

1-1-1969

Duty of a Pledgee Under Section 9-207

Gerald J. Hoenig

Follow this and additional works at: <http://lawdigitalcommons.bc.edu/bclr>

 Part of the [Bankruptcy Law Commons](#), and the [Securities Law Commons](#)

Recommended Citation

Gerald J. Hoenig, *Duty of a Pledgee Under Section 9-207*, 10 B.C.L. Rev. 301 (1969), <http://lawdigitalcommons.bc.edu/bclr/vol10/iss2/5>

This Uniform Commercial Code Commentary is brought to you for free and open access by the Law Journals at Digital Commons @ Boston College Law School. It has been accepted for inclusion in Boston College Law Review by an authorized editor of Digital Commons @ Boston College Law School. For more information, please contact nick.szydowski@bc.edu.

DUTY OF A PLEDGEE UNDER SECTION 9-207

I. SECTION 9-207

The remaining assets of an insolvent debtor are commonly insufficient to satisfy all of his debts. To protect themselves against a debtor's insolvency, creditors often take security interests in specific personal property of their debtors.¹ This interest assures the creditor of the satisfaction of the debt, up to the value of the collateral, unless another creditor has a superior security interest.² Article 9 of the Uniform Commercial Code was adopted to regulate the various transactions which involve security interests in personal property.³ Under Article 9, a security interest may be created in many ways, including pledge, chattel mortgage, trust deed, conditional sale and consignment.⁴

When a security interest is created by pledge, a special problem arises. Since the creditor holds the secured property, it might be damaged, destroyed or devalued while in his possession. Under what circumstances the creditor is liable for such a loss is an important question. Section 9-207 of the Code establishes the liability of a pledgee by providing:

A secured party must use reasonable care in the custody and preservation of collateral in his possession. In the case of an instrument⁵ or chattel paper⁶ reasonable care includes taking necessary steps to preserve rights against prior parties unless otherwise agreed.⁷ (Footnotes added.)

Section 9-207(3) adds that "[a] secured party is liable for any loss caused by his failure to meet [these] . . . obligation[s]. . . ." The extent of the duty of care imposed by section 9-207 is not clearly defined. "Reasonable care" as it relates to pledgees is not defined in any section of the Code,⁸ and it is

¹ For a general discussion of the use of security interests to protect against bankruptcy, see 1 P. Coogan, W. Hogan and D. Vagts, *Secured Transactions under the Uniform Commercial Code* § 1.04 (1967).

² For rules establishing priorities among conflicting creditors' claims, see U.C.C. §§ 9-301, 9-307, 9-308, 9-309, 9-310, 9-312, 9-313, 9-314, 9-315, 9-316. All Uniform Commercial Code citations are to the 1962 Official Text.

A party with a security interest is subject also to the applicable provisions of the Federal Bankruptcy Act, 11 U.S.C. §§ 1-1103 (1964), as amended, (Supp. III, as amended 1965-67).

³ U.C.C. § 9-101, Comment.

⁴ See U.C.C. § 9-102(2).

⁵ "Instrument" is defined by U.C.C. § 9-105(1)(g) as being any writing which evidences a right to the payment of money and is not itself a security agreement or lease and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment.

⁶ "Chattel paper" is defined by U.C.C. § 9-105(1)(b) as being a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods. When a transaction is evidenced both by such a security agreement or a lease and by an instrument or a series of instruments, the group of writings taken together constitutes chattel paper.

⁷ U.C.C. § 9-207(1).

⁸ "Reasonable care" for warehousemen and carriers is given a general definition in §§ 7-204 and 7-309. See U.C.C. §§ 7-204(1), 7-204, Comment, 7-309(1), 7-309, Comment. However, the broad language of the definitions does not help in the determination of the duties to be imposed on a pledgee § 9-207. Section 7-204(1) states:

not certain what "preserving rights against prior parties" means. Moreover, there is no indication whether the "preserving of rights" is the extent of the pledgee's duty of reasonable care toward instruments and chattel paper. If reasonable care does encompass other duties, there is no indication of what they are. The purpose of this comment is to analyze the scope of the duty of reasonable care imposed by section 9-207. This analysis will focus on the section itself and the comments thereto, the duty of a pledgee under prior law, and the only two cases decided under section 9-207, both of which consider the duty owed by a pledgee holding convertible debentures.⁹

Comment 1 to section 9-207 states that the pledgee's duty of reasonable care is "the duty to preserve collateral imposed on a pledgee at common law." This Comment cites Sections 17¹⁰ and 18¹¹ of the *Restatement of Security* as prior codifications of the common law duty. Comment *a* to section 17 states that reasonable care is "confined to the physical care of the chattel, whether

A warehouseman is liable for damages for loss of or injury to the goods caused by his failure to exercise such care in regard to them as a reasonably careful man would exercise under like circumstances but unless otherwise agreed he is not liable for damages which could not have been avoided by the exercise of such care.

A carrier . . . must exercise the degree of care in relation to the goods which a reasonably careful man would exercise under like circumstances. This subsection does not repeal or change any law or rule of law which imposes liability upon a common carrier for damages not caused by its negligence.

The only other section of the Code that discusses the duties to be imposed upon a party under a reasonable care test is § 4-103, which relates to the duties of banks in connection with their role in the bank collection process. Section 4-103 states that a bank is liable for failure to exercise "ordinary care," which is often said to be synonymous with "reasonable care." See, e.g., *Hotels El Rancho v. Pray*, 64 Nev. 591, 619, 187 P.2d 568, 582 (1947); *Chicago, R.I. & P. Ry. v. Shelton*, 135 Okla. 53, 55, 273 P. 988, 990 (1929). However, as stated in Comment 4 to § 4-103, "ordinary care" is not generally defined in the section. Thus § 4-103 is also not useful in determining the "reasonable care" duties of a pledgee.

It has been suggested that, although the Code does not adequately define "reasonable care," "the general standard may well be further refined by the test of 'commercial reasonableness' used for both secured parties' and sellers' disposition of goods upon debtor's or buyer's breach [under §§ 2-706 and 9-504 of the Code]." W. Willier & F. Hart, *Forms and Procedures under the Uniform Commercial Code* ¶ 94.46 (1965). This test is not helpful for defining reasonable care under § 9-207 because the general term "commercially reasonable" is not defined by §§ 2-706 or 9-504.

⁹ "A debenture, ordinarily, is an obligation of corporations, or, large moneyed copartnerships, issued in a form convenient to be bought and sold as investments." *Shamrock Oil & Gas Co. v. Campbell*, 107 F. Supp. 764, 766 (N.D. Tex. 1952). "[T]he normal distinction between a corporate bond and a corporate debenture or note, is that the former is usually secured by a mortgage, while the latter usually is not." *Fine v. H. Klein, Inc.*, 10 N.J. Super. 295, 299, 77 A.2d 295, 298 (Essex County Ct. 1950). A convertible debenture is one that can be exchanged for stock.

¹⁰ *Restatement of Security* § 17 (1941) [hereinafter cited as *Restatement*] provides: The pledgee owes to the pledgor the duty of reasonable care of the pledged chattel except where the chattel is in the possession of a third person designated by the pledgor or is in the possession of the pledgor himself.

¹¹ Section 18 of the *Restatement* states:

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.

DUTY OF A PLEDGEE

an object such as a horse or piece of jewelry, or a negotiable instrument or document of title." However, "[i]n the case of an instrument or document the pledgee also has other duties in certain circumstances." As an example of the additional duties imposed upon a pledgee, section 18 cites the duty either to collect on a matured instrument or to enable his pledgor to do so.¹² It is not clear from the language in sections 17 and 18 whether the duty to collect is the only duty in addition to that of physical preservation that is owed by a pledgee to an instrument. But if the requirement of reasonable care places any other duties on a pledgee, sections 17 and 18 make no reference to them. Despite their failure to present a clear definition of reasonable care, section 9-207 and Sections 17 and 18 of the *Restatement* appeared to have defined adequately the pledgee's duty of reasonable care for more than a decade, because no disputes regarding its meaning reached the courts. Within the last two years, however, two courts, one in Massachusetts and the other in New York, have considered the extent of the duty of reasonable care under section 9-207.

In both cases, the pledgees failed to exchange convertible bearer debentures for stock worth a great deal more than the face value of the debentures. The pledgors claimed that Section 9-207 of the Code requires a pledgee to convert bonds to stock in order to comply with his duty of "reasonable care." These cases raise important questions about section 9-207. First, does the pledgee's duty of reasonable care encompass any duties in addition to those of the physical preservation of collateral and the collection of matured instruments? Second, if there are additional duties, what are the criteria for determining whether the section 9-207 obligation of "reasonable care" requires a certain act to be performed by a pledgee? Finally, what are the ramifications of the Massachusetts and New York courts' interpretations of section 9-207?

II. THE CASES

In the Massachusetts case, *Traverse v. Liberty Bank & Trust Co.*,¹³ the plaintiff pledged twenty-five bearer convertible debentures as collateral for a loan to the Liberty Bank and Trust Company (Liberty). The bonds had been purchased by the plaintiff for \$59,446.88, although they had a face value of only \$25,000. Their price was greatly influenced, however, by the price of the common stock into which they were convertible. While Liberty held the debentures, a notice of redemption was published by the issuer of the bonds in the *Wall Street Journal*. The notice stated that the owners of the

¹² Restatement § 18 provides that where the pledge is an instrument which represents the claim of the pledgor against a third party, the pledgee must use reasonable diligence to preserve and collect the claims or to enable the pledgor to take such action. Thus, upon the maturity of an instrument or chattel paper within his possession, a pledgee must either make a timely presentment for payment or permit his pledgor to do so. When timely presentment has not been made, the pledgee will be liable for any loss caused by the insolvency or discharge of the obligor or indorser of the instrument or chattel paper. The pledgee will be similarly liable if the obligor or indorser is relieved from payment by the statute of limitations. See Restatement § 18, comment *a* and illustrations 1-4.

Also the pledgee must file a proof of claim if the obligor becomes insolvent "unless he enables the pledgor to file such a claim." *Id.* at § 18, comment *a*.

¹³ 5 U.C.C. Rep. Serv. 535 (Mass. Super. Ct. 1967).

debentures would lose their conversion rights as of a fixed date in the future. After that date the value of the bonds would be approximately the same as their face value.¹⁴ Liberty did not require any of its employees to keep informed of such a notice. Moreover, the bonds were being held by Liberty's note teller who knew neither what a convertible security was nor what affected its value. Nonetheless, an officer of Liberty who handled the plaintiff's loan did actually see the published notice. However, he did not attempt to notify the plaintiff. The stock that could have been received in exchange for the debentures was worth approximately \$78,000, but the redemption date passed without exercise of the plaintiff's conversion rights. Since the bonds were worth only slightly more than their face value of \$25,000 after the redemption date, the plaintiff suffered a loss of almost \$53,000. She claimed that her loss was caused by Liberty's failure to convert the debentures into stock and that this omission was a violation of Liberty's duty of reasonable care under Section 9-207 of the Code.

The Massachusetts court agrees with the plaintiff, and it presents several arguments to support its conclusion. The first begins with the premise that a pledgee must exercise reasonable care toward convertible debentures under section 9-207. This premise is clearly valid, because under section 9-207 a pledgee has the duty of reasonable care towards all collateral.¹⁵ The court's next argument states a general rule under the common law that the duty of reasonable care is to be defined by consideration of all the circumstances of the pledge and the character of the collateral.¹⁶ The court reasonably infers that each type of collateral requires a different kind of care, and that the reasonable care of convertible debentures requires that their convertibility characteristics be considered. Consequently, it finds that a pledgee who fails to give thought to conversion rights has not exercised the care required by section 9-207. Under this reasoning Liberty was held liable for failing to exercise the care required by section 9-207, because the note teller who cared for the bonds knew nothing of their conversion characteristics.

The court's specific ruling that conversion rights must be considered in the determination of compliance with the section 9-207 duty of reasonable care does not require a pledgee to convert bonds or to inform his pledgor of a redemption notice, which are the acts that must be performed to avoid a loss such as the one that occurred in *Traverse*. Consequently, even if there is a duty under section 9-207 to take conversion rights into consideration in caring for debentures, a pledgee in Liberty's situation should not be held liable for the devaluation of the bonds unless it had the additional duty of exchanging the debentures for stock or of notifying the pledgor of a published call to redeem.

The court presents another line of reasoning which attempts to establish that section 9-207 requires a pledgee to convert or notify. At common law a

¹⁴ The bonds were redeemable at 103.25% of the face value plus interest accrued to the redemption date. *Id.* at 537.

¹⁵ See U.C.C. § 9-207(1).

¹⁶ 5 U.C.C. Rep. Serv. at 539.

For cases stating the rule at common law see, e.g., *Hibernia Bank & Trust Co. v. Turner*, 156 Miss. 842, 127 So. 291 (1930); *Cutting v. Marlor*, 78 N.Y. 454 (1879).

DUTY OF A PLEDGEE

pledgee's primary duty is to hold the collateral in its original form so that the pledgor can redeem his property at any time by payment of his debt, and thus retake it in the form originally given.¹⁷ Unless this were the rule, the pledgor would probably be unwilling to give possession of his goods and securities to a pledgee, and an important method of financing would be lost. When convertible debentures are called for redemption, it is impossible to hold them in their original form, because they must either be exchanged for stock or become unconvertible bonds. Under these circumstances, a pledgee's duty under section 9-207 is to hold the collateral in a form and of a value most similar to the original.¹⁸ Applying this reasoning, the court finds that Liberty had the duty to convert the bonds, because the value of the stock that would have been received was closer to the value of the convertible debentures than to that of the debentures after the plaintiff's conversion rights were lost.¹⁹

The court's conclusion does not logically follow from the common law rule that a pledgee is to care for the collateral so that a pledgor can have returned exactly what he gave the pledgee. At common law, the pledgee's duty of reasonable care arose from the fact that the pledgee had the actual and exclusive control of the pledgor's goods, so that the pledgor had no power to protect his property from harm. Thus, the courts imposed upon the pledgee the duty to care for the pledged property with reasonable diligence.²⁰ Consequently, it appears that the pledgee had to provide the necessary care for the pledged goods which the pledgor was unable to provide. For example, when the collateral is in the pledgee's possession, the pledgee is generally the only party who has the ability to take precautions against theft. Accordingly, it has been held that he has the duty to guard against theft.²¹ Nonetheless, where a particular precaution could have been taken by the pledgor, the pledgee has been relieved of the duty to act. Thus, when a pledgor had the right to inspect his goods at the warehouse in which the pledgee stored them, the pledgee did not have the duty to inspect the goods to discover whether conditions of decay existed.²² When an act necessary for the protection of pledged property can be performed by the pledgor, the law does not impose upon the pledgee the duty to perform that act. Since section 9-207 states the pledgee's duty at common law,²³ it follows that this rule applies to the pledgee's duty of reasonable care under section 9-207.

The ability to look for redemption notices in a newspaper such as the *Wall Street Journal* is not limited to those who have the exclusive possession

¹⁷ 5 U.C.C. Rep. Serv. at 540. For a statement of the rule at common law, see *Warfield v. Adams*, 215 Mass. 506, 515, 102 N.E. 706, 710 (1913); 41 Am. Jur. Pledge and Collateral Security § 75 (1942).

¹⁸ 5 U.C.C. Rep. Serv. at 540.

¹⁹ *Id.*

²⁰ See *Willets v. Hatch*, 132 N.Y. 41, 30 N.E. 253 (1892); 72 C.J.S. Pledges § 33 (1951); Restatement § 18 and comment *a* at 67 (1941).

²¹ See *Adye v. Grossman*, 214 Ore. 363, 329 P.2d 1116 (1958); *Bank of Monango v. Ellendale Nat'l Bank*, 52 N.D. 8, 201 N.W. 839 (1924); 41 Am. Jur. Pledge and Collateral Security § 50 (1942); Annot., 68 A.L.R.2d 1259 (1959).

²² *Willets v. Hatch*, 132 N.Y. 41, 30 N.E. 253 (1892).

²³ U.C.C. § 9-207, Comment 1.

of convertible securities, and the plaintiff, as well as Liberty, was able to perform the act necessary to protect the value of the bonds. In the light of the above rule, these facts indicate that Liberty should not be held liable for the depreciation of the debentures. The court reaches a contrary conclusion, but states that a pledgee may fulfill his section 9-207 duty of reasonable care by notifying his pledgor of a redemption notice.²⁴ Consequently, the only acts necessary for a pledgee to comply with section 9-207 are those of keeping informed of published redemption notices and of notifying his pledgor of them.²⁵ However, since the plaintiff also could keep informed of notices of redemption, Liberty should not have borne the duty to do so.²⁶

The *Restatement of Security* supports this conclusion. It states that a pledgee has the duty to notify his pledgor only when the knowledge is peculiar to the pledgee.²⁷ An example is given of a situation in which a pledgee has the duty of notification. It involves a corporation which notifies by mail only the holders of securities of any opportunity to convert their securities, and the pledgee as holder of the securities received a notice while his pledgor did not.²⁸ This is an obviously different situation from that in the *Traverse* case where the redemption notice was published in the *Wall Street Journal*.²⁹

It is important to note that the Massachusetts court held as a matter of law that the pledgee, Liberty, was obliged by the reasonable care requirement of section 9-207 at least to notify its pledgor of a redemption notice. To the contrary, the New York court does not treat section 9-207 as meaning that a pledgee will necessarily have the duty to inform his pledgor as a matter of law.

In the New York case, *Grace v. Sterling, Grace, & Co.*,³⁰ the plaintiff pledged convertible bearer debentures, worth \$25,000 on their face, to the

²⁴ 5 U.C.C. Rep. Serv. at 541.

²⁵ The pledgor can then decide whether to convert the bonds and instruct the pledgee accordingly. *Id.*

²⁶ Moreover, the court concedes that an obligation to convert the debentures ought not to be imposed on a pledgee, because the conversion of debentures imposes too great a burden on the pledgee. *Id.* Converting debentures upon a redemption notice is not always sound business conduct because the price of the stock that can be received might fall after the conversion. Since the price of the stock might fall, a pledgee bears the risk that the conversion will be deemed not "commercially reasonable." See note 8 supra.

²⁷ Section 21 of the Restatement states:

(1) Where changes must be made in pledged corporate securities or in other pledged chattels during the existence of the pledge, as the result of a power exercised by the corporation issuing the securities or a power exercised by government or other third person, and a choice is allowed in respect to such change, the pledgor can make the choice but he must act with reasonable promptness and so far as possible maintain the value of the pledgee's interest. Where the pledgor has made such a choice, it is the duty of the pledgee to perform any act within his power which is necessary to effectuate this choice.

(2) Where the proposed changes are *peculiarly within the knowledge of the pledgee*, he has a duty to notify the pledgor of the proposed changes. [Emphasis added.]

(3) Where the pledgor refuses, or after reasonable opportunity, neglects to express a decision, the pledgee's choice is binding on the pledgor.

²⁸ Restatement § 21, illustration 3.

²⁹ 5 U.C.C. Rep. Serv. at 537.

³⁰ 30 App. Div. 2d 61, 289 N.Y.S.2d 632 (1968).

DUTY OF A PLEDGEE

brokerage firm of Sterling, Grace, and Company (Sterling) as collateral for a loan. In turn, the brokerage firm repledged the bonds to the Cleveland Trust Company (Cleveland) also as collateral for a loan. Because its facilities were outside New York City and because Sterling wanted the right to substitute securities, Cleveland deposited these securities and others with the Irving Trust Company in New York City. In the custodian agreement, there was a provision that the Irving Trust Company "would 'not endeavor to keep [Cleveland] informed of changes affecting the collateral, such as conversions, rights to subscribe, collection of dividends, etc.'" ³¹

While the debentures were in the possession of the Irving Trust Company and the plaintiff was traveling abroad, notice was given by publication that the bonds were being called for redemption. At that time, the market value of the stock was approximately twice the face value of the debentures. No party sought to convert the bonds into stock, and no attempt was made to inform the plaintiff of the notice for redemption. Consequently, the redemption date passed without the conversion of the bonds, and the value of the bonds was diminished by almost \$25,000.

Plaintiff brought an action against Sterling and Cleveland, alleging that their failure to exercise reasonable care as required by section 9-207 caused her to suffer a loss of \$24,490. The lower court held that Sterling was liable for the loss. Cleveland, however, received a summary judgment in its favor because plaintiff did not have privity with it. On appeal, the decision against Sterling was upheld and the summary judgment for Cleveland was vacated. The court ruled "that the record as a matter of law supports the liability of Sterling." ³² The court did not specify the facts of the record creating Sterling's liability. It is not entirely clear whether it found Sterling to have the duty of notifying plaintiff merely because Sterling was an ordinary pledgee bound by section 9-207 or whether the duty was imposed for some other reasons. Because plaintiff was the wife of a partner of Sterling, ³³ a relationship might have existed between pledgor and pledgee requiring Sterling to exercise more care than an ordinary pledgee.

However, from the court's opinion regarding Cleveland's liability, it is obvious that it does not hold that a sub-pledgee has the duty either to convert debentures upon the publication of a redemption notice or to inform the pledgor of the notice. Cleveland's summary judgment was vacated because its lack of privity with plaintiff was held not to bar plaintiff's action under section 9-207. ³⁴ Eliminating the question of privity, the court treated Cleveland as an ordinary pledgee. If the court had held that a pledgee as a matter of law has the duty to convert or notify, then it would have found that the record as a matter of law established Cleveland's liability. To the contrary, the court held that the question of Cleveland's liability was a mixed question of fact and law. ³⁵

The court supports its ruling that the question of privity is irrelevant to

³¹ *Id.* at —, 289 N.Y.S.2d at 636.

³² *Id.* at —, 289 N.Y.S.2d at 637.

³³ *Id.* at —, 289 N.Y.S.2d at 636.

³⁴ *Id.* at —, 289 N.Y.S.2d at 637.

³⁵ *Id.* at —, 289 N.Y.S.2d at 642.

Cleveland's liability with the general common law rule that the duty to exercise reasonable care is imposed by law and is not imposed by the pledge contract.³⁶ Therefore an actual transaction between a pledgor and a sub-pledgee does not have to take place for the duty of reasonable care to be placed on a sub-pledgee. The court adds that the trend of the law is to remove privity as an element in establishing a cause of action against defendants who have caused a loss by failure to exercise reasonable care.³⁷

The court's reasoning and conclusion on the question of privity and its treatment of Cleveland as an ordinary pledgee are sound. Whatever duty is imposed on a pledgee ought to be placed on a sub-pledgee, because the basic reason for the imposition of the duty is present. By virtue of the sub-pledgee's possession of the collateral, he is the only party who can perform certain acts in care of the property and assure that the pledgor will have returned exactly what he gave the pledgee.³⁸ The *Grace* court, however, fails to discuss the important question whether a pledgee should remain liable to his pledgor after the pledgee has given possession of the collateral to the sub-pledgee and thus no longer has more power than the pledgor to protect the collateral. The answer to this question must be that the pledgee's liability remains after a sub-pledge. Otherwise, the pledgee could effectively relieve himself of all duties of reasonable care by repledging the collateral to a corporation with very limited funds. However, the pledgee should have the right of subrogation against the sub-pledgee when the sub-pledgee is the only party who could have performed the act necessary to preserve the collateral and when the loss is caused by the sub-pledgee's failure to exercise reasonable care.

Eliminating the requirement of privity, the court attempts to establish that Cleveland, as a pledgee, is required by the section 9-207 duty of reasonable care under certain circumstances at least to inform his pledgor of a published notice to redeem convertible debentures. The thrust of the reasoning is an analogy between the conversion of debentures and the collection of matured instruments.³⁹ As has been noted, when an instrument matures in the possession of a pledgee, the pledgee has the duty under section 9-207 to make a timely presentment of the instrument for payment.⁴⁰ The court reasons that since section 9-207 requires an affirmative act in the maturing note cases, a similar act might be required when bonds are called for redemption. However, the court's analogy is not valid to establish that the section 9-207 duty of reasonable care requires a pledgee to convert bonds or at least to notify his pledgor of a redemption notice. When an instrument matures it is generally very sound business conduct to present the instrument for payment. In addition, when a pledgee holds an instrument, he is usually the only party who can make presentment.⁴¹ For this reason, the duty to make a timely presentment has been im-

³⁶ *Id.* at —, 289 N.Y.S.2d at 638.

On this point of law, see 8 Am. Jur. 2d Bailments § 198 (1963); 8 C.J.S. Bailments § 26 (1962). These citations refer to the duty of a bailee, but a pledgee is a type of bailee. Restatement § 1, comment a.

³⁷ 30 App. Div. 2d at —, 289 N.Y.S.2d at 638-39.

³⁸ See note 17 *supra*, and accompanying text.

³⁹ 30 App. Div. 2d at —, 289 N.Y.S.2d at 638.

⁴⁰ See note 12 *supra*.

⁴¹ Section 3-504(1) of the Code states: "Presentment is a demand for acceptance or

DUTY OF A PLEDGEE

posed on him.⁴² By contrast, the conversion of debentures upon publication of a notice of redemption is not always sound conduct. The possibility exists that the value of the stock will be less than the face value of the bonds or become less after the conversion is made. It can be inferred that the court recognizes this factor when it rules that a pledgee may fulfill his section 9-207 duty of reasonable care by notifying his pledgor of a redemption notice.⁴³ In effect, the ruling that section 9-207 requires a pledgee to notify his pledgor causes the pledgee to search for published redemption notices. This is an act necessary for the preservation of the value of convertible debentures, but it is an act that can be performed by the pledgor as well. Thus, whereas under section 9-207 the requirement that a pledgee present a matured note obliges him to perform an act which only he could perform, under the court's interpretation of section 9-207, a pledgee would be required to do what the pledgor can do as well, namely to look for redemption notices. As noted in the discussion of the *Traverse* case, the ability of the pledgor to perform an act necessary for the protection of the value of the collateral appears to be crucial in the determination whether the pledgee has the duty to perform that act.

The court seems to recognize the importance of the pledgor's ability to keep informed of redemption notices. It suggests that, if Cleveland had reason to believe that Sterling owned the debentures outright instead of being a pledgee, then Cleveland would not have any duty under section 9-207 to notify Sterling of the call to redeem because Sterling had the ability to discover this information itself.⁴⁴ The court, however, points out that because of the circumstances, "Cleveland may be considered to have been on notice that . . . the securities pledged by Sterling were individually owned by customers or other third persons having business relationships with Sterling."⁴⁵ Thus while the court indicates that its decision would be different if the original pledgor had the ability to keep informed of redemption notices, it also suggests that a pledgor who is merely an individual investor and not a brokerage firm does not have that ability. This suggestion would seem to lack basis in fact, because an individual investor as well as a brokerage firm can look in newspapers for redemption notices. Because it failed to take into consideration the crucial factor of the pledgor's ability to keep informed of published redemption notices, the court's application of section 9-207 in *Grace* appears to be erroneous. The fact that the plaintiff was traveling abroad ought not to be relevant, even if the plaintiff could not purchase the newspaper in which the notice of redemption was published. The duty to perform acts to preserve collateral are imposed on a pledgee when the pledgor is unable to

payment made upon the maker, acceptor, drawee or other payor by or on behalf of the holder." A "holder" is defined by § 1-201(20) of the Code as "a person who is in possession of a document of title or an instrument or an investment security drawn, issued or indorsed to him or to his order or to bearer or in blank." Thus the pledgee, the holder of the instrument, is the only person who can initiate the presentment of the instrument.

⁴² Restatement § 18, comment *a* states that a pledgee may be relieved of his duty to collect on an instrument by enabling the pledgor to collect. It is obvious that the duty is placed on the pledgee only when the pledgor cannot make a presentment for collection himself.

⁴³ 30 App. Div. 2d at —, 289 N.Y.S.2d at 641.

⁴⁴ *Id.* at —, 289 N.Y.S.2d at 640.

⁴⁵ *Id.*

perform them because he has given possession of the collateral to the pledgee. The pledgee should not acquire more duties toward the collateral merely because the pledgor becomes unable to perform certain acts for other reasons, such as traveling abroad.

Although it is submitted that the New York court's interpretation of section 9-207 is erroneous, that interpretation is the law in New York and it consequently might affect the law in other jurisdictions. Insofar as the court established the proposition that under certain circumstances section 9-207 requires a pledgee to inform its pledgor of a redemption notice, it is important to note the factors which the court deems important to the creation of this duty. The court first listed them in the following general terms: the "nature and value of the property, and the means of protection possessed by the bailee and the relation of the parties and other circumstances. . . ." ⁴⁶ It then catalogued a number of specific facts tending to indicate that Cleveland had the duty under section 9-207 to inform the plaintiff of the notice. These facts were as follows: the value of the debentures depended a great deal upon their conversion rights; Cleveland most likely knew of the bonds' convertibility features; Cleveland occasionally reviewed and appraised the securities which it held as collateral; Cleveland had a department to check for notices of conversion or redemption as a service for its individual customers; and the custodian agreement with Irving Trust Company put Cleveland on notice that it had some responsibility toward the conversion rights, because the Irving Trust Company disclaimed any duty to keep Cleveland informed of changes affecting the collateral.⁴⁷ All of the facts listed except the last one tend to establish that the conversion rights were valuable and that Cleveland could easily have kept informed of conversion notices. The last circumstance listed by the court raises an inference that if Irving Trust Company had not disclaimed the duty to keep Cleveland informed of conversion rights, then the court would not have held that section 9-207 required Cleveland to keep itself informed. In other words, if a pledgee repledges or bails a convertible debenture to a party who does not disclaim the duty to keep informed of redemption notices, then the pledgee is relieved of that duty. This inference, however, does not appear to be valid because, although Sterling repledged the bonds to Cleveland who did not disclaim the duty, Sterling was still held liable for the plaintiff's loss.⁴⁸

Another significant aspect of the *Grace* case was the non-liability of Irving Trust Company. Whether it could be held liable if it had not made its disclaimer is an additional question. The answer to it, however, is outside the scope of section 9-207, because it was an ordinary bailee and not a secured party subject to section 9-207.⁴⁹ It is, however, relevant to the scope of the section 9-207 duty of reasonable care to ask whether a pledgee can disclaim its duty in the same manner as did the Irving Trust Company. The answer given by Comment 1 to section 9-207 is that

⁴⁶ *Id.* at —, 289 N.Y.S.2d at 639. For cases stating the rule at common law see note 16 *supra*.

⁴⁷ *Id.* at —, 289 N.Y.S.2d at 640.

⁴⁸ The court does not determine whether Sterling or Cleveland bears the ultimate liability or if both are liable as joint tortfeasors. *Id.* at —, 289 N.Y.S.2d at 642.

⁴⁹ See U.C.C. § 9-207(1).

DUTY OF A PLEDGEE

the duty to exercise reasonable care may not be disclaimed by agreement, although . . . the parties remain free to determine by agreement, in any manner not manifestly unreasonable, what shall constitute reasonable care in a particular case.

CONCLUSION

Both the Massachusetts and New York courts interpret section 9-207 as imposing a duty upon a pledgee to inform his pledgor of a notice to redeem. However, while the Massachusetts court would apply this duty in all instances, the New York court would impose the duty only under certain circumstances. Furthermore, the New York court holds that a sub-pledgee is to be treated as an ordinary pledgee under section 9-207.

If pledgees are to avoid liability in jurisdictions interpreting section 9-207 as New York and Massachusetts do, they must either keep informed of redemption notices and notify their pledgors of them, or draft into their pledge contracts a definition of reasonable care which excludes the necessity of searching for calls to redeem. The second option, however, carries the danger of a decision that such an exclusion is manifestly unreasonable and therefore invalid under Comment 1 to section 9-207. If, however, the clause is conspicuous and there are no indications of undue influence on the part of a sophisticated pledgee against a naive pledgor, there is no reason to believe that such an exclusionary clause would be held manifestly unreasonable.

The language of section 9-207 was not very useful to the solution of the problems presented to the Massachusetts and New York courts. The section lacks any reference to the duty of a pledgee when the collateral must be changed, such as when convertible debentures are called for redemption. The absence of such language may reflect the intent to place no duty on a pledgee in such a situation. But this conclusion remains far from clear. Section 21 of the *Restatement of Security* does provide for situations where the form of the collateral must be changed.⁵⁰ Its incorporation into section 9-207 would greatly clarify the duty of a pledgee in relation to convertible debentures. Under the *Restatement*, a pledgee has the duty to inform his pledgor of a redemption notice if it is "peculiarly within the knowledge of the pledgee."⁵¹ This standard provides a specific guideline for the determination whether a pledgee has the duty to inform his pledgor. Under the *Restatement* rules, the pledgor has the right to choose what to do with the collateral, and the pledgee must effectuate the choice. If, however, "the pledgor refuses, or after reasonable opportunity, neglects to express a decision, the pledgee's choice is binding on the pledgor."⁵² These *Restatement* rules apply only when the change in collateral is compulsory, such as when debentures must either be redeemed or converted.⁵³ Without this stipulation, a pledgor could force a pledgee to speculate with collateral at any time by requesting the pledgee to convert to stock, and thus could endanger the pledgee's secured position. If these *Restatement* rules were incorporated into section 9-207, the law regarding

⁵⁰ Restatement § 21, supra note 27.

⁵¹ Restatement § 21(2).

⁵² Restatement § 21(3).

⁵³ Restatement § 21, comment a.

a pledgee's duty in relation to convertible securities and especially in relation to the problems of the *Traverse* and *Grace* cases would obviously be greatly clarified.

Application of the reasoning of the *Restatement* rules to other situations which might arise under section 9-207 will help to clarify the pledgee's duty of reasonable care. In order to comply with this duty, a pledgee must take affirmative action when that action can be performed only as a consequence of possession of the collateral. The extent to which the pledgee must act will necessarily be determined by the nature of the collateral and the conditions of the pledge agreement.

GERALD J. HOENIG