgee to convert the debentures.\(^79\) In Reed the position of the pledgor was even stronger "because he took affirmative action to obtain conversion."\(^80\)

In the other two convertible debenture cases discussed above, the pledgee was not held liable because the security agreement had modified the duty of care.\(^81\) However, in both cases the court commented on the pledgee's failure to demand that the securities be converted. In Brodheim the court indicated that the pledgor's contributory negligence would bar re-

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78. 5 UCC Rep. Serv. at 538.
79. 30 App. Div. 2d at 61, 289 N.Y.S.2d at 632.
80. 421 F.2d at 117.
covery since he "was an experienced investor, who kept himself informed of events in the securities market." Similarly, in Siedman the court noted that the pledgor had access to the same financial journals as the pledgee. "Thus, [the pledgor], a businessman accustomed to handling documents, must be charged with the same knowledge of what he claims defendant should have known. Even had [the pledgee] . . . been negligent, [pledgor's] negligence would bar this action."

The stock warrants case, Tallahassee Bank, also presented an issue of contributory negligence. There, the pledgor had asked the pledgee to return all of the pledged warrants prior to their expiration date. For some reason the bank failed to return 1000 of the warrants. However, the pledgor had records in his possession which would have disclosed this error. The court ruled that the issue was properly submitted to the jury and affirmed the judgment against the pledgee.

No conclusion can be drawn from these cases about the effect of a pledgor's demand that the pledgee convert called securities. The pledgor's failure to make a demand appeared to be less important in the earlier cases imposing a stricter duty of care on the pledgee. But the issue of contributory negligence considered in the later cases suggests that the pledgor can improve his position by making a demand.

2. The Market Decline Cases

In the cases involving the pledgee's failure to take affirmative action to limit the pledgor's losses, the necessity to sell is created by the movement of the market. Here, notice of the decline in value will come to the pledgee either through his own observation of the market or from the pledgor who requests that the pledgee cooperate in attempts to limit losses in the value of the collateral. This situation differs from that in the convertible debenture cases in that there is no obvious need for action. While their value may fluctuate, the pledged securities will remain in their current form and any decision to act on the part of the pledgee would be highly discretionary.

In these situations the common-law rule favored the pledgee: "Before the maturity of the claim secured by the pledgee:"

82. 75 Misc. 2d at 288, 347 N.Y.S.2d at 397.
83. 7 UCC REP. SERV. at 885.
84. 271 So. 2d at 193-94.
the pledgee has no duty to sell pledged chattels at the request of the pledgor. Under this rule the pledgee would never have to cooperate with the pledgor in limiting losses. There is a question, however, whether this conflicts with the pledgee’s duty to act to preserve the value of the pledgor’s collateral in some circumstances.

In three of the cases discussed above, *Production Metals*, *Hutchison* and *Dubman*, the pledgor sought to have the pledgee cooperate in his plans to limit his own losses. In all three cases the courts imposed no obligation on the pledgee to relinquish control of the collateral where its value was less than the amount of the underlying obligation. In *Production Metals*, however, the court hinted at a change in the common-law rule, “[C]onsidering the unnecessary, and sometimes catastrophic, financial losses that a pledgor can be forced to incur by a narrow application of both the Code and common law rules.” The court considered the duty to preserve value to include compliance with a request to sell where the value of the collateral exceeded the amount of the debtor’s entire obligation. It should be noted that only in *Dubman* was the pledgor not in default at the time of the demand.

In the two market decline cases where no demand was made, the courts were extremely reluctant to impose a duty to preserve value on the pledgee. Relying on two pre-Code cases, the court in *New Jersey Bank* ruled that a pledgee would not be liable unless there had been a demand by the pledgor with which the pledgee had negligently or in bad faith refused to cooperate. The court in *Capos* cited another reason for not finding a duty to sell in the absence of a demand by the pledgor. Such a duty would place the pledgee in the role of an investment adviser and there is “nothing harsh or unrealistic about requiring a borrower/investor to contract for investment advice if he wishes to receive it.”

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85. *Restatement of Security* § 52 (1941). The comment adds that, “[The pledgee] need not permit an acceleration of satisfaction nor any change in security at the request of the pledgor.” *Id.* Comment a. The illustrations to a section dealing with corporate stock declining in value all conclude that the pledgee is not liable.


87. 366 F. Supp. at 618.

88. *Id.*

89. 139 N.J. Super. at 353 A.2d at 118.

90. 581 F.2d at 681.
Thus, the market decline cases clearly indicate the importance of a timely demand on the part of the pledgor. Unlike the convertible debentures cases, simple awareness of the market decline will not impose the duty on the pledgee to act. Several of these cases imply the importance of the value of the collateral in relation to the amount of the debt. Although all of these cases refused to require action by the pledgee where the collateral had declined in value below the amount of the obligation, *Production Metals* suggested that the courts might be willing to ease the restrictiveness of the common-law rule where the collateral was worth more than the amount of the debt.

**C. Limitations on the Pledgee’s Duty**

The Uniform Commercial Code suggests two ways in which the pledgee’s duty to exercise reasonable care can be limited by agreement between the parties. First, although the duty of reasonable care cannot be disclaimed entirely, the standards by which performance of the duty is to be measured can be prescribed by agreement unless they are “manifestly unreasonable.”\(^9\) Also, the second sentence of 9-207 allows the parties to agree to eliminate the pledgee’s duty to take “necessary steps to preserve rights against prior parties.”\(^9\) Therefore, the language of the security agreement in pledge cases may significantly affect the rights and duties of the parties.

Thus, in *Siedman* the agreement contained the following language which clearly conformed to the requirements of the Code:

> “The Bank’s duty with reference to the Collateral shall be solely to use reasonable care in the custody and preservation of Collateral in its possession, which shall not include any step necessary to preserve rights against prior parties nor the duty to send notices, perform services, or take any action in connection with the management of the Collateral.”\(^9\)

However, in two other cases there was a question as to

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91. The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable.

92. U.C.C. § 9-207(1).

whether the security agreement’s limitation on the pledgee’s duty was permissible under the Code. In *Brodheim* the letter agreement between the parties provided that, “You [the pledgee] shall have no responsibility for ascertaining any maturities, calls, conversions, exchanges, offers, tenders or similar matters relating to any of the Security, nor for informing the undersigned with respect to any thereof (whether or not you have, or are deemed to have, knowledge).”94 The pledgor challenged the agreement asserting that it attempted to completely disclaim the pledgee’s obligation of reasonable care. The court rejected the argument, saying that the agreement “merely sets the standards by which such due care is to be measured—that is, the failure to notify plaintiff of a conversion call is not to be considered lack of due care.”95

An opposite result was reached in *Reed*. There, the security agreement provided, “that the bank could substitute or exchange [collateral] and that it would not be liable ‘on account of any failure to present for payment, or collect by suit or otherwise, any of the above described collateral.’”96 Notwithstanding the express language of the second sentence of section 9-207, the court held that the agreement constituted an improper disclaimer of the duty of reasonable care: “The security agreement could modify this duty only by establishing standards of reasonable care . . . . In our opinion the provisions purporting to exculpate the bank do not constitute such standards.”97

These decisions indicate the importance of the security agreement in the pledged securities cases. If drafted correctly, the pledgee’s duty of reasonable care can be limited extensively by the security agreement. Thus, both parties should be aware of the effect of the terms of the agreement.

The pledgee’s duty to exercise reasonable care may also be limited by action on the part of the pledgee after the agreement has been executed. As mentioned earlier, the comments to section 9-207 suggest that the pledgee “may satisfy this duty by notifying the debtor of any act which must be taken and allowing the debtor to perform such act himself.”98 This possibility

94. 75 Misc. 2d at 287, 347 N.Y.S.2d at 395.
95. Id. at 288, 347 N.Y.S.2d at 396.
96. 421 F.2d at 115.
97. Id. at 117.
was referred to in the two earliest convertible debentures cases. The court in Traverse noted that, "A pledgee could reasonably fulfill this duty by notifying the pledgor and awaiting action or instruction; and acting according to his own judgment should these not be forthcoming within a reasonable time." In Grace the court indicated that a subpledgee could have performed its duty simply by notification. Although this alternative appears to be more of an advantage in the convertible debentures cases, it may be found to apply in other situations as well.

III. The Commercial Setting—Possible Source of Further Answers

The typical pledge transaction does not take place in a vacuum. Besides the factors specifically dealt with in the Code and the cases, the commercial setting in which these transactions usually occur may suggest other considerations which are relevant in determining the duties of a pledgee under the Code. For example, the fact that in nearly all of the cases discussed the pledgees were institutions is important in determining the duties which they may reasonably be expected to perform.

Such lenders take a number of factors into account before they lend money to an individual: (1) the borrower's character and reputation, (2) his present capital and future ability to repay, (3) the purpose of the loan, (4) possible benefits to both the borrower and the lender and (5) the terms of repayment. The purpose of secured lending is, in part, to compensate for deficiencies in some of these areas. In the ideal secured loan the value of the collateral will always exceed the amount due on the loan so that the lender never loses the option of liquidating the collateral to satisfy the debt.

In order to protect itself in this way the lender must be familiar with the collateral at the outset. Determining the original value of the collateral is easier in the case of investment securities because market quotations are usually available. However, the lender must also have some idea of the future

99. 5 UCC REP. SERV. at 541 (emphasis in original).
100. 30 App. Div. 2d at 68, 289 N.Y.S.2d at 641.
102. Id.
103. BENDER, supra note 1, § 14.01[1]. See also Lott & Myers, supra note 101, at 717.
market prospects for the securities in order to establish an adequate margin between the amount of the loan and the value of the collateral to protect itself both from possible market fluctuations and from the costs and hazards of liquidating the collateral.\(^{104}\)

In addition, some lending institutions protect themselves by adopting firm internal policies governing maximum amounts for loans collateralized by securities.\(^{105}\) Federal Reserve Board regulations also place limits on loans taken out to purchase or carry registered stock when they are secured, either directly or indirectly, by the same or other such stock.\(^{106}\)

Further, sound lending policy entails continued evaluation and control of collateral during the term of the loan.\(^{107}\) In some instances the Federal Reserve regulations require the lender to demand either additional collateral or early payment in the event of a market decline.\(^{108}\) With respect to control, a pledgee of stock may have the stock transferred into its own name.\(^{109}\) Lenders can also establish systems for detecting stock splits or stock dividends,\(^{110}\) and require that stock received as the result of a dividend or split remain with the pledgee.\(^{111}\)

Another factor relevant in assessing the pledgee's duty to cooperate with transactions proposed by the pledgor is its rights upon default. Sales of registered securities are subject to strict SEC regulations in a number of situations.\(^{112}\) Upon default, then, the lender might have far less freedom to sell than is contemplated by the U.C.C.

Thus, the properly prepared lender is not operating in the dark. From the outset it should have a fair amount of informa-

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104. Lott & Meyers, supra note 101, at 701.
109. BENDER, supra note 1, §§ 14.02[4], 14.03[3]-[5].
111. BENDER, supra note 1, §14.05[5].
112. See Harfield, supra note 106, at 293.
tion about both the borrower and his collateral. Institutional protections reduce the lender's exposure to risk even further. Thus, in convertible debentures situations it may not be unreasonable to expect lenders to take the necessary steps. In market decline cases it might be appropriate to require lenders to take affirmative action, especially if their rights are uncertain upon default.

IV. Formulating a Workable Duty

Only a small number of cases have dealt with the duty of reasonable care of a pledgee of investment securities under section 9-207. The section itself has provoked little critical comment. However, because the case law that exists is difficult to reconcile, the remainder of this comment will attempt to formulate a workable standard for the pledgee of investment securities under the Code.

Naturally, a carefully drafted security agreement can solve many of the problems created by the uncertainty regarding an investment security pledgee's duties under section 9-207.114 The Code allows the parties to define the standards of reasonable care in the agreement unless the provisions are "manifestly unreasonable."115 Furthermore, the second sentence of section 9-207 expressly provides that the parties can agree to eliminate some of the pledgee's duties with respect to pledged instruments.116 The agreement should, of course, deal with the parties' rights with respect to voting, dividends and interest. However, the agreement should also define, to the greatest extent possible, their respective rights and duties in special transactions, such as the conversion of corporate debentures.117 The agreement might also include provisions concerning the rights of the pledgor to act in the event of a decline in the market value of the collateral. The only constraint is that the agreement should be kept within the bounds of reason.118

Where there is no effective provision in the security agreement defining the duties of the pledgee, the less specific provi-

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113. The section was not amended in the 1972 revision of the Code.
116. U.C.C. § 9-207(1).
117. BENDER, supra note 1, §§ 14.08[3]-[5]. See also GILMORE, supra note 13, § 42.3, at 1134.
118. GILMORE, supra note 13, at § 42.2. See also Duty of a Pledgee, supra note 14, at 311.
sions of section 9-207 apply. That the duty of a pledgee of investment securities under that section extends beyond mere physical preservation of the collateral seems fairly apparent from the section itself, its comments and the few cases which have been decided under it. However, the cases are not clear on just how far this duty extends.

Naturally, in the vast majority of situations a pledgee of investment securities can fulfill its duty of reasonable care, including both the duty to preserve physical form and the duty to preserve value, simply by holding the collateral in safekeeping. The Code and the cases decided under it have done nothing to change the common-law rule that a pledgee is not liable for a mere decline in the market value of the collateral. However, in the relatively infrequent cases where there was no doubt that action should have been taken, a pledgee has been required to take affirmative steps to protect the value of its security.

The convertible debentures cases seem to be the most common examples of such situations. There, the loss of value was certain to occur and the advisability of conversion was obvious. Based either on the general definition of reasonable care under the first sentence of section 9-207 or by analogy to the “necessary steps” language of the second sentence, the courts have been willing to impose liability in such situations. However, several courts have suggested that simple notification of the pledgor will satisfy the pledgee's duty to act in such cases. Furthermore, although it has never been dispositive, some courts have hinted the failure of the pledgor to take action on his own initiative might bar recovery from the pledgee in some cases. Nevertheless, it seems likely that pledgees will still be found liable in many cases where they fail to take obvious steps to preserve the value of the collateral, especially where they relied upon and were aware of the nature of the collateral in the first instance.

In situations where some action is mandatory, but there is a choice of alternatives, it seems likely that the common-law rule will continue. The pledgee should be able to fulfill its duty simply by notifying the pledgor and awaiting instructions. Absent such instructions, a pledgee should not be liable for action taken responsibly and in good faith.

Where an even greater amount of discretion is involved, in the market decline cases, the likelihood of a pledgee being held
liable is much smaller. Under common law a pledgee had no duty to accede to the pledgor's request for the sale or exchange of collateral prior to maturity of the obligation. Even today there is no indication that a pledgee will be held liable for the failure to limit the pledgor's losses in the face of a market decline where the pledgor makes no demand for such action.

However, Production Metals recognized the possibility of serious financial loss to the pledgor in such situations and indicated that the pledgee may be bound to cooperate with the plans of the pledgor where the value of the collateral exceeds the amount of the debt. Nonetheless, where the collateral has declined in value below the amount of the debt, the collateral "may provide the only leverage available to encourage the debtor to repay the debt in full."119 Consequently, it may not be reasonable to require the pledgee to consent to transactions involving the collateral in such situations, but even this rule should not be applied unwaiveringly. Where, for example, the chance for a change in the downward trend of the market value is remote and there is no chance for the pledgor to provide additional security, waiting for default would only increase the amount of the deficiency. In such situations a pledgee should not be immune from liability for the refusal to exercise sound business judgment, regardless of the relative values of the debt and the security.

V. CONCLUSION

The approach suggested above represents a moderate departure from the common-law rules. However, the departure is not unreasonable in light of the commercial climate in which these transactions take place. Nor is it contrary to the purposes of the Code to "simplify, clarify and modernize the law governing commercial transactions."120 The courts have suggested a trend in this direction through decisions recognizing that the duty of reasonable care includes the duty to take affirmative steps to preserve value in some cases. Breach of the duty should always be determined with reference to a standard of care based on responsible, though not infallible, good faith judgment. Under such an approach the pledgee would not be subjected to haphazard liability, but the pledgor would not be

119. 366 F. Supp. at 618.
120. U.C.C. § 1-102(2)(a) (1976).
required to suffer financial hardship because of the pledgee's arbitrary intransigence.

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Editor's Note: After this article was prepared for publication, the Court of Appeals decision in Dubman v. North Shore Bank was affirmed by the Wisconsin Supreme Court. 90 Wis. 2d 226, 279 N.W.2d 455 (1979). In dicta, it was stated, "This court would agree that the Bank had a duty to act reasonably to preserve the value of collateral. However, the defining of the scope of that duty is best left to a more appropriate case." Id. at 234-35, 279 N.W. 2d at 459.