PRINCIPLE AND UTILITY IN THE STRUCTURE OF SECURITIES OWNERSHIP

A COMMENT ON SCHWARCZ & BENJAMIN

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In *Intermediary Risk in the Indirect Holding System for Securities*,[1] Professors Schwarcz and Benjamin take as their central motivating principle the time-honored idea that *nemo dat quod non habet*, or no one gives more than he or she has. This principle, also known as the "derivation principle" of property ownership because it maintains that the rights of each property owner should be derived from the rights of the property's previous owner,[2] provides a window onto some of the most central and intractable questions in the commercial law field.

The *nemo dat* principle seemingly makes abundant and conclusive common sense: how, a non-lawyer would truculently ask, could anyone possibly give more than he or she has? But common sense turns out to be under-determinative in this area,[3] and the answer to the truculent question is easy: by legal fiat. That is, the commercial law system can enable X to give more to Y than X has, not by con-

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1. Steven L. Schwarcz & Joanna Benjamin, *Intermediary Risk in the Indirect Holding System for Securities*, 12 DUKE J. COMP. & INT'L L. 309 (2002). As the authors note, the article integrates and abridges others of their works. *See* Steven L. Schwarcz, *Intermediary Risk in a Global Economy*, 50 DUKE L.J. 1541 (2001) [hereinafter Schwarcz, *Global Economy*]; JOANNA BENJAMIN, INTERESTS IN SECURITIES: A PROPRIETARY LAW ANALYSIS OF THE INTERNATIONAL SECURITIES MARKETS (2000); JOANNA BENJAMIN, LEGAL RISK MANAGEMENT IN GLOBAL SECURITIES INVESTMENT AND COLLATERAL (forthcoming 2002).

2. Douglas G. Baird & Thomas H. Jackson, CASES AND MATERIALS ON SECURITY INTERESTS IN PERSONAL PROPERTY 4 (2d ed. 1987); Jeanne L. Schroeder, *Is Article 8 Finally Ready This Time? The Radical Reform of Secured Lending on Wall Street*, COLUM. BUS. L. REV. 291, 296–97 n.6 (1994).

3. Consonant with this under-determinativeness, Schwarcz's and Benjamin's support for the *nemo dat* principle in the context of indirect securities ownership is based on considerations, beyond the scope of this brief commentary, that are considerably more detailed than a simple invocation of common sense. *See* Schwarcz, *Global Economy*, *supra* note 1, at 1573–77, 1580–86.

juring additional rights out of thin air, but by expropriating some of Z's rights in order to include them in the package that Y gets from X. And as I explore in detail in a forthcoming article,[4] the American commercial law system does so over and over again, in widely varying contexts.[5] (One example, salient here because Schwarcz and Benjamin explicitly focus on it,[6] is the U.C.C. provision that gives priority to the secured creditor (Y) who takes as collateral from a securities intermediary (X) the securities entitlements held by an entitlement holder (Z), even if the entitlement holder does not consent.[7]) The commercial law system's reason for taking these steps is to foster commerce between X and Y, by freeing Y from concerns that third parties, such as Z, will have claims to the property that defeat Y's. These violations of the *nemo dat* principle have a common sense of their own, one which duels with the common sense of the *nemo dat* principle itself, and hence, the validity or invalidity of the principle cannot be resolved simply by applying common sense.

Moral philosophy can hardly lay claim to being a readier problem-solver than is common sense. The moral philosophical approach does, however, frame the issues more sharply and, more important, reveals the depths of what is at stake in a way that ordinary commercial law scholarship often does not. The *nemo dat* principle is of a piece with the classical liberal tradition, which of course prizes individual autonomy for its own sake, including, notably, freedom of alienation.[8] Thus, if the only way for Y to get more than X had is for the law to conscript Z's property, then protection of Z's freedom from non-consensual alienation calls for denying Y anything more than X had. (This classical liberal outlook is enshrined in the U.C.C.'s own self-declared purposes and policies, which include expanding commercial practices through "custom, usage and *agreement of the parties*."[9]) By contrast, departures from the *nemo dat* principle

4. Carl S. Bjerre, *Commerce and Community: The Redistributionist Streak in American Commercial Law* (on file with the author).

5. In addition to the priority issues discussed in the text below, examples include the voidable title and entrusting rules for goods, the holder in due course rules for negotiable instruments, the protected purchaser rules for securities in the direct holding system, the true consignment rules in secured transactions, and, in the indirect holding system for securities, the rule imposing pro rata treatment on entitlement holders.

6. Schwarcz & Benjamin, *supra* note 1, at 325–26.

7. U.C.C. § 8-511(b) (2000) (secured creditor of a securities intermediary has priority over entitlement holder when secured creditor has control of the financial asset).

8. The authorities here range from Locke and Kant to Robert Nozick, and are more fully explored in Bjerre, *supra* note 4.

9. U.C.C. § 1-102(2)(b) (2000) (emphasis added).

in the interest of fostering commerce are of a piece with the utilitarian and pragmatic philosophical traditions, which of course reject the idea of inviolable natural-law rights and, instead, evaluate rules or actions in light of their practical results.[10]

In the continuing conflict between these two philosophical traditions, Schwarcz and Benjamin have focused on an area that has been a true stronghold for the utilitarian tradition, simply because the indirect holding system for securities has an even more potentially enormous practical impact than do most commercial law rules. The richly interlocking, complexly tiered and cross-wired nature of the indirect holding system presents the specter of "systemic risk," in which problems with one intermediary can readily cause problems with other intermediaries, and so on, potentially destabilizing the entire system.[11] For these reasons it is refreshing and laudable that Schwarcz and Benjamin remind us of the individualistic, classical-liberally rooted *nemo dat* approach even in this context, while remaining non-doctrinaire enough to entertain utilitarian countercurrents, such as the secured creditor priority mentioned above.

It is unclear whether Schwarcz and Benjamin would, if pressed as a philosophical matter, align themselves generally with the classical liberals or the utilitarians. On one hand, they clearly see the secured creditor priority rule as a limited departure from their starting principle of *nemo dat*.[12] On the other hand, however, they imply a utilitarian bent more generally by, among other things, expressing reservations about a conflict-of-laws approach to the intermediary risk problem (such as that currently proceeding under the auspices of the Hague Conference on Private International Law[13]) on the grounds that such an approach might sometimes point to a jurisdiction that does not award priority to secured creditors.[14] To notice this ambivalence is not to criticize it, for as I note above and elsewhere,[15] the

10. The authorities here, too, are wide-ranging, from the Skeptics through Hume and the Chicago-school law and economics analysts. This tradition is, usually tacitly, the predominant viewpoint in commercial law scholarship today.

11. Jim Rogers accordingly calls U.C.C. Article 8's work on controlling systemic risk "part [of] what might be described as 'Armageddon planning' for the financial system." James S. Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 UCLA L. REV. 1431, 1436 (1996). Rogers was the Reporter for the Article 8 Drafting Committee.

12. Schwarcz & Benjamin, *supra* note 1, at 325–26.

13. *Id.* at 316; Sandra M. Rocks & B. Shea Owens, *Survey of International Commercial Law Developments: 1999-2000*, 56 BUS. LAW. 1867, 1874–75 (2001).

14. Schwarcz & Benjamin, *supra* note 1, at 329–30; *see also id.* at 320–21 (discussing the indirect holding system itself in terms of a utilitarian framework).

15. *See supra* notes 4–5 and accompanying text.

same ambivalence pervades much of the body of American commercial law.