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## SECURITIES LAW

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### Immunity for the Broker-Dealer

A broker-dealer is protected from adverse claims to client assets

Securities broker-dealers sometimes face claims by third parties relating to assets maintained in the accounts of the broker-dealers' customers. For example, the broker-dealer's customer, the general manager of a limited liability company, instructs the broker-dealer to transfer funds to another financial institution. The general manager thereafter improperly converts those assets. A third party LLC member, claiming that he held an interest in those assets, may allege that the broker-dealer is responsible for losses related to the conversion because the broker-dealer allegedly aided and abetted said conversion.

The good news for the broker-dealer is that Section 8-115 of the Uniform Commercial Code provides a complete defense to such claims (with very limited exceptions). This article examines the Section 8-115 defense and its primary exception, i.e., where the broker-dealer has colluded with the wrongdoer and violated the rights of the adverse claimant. Except in highly unusual situations, Section 8-115 effectively immunizes a broker-dealer from liability to third parties asserting adverse claims related to the maintenance of assets in its customer's accounts.

Section 8-115 is part of the revised

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UCC Article 8 enacted by all 50 states and the District of Columbia between 1994 and 1998. Virtually every jurisdiction, including New York and New Jersey, adopted the official text of Section 8-115 without amendment. Uniform Commercial Code (U.L.A.) § 8-115 at 462-66 and 522-25 (2005). Section 8-115 provides:

A securities intermediary that has transferred a financial asset pursuant to an effective entitlement order, or a broker or other agent or bailee that has dealt with a financial asset at the direction of its customer or principal, is not liable to a person having an adverse claim to the financial asset, unless the securities intermediary, or broker or other agent or bailee:

- (1) took the action after it had been served with an injunction, restraining order, or other legal process enjoining it from doing so, issued by a court of competent jurisdiction, and had a reasonable opportunity to act on the injunction, restraining order, or other legal process; or
- (2) acted in collusion with the wrongdoer in violating the rights of the adverse claimant; or
- (3) in the case of a securities

certificate that has been stolen, acted with notice of the adverse claim. N.Y.U.C.C. § 8-115 (McKinney 2006).

According to the Official Comment, Section 8-115 reflects a legislative policy that "it is essential to the securities settlement system that brokers and securities intermediaries be able to act promptly on the directions of their customers." N.Y.U.C.C. § 8-115, cmt. 3 (McKinney 2006). Indeed, the policy behind the provision is so strong that even though a broker-dealer *has notice* that a third party asserts a claim to assets in a customer's account, "the firm should not be placed in the position of having to make a legal judgment about the validity of the claim at the risk of liability either to its customer or to the third party for guessing wrong." Thus, subject to very narrow exceptions, "the broker or securities intermediary is privileged to act on the instructions of its customer or entitlement holder...."

As used in Article 8, a securities intermediary is a "clearing corporation" or a "person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity." N.Y.U.C.C. § 8-102(a)(14) (McKinney 2006). A broker is defined as a "broker or dealer under the federal securities law, but without excluding a bank acting in that capacity." N.Y.U.C.C. § 8-

102(a)(3) (McKinney 2006). An entitlement order is “a notification communicated to a securities intermediary directing transfer or redemption of a financial asset to which the entitlement holder has a security entitlement.” N.Y.U.C.C. § 8-102(a)(8) (McKinney 2006). An entitlement holder is a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary. N.Y.U.C.C. § 8-102(a)(7) (McKinney 2006). Financial asset is broadly defined to include not only securities “but also a broader category of obligations, shares, participations, and interests.” N.Y.U.C.C. § 8-102(9), cmt. 9 (McKinney 2006).

Although the statute does not specifically address whether cash deposited into a brokerage account constitutes a “financial asset,” to the extent cash is invested into shares of a money market fund, those shares constitute a “security” for purposes of Section 8-115. N.Y.U.C.C. § 8-102(15) (McKinney 2006). Moreover, at least one court has found impliedly that funds deposited into a securities brokerage account constitute a “financial asset.” In *Pine Belt Enterprises, Inc. v. SC & E Administrative Services, Inc.*, 9 UCC Rep. Serv. 2d 963, 2005 WL 2469672 (D.N.J. Oct. 6, 2005), the Court concluded that the defendant broker-dealer was entitled to the protections of Section 8-115 where the funds were transferred out of the account pursuant to an effective entitlement order.

A securities intermediary incurs liability to an entitlement holder if it honors an entitlement order that is “ineffective.” N.Y.U.C.C. § 8-507, cmt. 4 (McKinney 2006); *Powers v. American Express Financial Advisors, Inc.*, 82 F. Supp. 2d

448, 452 (D. Md. 2000). Thus, where the appropriate person to make an entitlement order under the customer agreement is either owner of a joint account, both owners must make the order for it to be an “effective entitlement order.” As such, a joint account holder who asserts a claim relating to assets transferred out of the account at the instruction of the other account holder cannot be deemed an “adverse claimant,” thereby precluding a broker-dealer from relying on Section 8-115.

Of the three exceptions to the broad protections of Section 8-115, the exception most likely to be invoked by an adverse claimant is Section 8-115(2), i.e., where the broker-dealer allegedly colludes with the wrongdoing customer. To demonstrate collusion, a plaintiff must allege facts showing that the broker-dealer’s conduct “rises to a level of complicity in the wrongdoing of its customer...” N.Y.U.C.C. § 8-115, cmt. 5 (McKinney 2006). According to the Official Comment, “the collusion test is intended to adopt the standard akin to the tort rules that determine whether a person is liable as an aider or abettor for the tortious conduct of a third party.” Thus, mere notice of an adverse claim—or even knowledge of wrongful conduct by the customer—is not enough to demonstrate collusion. The collusion exception requires a showing of “egregious” misconduct on the part of the broker-dealer, meaning conduct that goes “beyond the ordinary standards of the business of implementing and recording transactions, and reaches a level of affirmative misconduct in assisting the customer in the commission of a wrong.”

The few reported decisions interpreting the collusion exception confirm that claims involving passive misconduct

by a broker-dealer, such as alleged failures to conduct due diligence or to apprise the plaintiff of “red flags,” are insufficient. *Pine Belt*, 2005 WL 2469672, \*\* 7-8; *H&R Block Financial Advisors, Inc. v. Express Scripts, Inc.*, 426 F. Supp. 2d 656, 662-63 (E.D. Mich. 2006) (*Express Scripts I*). Instead, the courts have held that collusion requires a showing of affirmative misconduct, such as the knowing encouragement and facilitation of the customer’s wrongful conduct. *H&R Block Financial Advisors, Inc. v. Express Scripts, Inc.*, 60 UCC Rep. Serv. 2d 376, 2006 WL 2125226, \*\* 6-7 (E.D. Mich. July 27, 2006) (*Express Scripts II*). For example, in *Express Scripts II*, the Court granted the defendant stock transfer agent leave to amend its counterclaim against the plaintiff broker-dealer seeking damages in connection with the erroneous issuance of a stock certificate to the third-party defendant customer. The court held that the facts demonstrated that the broker-dealer “blatantly ignored and suppressed conclusive proof” that the third-party defendant did not own the subject securities, ruling that such conduct was not protected by Section 8-115.

Section 8-115 provides a broker-dealer with a valuable defense to third-party claims that it improperly facilitated its customer’s conversion of assets in a brokerage account, imposing a very high burden to overcome the statutory bar to such claims. Unless the plaintiff can demonstrate highly unusual facts showing that the broker-dealer departed from the normal standards of the business of implementing and recording transactions, Section 8-115 will effectively immunize the broker-dealer from liability for conversion of the account’s assets. ■