

ARTICLE 8—INVESTMENT SECURITIES

CARLOS L. ISRAELS*

This Article deals with investment paper—here termed “securities”—as distinct from commercial paper dealt with in Article 3. Axiomatically bonds, stock certificates, and the like, which serve as media for public participation in the financing of business enterprise, must be negotiable. As against a purchaser for value without notice of a defense, the issuer must so far as possible be precluded from raising that defense; and one whose title is defective must be able nonetheless to convey a better title than he has, so that the purchaser for value without notice of a claim of ownership will not be subject to it. The possible far-reaching consequences of the non-negotiability of a particular type of investment paper are illustrated by two famous cases in the field. J. P. Morgan and Co. issued so-called “interim receipts” entitling the bearer to the delivery of bonds of the Kingdom of Belgium when received in definitive form. Some receipts were stolen, sold to a purchaser for value without notice, and sued upon. Judgment was for the defendant. The certificates, despite their recitation that

Every taker and holder of this certificate and the attached warrant hereby agrees that the undersigned may treat the bearer of this certificate and the attached warrant as the absolute owner hereof and thereof, as the case may be, for all purposes, and that the undersigned shall not be affected by any notice to the contrary

did not contain the necessary “unconditional promise or order to pay a sum certain in money . . . on demand or at a fixed or determinable future time.”¹ Therefore, the title of the original owner was not divested by the later purchase for value without notice.²

In the year 1928 Pulaski County, Kentucky, sold an issue of \$280,000 principal amount of road bonds to Caldwell & Co., bankers of Nashville, Tennessee. The proceeds were left on deposit, at interest, with Caldwell and the deposit was collateralized by Caldwell with the Bank of Tennessee. In 1930, both Caldwell and the Bank (a Caldwell affiliate) became insolvent, and the collateral turned out to be worth only \$15,000. The County refused to honor the bonds, claiming “fraud” and non-negotiability because of language which it construed to limit the fund from which the bonds were payable, and thus to condition the promise to pay. Judgment for the defendant had widespread and immediate repercussions. The market for

* A.B. 1925, Amherst College; LL.B. 1928, Columbia University. Visiting Lecturer in Law, Columbia University Law School, 1946-48; Lecturer on Corporate Practice and Finance, Practising Law Institute, since 1937; Reporter on “Investment Instruments” (Article V), 1945. Contributor of articles on corporation law and finance to periodicals. Member of the New York bar.

¹ NEGOTIABLE INSTRUMENTS LAW §1.

² President and Directors of Manhattan Co. v. Morgan, 242 N. Y. 38, 150 N. E. 594 (1926). The quotation, of course, is from NIL §2. There are many law review comments on this case and the questions which it raises, *e.g.*, negotiability “by contract” or “by estoppel.”

road and bridge bonds of Kentucky counties dropped an average of thirty points. Other governmental units contemplating such financing found no takers. The case was reheard, and the promise re-construed as unconditional.³

Here were two obvious examples of paper "of a type commonly . . . recognized . . . as a medium for investment"⁴ which failed to fit snugly within the straitjacket of the NIL definition of a negotiable instrument.⁵

Similarly the registered bond is non-negotiable as not "payable to order or to bearer"; the income bond does not call for "a sum certain"; and all non-money paper, such as stock certificates, must find its basis for negotiability elsewhere, *e.g.*, in the Uniform Stock Transfer Act,⁶ which applies specifically only to certificates of stock. The answer has been state amendments to the NIL or the passage of additional statutes broadly if ineptly defining such terms as "corporate bonds," "security receipt," and the like,⁷ to fill in the gap between commercial usage, and the NIL and Transfer Act definitions.

The Code will draw together the concept of what is properly investment paper—and therefore negotiable—on a pragmatic basis, following the English theory where limitation of the Bills of Exchange Act to Bills, Notes, and Cheques as there defined left custom free to impart negotiability to any other type of instrument *dehors* the statute.⁸

The definition of "Security" in Section 8-102 emphasizes the common characteristics,

issuance in bearer or registered form;

type commonly dealt in on organized markets or commonly recognized in the relevant area as a medium for investment;

one of a class or series or by its terms divisible into a class or series; and representing an interest in property or in an enterprise, or evidencing the obligation of the issuer.

"Registered form" is defined by reference to terms of the instrument providing for registration of transfer on books maintained for that purpose by the issuer.

The analogy to various definitions of a "security" in state blue sky laws and the Federal Securities Acts⁹ will be noted. It is the added elements, however, which are significant. The regulatory statutes make no reference to form, nor to the acceptance of the instrument or its prototype as a medium for investment in any market. They are police statutes, designed primarily to require an adequate informational background for a market which may not yet have developed. Thus the

³ *Pulaski County v. Ben Hur Life Ass'n of Crawfordsville, Indiana*, 286 Ky. 119, 149 S.W.2d 738 (1941), reconsidering an unpublished opinion dated October 8, 1940. See Peak, *Negotiable Non-negotiables*, 30 Ky. L. J. 174 (1942).

⁴ Sec. 8-102(1)(a), Uniform Commercial Code, Proposed Final Draft, Spring, 1950.

⁵ NEGOTIABLE INSTRUMENTS LAW §1.

⁶ The Transfer Act.

⁷ *E.g.*, N. Y. PERS. PROP. LAW §260 *et seq.*

⁸ BRANNAN'S NEGOTIABLE INSTRUMENTS LAW 107 (6th ed., Beutel, 1938).

⁹ The Securities Act of 1933, 48 STAT. 74 (1933), and the Securities Exchange Act of 1934, 48 STAT. 881 (1934), 15 U. S. C. §§77a-78 inclusive (1946).

rabbit contract,¹⁰ the oyster bed certificate,¹¹ and the citrus grove development units¹² which have been held to be securities under the regulatory statutes may never become such under the Code.

The exclusion of order paper and of "one name" paper which does not provide for registration of its transfer accords with commercial practice. The former may be negotiable or not as commercial paper under Article 3. The latter, while assignable as any chose in action, is not issued with the idea that transfers will be frequent or even likely and that therefore it needs negotiability.¹³

Once investment paper is thus removed from the straitjacket of the NIL requirements it becomes relatively easier to deal with the relationships between its holders and the issuer as to defenses, and as between successive holders or holder and issuer as to claims of ownership.¹⁴ Problems of parties secondarily liable (except the guarantor who is included in the definition of "issuer" in Section 8-201) do not exist. The indorser of a registered bond or stock certificate never undertook that the issuer would honor the instrument—and Section 8-308(4) specifically codifies that rule.

No attempt will be made to summarize the Article section by section. The text of the Spring 1950 edition of the Code is there for all to read, and the Comment is reasonably informative. What we shall try to do is to point up some of the highlights, particularly where adoption of the Code is likely either to make some change in the law, to require change in what has been the usual commercial practice, or both.

The scope of the phrase "commercial practice" is important. This Article will be applicable not only to the securities of the large "public issue corporation," but equally to the securities of the smallest family type enterprise, usually referred to as a "close corporation."¹⁵ Many of the sections will have no such impact because the securities of close corporations do not come into the framework of the organized securities markets with their brokers and professional transfer agents and registrars. Conversely, in the field of issuers' defenses and purchasers' notice of claims of ownership, the law today equally affects the two types. Transactions in the securities of close corporations will obviously be less frequent. Between members of a family or business associates, they are likely to be conducted much more informally. Arguably, in

¹⁰ *Gracchi v. Friedlander*, 93 Cal. App. 770, 270 Pac. 235 (1928).

¹¹ *Securities and Exchange Comm'n v. Cultivated Oyster Farms Corp.*, U. S. D. C., S. D. Fla., March 22, 1939, CCH, FEDERAL SECURITIES LAW SERVICE (1941-1944 Dec.) ¶90, 121.

¹² *Securities and Exchange Comm'n v. W. H. Howey Co.*, 328 U. S. 293 (1946).

¹³ *Cf.* the "interim receipt" in the *Morgan* case, *supra* note 2 (bearer form) with the window ticket issued by the bank retaining custody of securities in course of registration of a transfer (one name paper). There is a tendency, even among sophisticates of the financial community, to consider the latter "non-negotiable" in the sense of "non-transferable," thus equating the concepts of negotiability and transferability. The equation is obviously untrue and need not concern us here.

¹⁴ The Article adopts, as does Article 3, Professor Chafee's division of the concept of negotiability into these two main categories. Chafee, *Rights in Overdue Paper*, 31 HARV. L. REV. 1104 (1918), summarized in WILLIAM E. BRITTON, HANDBOOK OF THE LAW OF BILLS AND NOTES §156 (1943).

¹⁵ The distinction is best drawn on the basis that a close corporation is one in which management and ownership are substantially identical; any other is a "public issue corporation" regardless of whether its securities were ever actually publicly offered in the sense of the regulatory statutes. See generally, *Israels, The Close Corporation and the Law*, 33 CORNELL L. Q. 488 (1948).

such an atmosphere should there be a question of defense or claim of ownership, the warnings of its existence are likely to be loud and clear, but the extrinsic relationships of buyer and seller may well operate to encourage ignoring of the warnings. But all of this is speculative and hardly an area into which a statute such as this could safely venture. Earlier drafts contained a specific provision permitting an issuer of securities to negate their negotiability by stamping them "non-negotiable,"¹⁶ which the close corporation and its shareholders might occasionally find useful, for instance as protection against violation of an agreed restriction on transfer. This problem has been dealt with in what the writer believes to be a satisfactory manner by an amendment adopted at the September, 1950 meeting of the Commissioners on Uniform State Laws. That amendment is discussed below.¹⁷ The issuer's right to negate negotiability has been eliminated in the present draft. The writer believes that elimination wise. To have included it would have required either precise definition of a close corporation,¹⁸ or permission to all issuers to negate negotiability, which might lead to abuse and for which there appears to be no demand whatever.

Against this background, we shall review the Article primarily from the standpoint of its impact on the securities of public issue corporations because it is the holders and issuers of such securities in whose primary interest it is drawn. It will be applicable also to securities of close corporations, but in the writer's view should not raise any special problems in that field.

I

ISSUERS' DEFENSES

Obviously the objective here is to uphold the validity of the security in the hands of a bona fide purchaser for value¹⁹ to the greatest practicable extent. Due, however, to constitutional limitations on corporate power, it has been necessary to draw a distinction between the purchaser of a security on original issue, even though he may have given value without notice of a defect affecting its validity, and a subsequent bona fide purchaser.²⁰ Violation of a constitutional provision can invalidate the security in the former's hands, but not in the latter's. Where private issuers are involved the distinction seems unimportant. The principal constitutional provisions which might be pleaded are those declaring that securities issued for inadequate consideration (*e.g.*, par value stock for less than par) are "void." The better case law validates such securities in the hands of innocent purchasers—and since the purchaser on original issue would himself be the one who paid the inadequate price, he could hardly be considered innocent. Governmental issuers however are often

¹⁶ Cf. UNIFORM BILLS OF LADING ACT §8.

¹⁷ See p. 258 *infra*.

¹⁸ A problem which has proved difficult if not insuperable in another context. See "Act, Recommendation and Study Relating to Requirements of Greater Than Majority of Plurality Vote of Directors or Shareholders," contained in the report of the Law Revision Commission, N. Y. LEGIS. DOC. NO. 65, 381 *et seq.* (1948).

¹⁹ Defined in §8-302. The NIL term "holder in due course" is discarded.

²⁰ Shades of "the payee as a holder in due course"!

subject to more stringent constitutional restrictions—debt limits and the like. First purchasers from such issuers, then, must guard themselves and the ultimate investor is protected if the issuer is estopped by having received substantial consideration, and the stated purpose of the issue is one for which the issuer had power to borrow.

The writer is a little troubled by the question of whether a professional underwriter, if any be involved in the transaction, will always be the purchaser on original issue under this section. The professional underwriter is presumably most capable of making whatever investigation is required to see to it that all constitutional provision are complied with. The security issues of the well-established issuer (where obviously the danger of defense is minimal) are usually handled by underwriters who buy the entire issue outright and thus without question are themselves “purchasers” as defined in Section 8-201. It is in the smaller issue of the less well known issuer that the danger lurks, and it is in that same area that the underwriter often functions only as an agent whose sole commitment is to use his best efforts to market the securities. Typically, such an underwriter will never have physical possession of the security. He obtains orders which he transmits to the issuer who causes the security to be issued in the name of the investor and forwarded through the mails or otherwise against payment. Is it possible that such an underwriter is not a “purchaser” because he did not take by “purchase” as defined in Section 1-201? This is the definition:

“Purchase” includes taking by sale, mortgage, pledge, lien, issue or re-issue, gift or any other transaction creating an interest in property.

Arguably the agent underwriter is not within this concept. Certainly he acquires no interest in the security, but merely a contract claim against the issuer for his commission. The definition of purchase in this particular aspect bears re-examination, because for obvious reasons this is the case where the investor may most need protection.

The same Section (8-202) deals with the problem of incorporation by reference of extrinsic material, such as indentures, statutes, regulations, and the like, and states the sensible rule that as against a purchaser for value and without notice such matter relied on as a defense may be so incorporated “only to the extent that such additional terms do not contradict or materially vary the stated terms.” Section 8-104 makes equally clear that mere reference to the extrinsic matter (whether or not it varies or contradicts the stated terms) does not of itself charge a purchaser with notice of defenses resulting from such matter.

Let us examine these sections in the light of the “conditional promise” cases which arose under the NIL by reason of references in corporate bonds to indentures under which they were issued.²¹ The results of these cases are hardly consistent, but

²¹ The cases are discussed in R. A. McCLELLAND AND F. S. FISHER, *THE LAW OF CORPORATE MORTGAGE BOND ISSUES* 145 *et seq.* (1937); and by BRITTON, *HANDBOOK OF THE LAW OF BILLS AND NOTES* §17 (1948).

broadly speaking reference to an indenture "for a description of the property mortgaged and pledged . . . and the rights of the holders of the bonds *with respect thereto*" (italics mine) does not destroy negotiability,²² whereas "the holder of this bond shall have no right of action thereon or under said mortgage except as provided in that instrument" destroys it.²³ Thus the NIL operates as an indirect sanction against indenture provisions restricting individual bondholders' rights to sue at law for principal or interest when due without acceleration, and it has become customary for indentures specifically to preserve that right. Where the issue is \$1,000,000 principal amount or more and is publicly offered, such preservation is required by Federal statute.²⁴ Under the Code it will be possible in smaller issues to revert to the earlier practice without impairing negotiability, but at least the restriction to be effective would have to be spelled out in detail in the bond.

II

OVER-ISSUE

A note of the Advisers on Article 8 to the Council of the American Law Institute in 1948 said:

Over-issue, that is, the issuance of shares in excess of those authorized by the charter of the issuer, is viewed as the most heinous crime a corporation may commit by almost every court that thinks about mentioning the subject. . . . Even in the case of over-issue, however, damages run to the innocent holder. See *e.g.*, *N. Y. and E. Tel. & Tel. Co. v. Great Eastern Tel. Co.* (1908) 74 N. J. Eq. 221, 69 A. 528, *aff'd* 78 A. 1135, 75 N. J. Eq. 297 (1908), involving over-issue resulting from failure to cancel old certificates; *Smith v. Worcester & S. St. Ry.* (1916) 224 Mass. 564, 113 N. E. 462, involving a fraudulent over-issue; *N. Y. and New Haven R. R. Co. v. Schuyler* (1865) 34 N. Y. 30 (fraudulent over issue).

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There may have been considerable value in this view of over-issue as a serious matter when corporate charters were individual acts of the legislatures and when the corporate form was not yet thoroughly recognized as an integral part of our going business structure and, most fundamentally, when dealings in corporate stocks and bonds were not on the wide spread and quickly handled basis on which they now rest. To-day, however, with amendment of a charter possible by mere filing in the case of most corporations the sacredness of the concept is somewhat hard to see. When the problem of over-issue is set against that of stock issued for no consideration at all, the over-issue seems to be the weaker of the two defenses. In fact, were it not for the lip service constantly paid this concept, one could argue that it was an *a fortiori* case in view of the results under the constitutional provisions as to lack of consideration.

One of the basic questions of policy for this Article of the code is whether this sacrosanct character of over-issue be maintained. . . .²⁵

Unfortunately it has been deemed necessary to maintain "this sacrosanct char-

²² *Enoch v. Brandon*, 249 N. Y. 263, 164 N. E. 45 (1928).

²³ *Moody v. Pacific S.S. Co.*, 174 Wash. 256, 24 P.2d 609 (1933).

²⁴ The Trust Indenture Act of 1939, 53 STAT. 1149 (1939), 15 U. S. C. §§77aaa-77bbb, 77ppp(b) (1946).

²⁵ Note to Proposed Final Draft No. 1, April 26, 1948.

acter of over-issue." At various meetings where this Article has been considered, attempts to insert in Section 8-105 provisions which would require charter amendment where it can be done by filing after vote of shareholders were defeated, presumably on the theory that it would amount to coercing the body of shareholders to perform an act which under the statutes would be wholly voluntary. The writer lines up with the minority, and points to the precedent of the Public Utility Holding Company Act of 1935,²⁶ under which the power of the Securities and Exchange Commission to require recapitalization of a regulated utility company without the shareholders' vote which the state statute would require has been specifically upheld.²⁷

The solution chosen is to require the issuer, wherever possible, to purchase an identical security in the market and deliver it to the plaintiff. If unable to do this, the issuer must pay damages, but only to the amount paid by the plaintiff for the security. Application of this Section may bring some difficult cases. What is a market? Suppose there are twelve shareholders, only one of whom will sell and only at a clearly exorbitant price? The issuer tenders damages. The plaintiff refuses because the shares, though not worth the price demanded, are more valuable than when he bought them and under the rule of damages adopted by the Section he will lose the increment. He maintains there is a market. If the issuer can then persuade the majority shareholders to authorize an additional issue, must the plaintiff accept it?

The writer thinks the plaintiff should be required to accept a new and valid security, no matter how obtained. Nor does he think the Section requires further amendment to clarify the point. The suit will be to compel registration of the security in plaintiff's name; the judgment that plaintiff may recover a security so registered, which can be satisfied from any available source.

In selecting a rule of damages for the case where it must be applied, the Section has departed from all precedent and provides only for recovery of the price paid. That seems to the writer of no particular importance. None of the available rules²⁸ will be fair in all cases, and one can hope and assume that the damage cases will be negligible in quantity.

III

THE "MATURITY" RULE

If there be one point at which the NIL straitjacket spells danger to the innocent investor in corporate bonds, it is the requirement that a holder in due course take the instrument "before it was overdue."²⁹

Release from the tie-in to commercial paper has enabled Article 8 to deal with the problem of maturity or call realistically and simply. Sections 8-203 and 8-305 do the job. As against the issuer, they charge a purchaser with notice of "an act or event

²⁶ 49 STAT. 803 (1935), 15 U. S. C. §79 (1946).

²⁷ *Phillips v. S. E. C.*, 153 F.2d 27 (2d Cir. 1946), *cert. denied*, 328 U. S. 860 (1946). *In re Commonwealth & Southern Corp.*, 84 F. Supp. 809 (D. Del. 1949).

²⁸ They are set forth in the Comment to §8-105.

²⁹ NIL §52(2).

which creates a right to immediate performance of the principal obligation evidenced by the security or which requires that the security be surrendered for redemption or exchange," only (a) one year after any money required to be paid is available; and (b) two years after the date set for surrender or other performance not requiring the payment of money. The purchaser is charged with notice of claims of ownership under similar circumstances in one-half the time. Suppose the bonds are due. The issuer is in reorganization. The ticking of the clock prejudices no one until under the approved plan of reorganization or otherwise funds or new securities are available for distribution, and after that point time is given for the normal processes of presentation and exchange. Only when those periods have expired does the security become "stale"—and "overstaleness" has always been good cause for suspicion and inquiry.

IV

LOST SECURITIES

The problem of lost, stolen, or destroyed securities is dealt with in the Article in two aspects. Section 8-405 codifies the long standing corporate practice of voluntarily issuing new securities to replace those lost, destroyed, or stolen when reasonable requirements (indemnity bond, etc.) have been satisfied. A court order will be no longer necessary, nor will it be necessary in the case of a bond for the trustee to issue a "certificate of indebtedness" which is intended to and does have the same legal consequences as against the issuer as would a proper bond, but which could not be disposed of in the ordinary course.

The second aspect is the more important. Under Section 8-304(b), a purchaser is charged with notice of claims of ownership if "within six months prior to his purchase he has received notice that the security is stolen." The rule nicely disposes of the problem of "forgotten notice" by effectually imposing upon the purchaser the duty to keep his memory green for a six months' period, but for that period only. The rule should have a commendable effect on brokerage practice. All too frequently stolen bonds slip through the net spread for them throughout the financial community because brokerage houses throw the current list of stolen securities in the waste paper basket or merely post it somewhere and rarely check the securities physically delivered to them against the list. The obligation to make such checks is not too burdensome a one, and the six months' time limit seems entirely reasonable. If the securities do not turn up within that time, presumably the owner can protect himself for an additional period by giving a renewal notice.

V

RESTRICTIONS ON TRANSFER

We remarked above that this was a point at which the impact of the Article on close corporations appears to be particularly significant. The use of cross-options to restrict the transfer of shares without running afoul of the prohibition on unreason-

able restraints on alienation is growing. The options may be contained in agreements, extrinsic to the certificate of incorporation and the by-laws, or embodied in one or the other of those documents, certificate or by-law. The fact that the Commissioner of Internal Revenue recognizes the option price set in accordance with a properly drawn agreement as binding upon him for estate tax purposes has been a large factor in the increasing use of the device. The consequence of spelling out the restriction in one place or the other has not been thought particularly significant except for the fact that certificates of incorporation can usually be amended by majority or two-thirds vote of the shareholders,³⁰ and by-laws often by directors' vote alone, whereas amendment of an extrinsic agreement presumably requires the consent of all the parties to it. Use of the device is not restricted to close corporations. It is also useful in corporations which are not strictly within even the broad definition of close corporation suggested above,³¹ in order to preserve an existing control situation, with collateral benefits if questions of estate tax valuation should arise.

Section 15 of the Transfer Act denies validity to any restriction on transfer imposed "by virtue of any by-law of such corporation, *or otherwise*" (*italics mine*) unless the restriction be "stated upon the certificate." As submitted to the September meeting, Section 8-204 referred only to restrictions "imposed by the issuer," which it declared "ineffective unless noted on the security." By Comment it was indicated (a) that even a purchaser with actual knowledge of the restriction could take free of it if it did not "appear on the face of the security"; but that (b) where the restriction is imposed by agreement among shareholders, the Code would not affect its validity, scope, or binding effect upon purchasers. As changed at the September meeting, the Code will uphold the restriction as against a purchaser with notice, whether or not it is set forth on the security, in recognition of the economic fact that the restriction, no matter how imposed, is designed for the protection of the shareholding group rather than of the issuer as such. And that the purchaser with notice will not be left in a position to take unfair advantage of a technicality, merely for the sake of imposing a theoretical penalty on a careless issuer the burden of which would actually fall on the shareholders. The writer is familiar with situations where, because the affected shares are listed, it would be difficult if not impossible to deliver a stamped certificate after the required options had been offered and refused. The redraft should permit the certificates to remain unstamped in such a case, limiting the binding effect of the restriction to those with notice of it, and it may be hoped that the decisions involving shareholders' agreements will come into line.

VI

PURCHASERS' RIGHTS

In dealing with purchasers' rights, the Article defines a "bona fide purchaser" as

³⁰ Except where the statute permits a larger majority to be required, either with a time limit on the effectiveness of the provision (*e.g.*, NEW YORK STOCK CORP. LAW §9) or indefinitely for the life of the corporation (*e.g.*, DEL. GEN. CORP. LAW §5).

³¹ See note 15, *supra*.

one who "in good faith, for value, and without notice of any claims of ownership takes delivery of a security in bearer form or of one in registered form issued to him or indorsed to him or in blank" (§8-302(2)). A bona fide purchaser "acquires . . . a perfect title to the security." (§8-301(3).)

The question of what constitutes notice of claims of ownership produces this Article's first encounter with the "fiduciary" problem—the security registered in fiduciary name or known to the purchaser to be held for the benefit of a third person. Section 8-304 requires that to charge the purchaser with notice as a matter of law,

- (a) the proceeds of transaction must be placed by the purchaser in the individual account of the fiduciary; or
- (b) must be made payable in cash or to the fiduciary individually; or
- (c) the purchaser must have reason to know that such proceeds are being used, or that the transaction is for the individual benefit of the fiduciary.

Three other situations (non-fiduciary) are listed and given similar consequence. The Comment emphasizes that the listing "is not exhaustive and does not exclude other situations which may give similar notice"—presumably either as a matter of law or inference from facts known to the purchaser.³²

One other circumstance which will deny a purchaser "bona fide" status will come up with the revision of the indorsement section (8-308) adopted at the September meeting. As the Section now reads, it adopts the Transfer Act provision³³ for indorsements either on the instrument or by a separate document (typically the so-called stock or bond "power") which identifies the particular security affected. In addition it takes over from the NIL the requirement that "an indorsement . . . must be of the entire instrument." This will be eliminated to provide for the common case of "split-up" where the holder of a one hundred share certificate, having sold fifty shares, will sign a power affecting only fifty shares and send it with the certificate to his broker or the transfer agent, expecting to receive in return the proceeds of the sale of fifty shares and a new fifty share certificate in his own name. Obviously, the "entire instrument" requirement would prevent such practice with no concomitant benefit. Equally obviously, a purchaser who takes a partially indorsed security cannot become a bona fide purchaser.

VII

BROKER-CUSTOMER RELATIONSHIPS

This is the first of two important fields in which this Article plows new statutory ground. Transactions on the organized securities markets involve either a broker or a dealer. The former acts purely in an agency capacity; the latter as principal. The member firms of the major exchanges in effecting transactions on the exchange act as agents, while on the "over-the-counter" markets the pattern is usually one of

³² See, e.g., *State Bank of Binghamton v. Bache*, 162 Misc. 128, 293 N. Y. Supp. 667 (Sup. Ct. 1937), and for a pure "fact" case, *Morris v. Muir*, 111 Misc. 739, 181 N. Y. Supp. 913 (N. Y. Munic. Ct. 1920).

³³ Sec. 20.

sale to or purchase from the customer directly by a dealer. However, the distinction between "broker" and "dealer" is unimportant in this context.³⁴ Regardless of that distinction the customer who gives an order to purchase a security at once enters into a contractual relationship requiring the eventual delivery of a security which at the instant of the order is most unlikely to be in the broker's possession. Even the over-the-counter dealer who confirms a direct sale to his customer usually expects to deliver a security which he has substantially simultaneously purchased from another customer or another dealer. When does the relationship change? When does the customer acquire a property interest which, when the broker or dealer goes bankrupt, can form the basis for a valid reclamation claim to specific property and thus save the customer wholly or partially harmless from the impact of the bankruptcy?

The important sections of this Article are 8-313, "When Delivery to the Purchaser Occurs; Purchaser's Broker as Holder," and 8-314, "Warranties by Broker for Purchaser." The rules are applicable, regardless of whether under the Federal Act the professional involved in the transaction is a broker or a dealer, and we shall, therefore, use the former word, as does the Code. No statute can protect the customer against the dishonest broker who, having possession of securities registered in "street name,"³⁵ sells or pledges them to a bona fide purchaser in violation of his legal duty. Where the broker properly observes the standards of good practice the customer who buys "outright" *i.e.*, pays the full purchase price, takes no risk once the security in the possession of the broker has been clearly identified by physical segregation as belonging to the customer. On the other hand, the purchaser on margin has received from the broker an advance of a portion of the purchase price and has specifically authorized him by the "margin card" to repledge the purchased securities together with those of other customers in bulk for a total amount greater than the advance. Here, even assuming observance by the broker of proper standards of commercial practice, the customer's fortunes as against the broker's bankrupt estate may well depend upon the state law as to the nature of the relationship. Historically, the conflict has been between the so-called "New York" (majority) rule, regarding the margin customer as a pledgor and the broker as pledgee, and the so-called "Massachusetts" (minority) rule, construing the relationship as merely one of debtor and creditor.³⁶

Section 8-313 makes delivery to the broker effective as delivery to the customer, (a) at once if the security is received specially indorsed to or registered in the customer's name; and (b) otherwise when the broker has (i) sent his customer a con-

³⁴ It is made in the Securities Exchange Act of 1934, 48 STAT. 881 (1934), 15 U. S. C. §§78-c(4) and (5) (1946).

³⁵ The practice of holding securities in "street name"—that of the broker in possession or the broker from whom the broker in possession obtained the security with a blank indorsement—is widespread, particularly where trading accounts are involved. The lay customer does not wish to be put to the inconvenience of having to indorse a certificate registered in his name, in order to deliver it after it has been sold, and corporate and fiduciary holders in particular seek to avoid the necessity for proving their authority and the rightfulness of the proposed transfer. See p. 262 *infra*.

³⁶ The two rules are discussed in *Denton v. Gurnett & Co.*, 69 F.2d 750 (1st Cir. 1934), and by JOHN HANNA, *CASES AND MATERIALS ON SECURITY 1 et seq.* (2d ed. 1941).

firmation; and (ii) by book entry or otherwise identified a specific security "in his possession" as belonging to the purchaser. Acknowledgment by any person other than the transferor that the security is held for the purchaser has the same effect (§8-313(1)(d)). Under all other circumstances, delivery is still incomplete, *e.g.*, where the security is merely part of a fungible bulk held for several customers, "despite the customer's acquisition of a proportionate property interest in the fungible bulk" (§8-313(2)). The Comment points to the theoretical possibility of the customer receiving notice, while the security is part of such fungible bulk, of a claim of ownership of the specific certificate later identified as his, in which event he would not be a bona fide purchaser. The writer would be astonished if that case ever arises. What is significant is how this Section may affect the conflicts which arise in brokerage bankruptcy between the reclamation claimants and the trustee, legitimately interested in spreading the impact of loss as widely as practicable by relegating as many customers as possible to general creditor status, or at least to a proportionate interest in a mass of securities the claims to which may far exceed the value available to satisfy them. Obviously, once positive identification of a particular piece of paper has been made, the reclamation claim is good and under this Section such identification may be made "by book entry or otherwise." This should give full protection to the customer who buys outright except for the rare case of bankruptcy between the date of purchase and the date of delivery of the security to the broker. The margin customer, on the other hand, will still be subject to the vagaries of state law. Under the usual practice margined securities are not specifically identified, and under Section 8-314 the purchasing broker need not deliver to his customer except "on due demand" which obviously includes tender of the amount of the customer's indebtedness. Nor will a demand made after bankruptcy be "due" unless under state law the customer has an interest in specifically identifiable securities prior to their "delivery" to him; an unlikely situation under standard practice. Even as against the honest broker, then, this Article will not improve the status of the margin customer in the event of bankruptcy, but its recognition of the fact that it is entirely proper, even necessary, to efficient conduct of a brokerage business that margined securities not be required to be individually tagged may perhaps help to make the task of the trustee in future brokerage bankruptcies an easier one.

So long as the buying broker uses due diligence to enforce the purchase contract his customer assumes the risk of insolvency of the selling broker (§8-306(3)). Normally, that risk will not be serious because to make payment in advance of actual delivery would no more be due diligence than would the granting of an extension of time for delivery without the customer's consent (§8-314(2)).

VIII

INCIDENTS TO TRANSFER

The warranties of the transferor are extended only to a purchaser for value, and as to validity of the security, the transferor warrants only that he has no knowledge

of any fact which would impair validity. Intermediaries (excluding brokers) warrant only their own good faith and authority. (§8-306.) Section 8-311 on forged or unauthorized indorsement fills a gap in the Transfer Act. It adopts the obvious rule, but protects the bona fide purchaser who has received a new security registered in his name even though the old security in exchange for which the new one was issued bore a forged indorsement. As the Comment notes, in the normal transaction in registered securities the purchaser never sees the old certificate and should not be held to have had notice of or to have "relied upon" the forgery. The case law to the contrary is rejected for strained reasoning.

Section 8-312 recognizes the universal practice on the organized markets of requiring "guarantee of signature."³⁷ The rule adopted is that of the leading case.³⁸ As a first step toward eliminating the necessity for inquiry by the purchaser into the rightfulness of the particular transfer (as distinct from the authority of the transferor or of the indorser) the concept of "guarantee of an indorsement" is introduced. With respect to this, however, text and Comment may be a little confusing. Section 8-312(3) says "... no issuer may require an indorsement guarantee as a condition to registration of transfer of a security" while Comment 2 states "Such a guarantee makes it possible for the issuer [sic] to recover over on the basis of his reliance if the guarantor was reasonably believed to be a responsible person"; the guarantee presumably having been offered by the holder to avoid otherwise justifiable but burdensome requirements.

The prevailing case law as to the effect of the signature of the authenticating trustee, registrar, or transfer agent is similarly codified (§8-208).

Sections 8-315 and 8-317 inclusive deal with the transferor's obligation as to delivery, what is a good delivery, and the purchaser's remedies when delivery is not proper. The problem here arises from the fact that registration of transfer will require something more than the indorsed security—at least an acceptable guarantee of the indorser's signature in the usual case, and in the case of an "irregular transfer" (e.g., by a fiduciary) other items. As these Sections are to be revised by direction of the September meeting, they will make clear that,

(a) The transferor must tender the security properly indorsed and together with all requisites for registration of its transfer, or the purchaser may reject the delivery as insufficient;

(b) If the purchaser has accepted delivery minus some requisite for registration of transfer (as an unsophisticated purchaser might well do) he may demand the missing item and, failing to receive it, rescind the transaction, supply the item himself and recover the expense incurred, or if the item is peculiarly within the province of the transferor (e.g., a certified resolution of the transferor corporation), sue for specific performance.

³⁷ The Rules of the New York Stock and Curb Exchanges require such guarantee by a member firm, a New York bank, or a bank having a correspondent in New York. The act of guarantee is unquestionably *ultra vires* a bank, but the defense has never been relied upon.

³⁸ The Jennie Clarkson Home for Children v. Missouri K. & T. R. R., 182 N. Y. 47, 74 N. E. 571 (1905), cited in the Comment.

IX

REGISTRATION OF TRANSFER

Commercial practice with respect to registration of transfer of securities has developed almost wholly free of statutory influence save for one section of the Uniform Fiduciaries Act³⁹ which has fallen far short of its objective. Once a security is issued in registered form the issuer undertakes to register its transfer on books maintained by him or by his transfer agent for that purpose. If the securities are debt obligations issued under an indenture, the Indenture Trustee has an *alter ego*—that of registrar maintaining the transfer books. Where stock certificates are issued, the issuer may “act as its own transfer agent,” *i.e.*, maintain the books itself, or employ a fiduciary institution (typically a trust company or a bank with trust powers) to do the job. Where securities are listed (as on the New York Stock Exchange) the employment of a professional transfer agent and in addition a professional registrar is required by Rule of the Exchange. However, the Registrar is just a double-check, and both are mere agents of the issuer. In their relations with the transferor and transferee (*a fortiori* with the brokerage community) they speak for the issuer, and their agreement or refusal to register a particular transfer is the agreement or refusal of the issuer.

The problems dealt with in the decided cases arise from their treatment of the issuer as a policeman or insurer as to claims of ownership. The issuer may be held in conversion if,

- (a) it refuses to register a security in the hands of a bona fide purchaser; or
- (b) it registers a security while charged with notice of a claim of ownership.

The scope of the liability is the same as that of a purchaser and fear of its impact has led the professionally cautious transfer agents to two diametrically opposite policies,

- (a) where the transfer appears “regular,” *i.e.*, an individual or partnership indorsement, with signature properly guaranteed, the bank having no notice of incapacity or death, the requested transfer will almost always be immediately made, even though there be a “stop transfer” on file, unless the claimant immediately gets an injunction or provides indemnity sufficient to cover the possibility that the value of the shares may rise before judgment, and under the state rule of damages the increased figure be recoverable; but
- (b) where the transfer is “irregular,” *e.g.*, the registration is in fiduciary or in corporate name, or from a decedent, infant, or incompetent, the bank will impose rigorous requirements to prove beyond all reasonable doubt that the transferor has authority to transfer, and that the particular transfer is in every respect rightful.

Part 4. of Article 8 attempts codification of the duties and liabilities of the issuer

³⁹ Discussed *infra* p. 263.

with respect to registration of transfer. First it confirms the purchaser's right to registration in a proper case (§8-401) and, as amended at the September meeting, specifically absolves the issuer (*a fortiori* the transfer agent) from liability to anyone by reason of a transfer registered pursuant to the Section.

Section 8-402 governs and limits the evidence which may be required as to the sufficiency of an indorsement absent notice of lack of power to indorse, in terms of signature guaranty plus evidence of tenure of fiduciary office at the date of the indorsement. Under Section 8-403 the issuer is absolved of any duty to inquire into the rightfulness of the particular transfer, absent notice of a claim of ownership. Subdivision (2) of the Section, dealing specifically with the fiduciary situation (security registered in T's name as Trustee or known to be held by him in that capacity) is to be revised to equate with Section 8-304,⁴⁰ so that only items such as a transfer from the fiduciary as such to himself individually, payment of proceeds for the fiduciary's individual benefit, etc., known to the issuer or the transfer agent will create a duty of inquiry into the rightfulness of the transfer.

Once this Article is in force, unless it has notice or is charged with notice under Section 8-403 that the transfer may be unrightful, the issuer can no longer require a copy of the will and examine it to see that the legacy to the decedent's Cousin Jane may be properly construed to include the securities proffered for registration in her name. Nor, if the signature of a receiver is guaranteed, may the issuer inquire as to whether the appointing court has ordered the security disposed of. If the issuer believes that it has notice or is charged with notice of the possible unrightfulness of a fiduciary transfer it may of course continue the present practice of requiring evidence sufficient to satisfy a reasonable person that the transfer is rightful. This is often a difficult and time consuming process for the security holder. Under these circumstances a solution may often lie in a guarantee of indorsement, as distinct from a guaranty of signature, since the former guarantees not only the authority to transfer but the rightfulness of the particular transfer. As noted above, the issuer may not demand a guarantee of indorsement, but if it is voluntarily offered by a person reasonably believed to be responsible the issuer may rely upon it.

To some extent the same ground is covered by the Uniform Fiduciaries Act. That text absolves the issuer of liability on a transfer out of fiduciary name unless it knows of a breach of fiduciary obligation or has "knowledge of such facts that the action in registering the transfer amounts to bad faith."⁴¹

However, the failure of many states to adopt the Uniform Fiduciaries Act (largely because of other provisions not relevant here) has limited the effectiveness of this section of it. The fact that the law of the state of incorporation may require inquiry into the rightfulness of the particular transfer,⁴² though the certificate is tendered for registration of transfer in New York which has enacted Section 3 of the

⁴⁰ Discussed *supra*, p. 258.

⁴¹ UNIFORM FIDUCIARIES ACT §3.

⁴² E.g. (Utah) *Geyser-Marion Gold-Mining Co. v. Stark*, 106 Fed. 558 (8th Cir. 1901) cited in the Comment to §8-403 as "expressly rejected."

Fiduciaries Act,⁴³ leads transfer agents generally still to require proof of the rightfulness of the transfer, in order to be certain that if the issuer were sued in its home jurisdiction its defense would be complete and would not be dependent upon the New York statute.

The mandatory language of Sections 8-401 and 8-402 is designed to outlaw this practice. To put it another way, mandatory language has been designed to do the job which the permissive language of the Fiduciaries Act has failed to do. Section 8-402 says that "the issuer *shall not* require more evidence than the following" (*Italics mine.*) What then of the situation where the issuer is incorporated in state *X* and maintains a transfer agency in New York? The certificate in the name of *T* as Trustee is presented for registration of transfer with a proper guarantee of *T*'s signature and evidence that *T* is the Trustee. New York having adopted the Code, the transfer must be made. A year later *T*'s beneficiary sues the issuer in state *X* for wrongful transfer, state *X* not having yet adopted the Code and by decision having required inquiry into the rightfulness of any fiduciary transfer. The writer believes that the issuer's defense should be sustained on the basis that it made the transfer in New York under circumstances which by the law of New York made the action mandatory. The situation is helped considerably by the fact that the Transfer Act is now in force in all of the forty-eight states and by cases decided under it. The older theory has been that while, as between transferor and transferee, the law of the place of delivery of the certificate controls, the issuer's duty to register a transfer is a matter of the law of the state of incorporation. That concept was shaken by the decision in the *Disconto-Gesellschaft* case⁴⁴ where the federal courts upheld the United States Steel Corporation in having transferred shares on its books in compliance with British wartime regulations affecting enemy alien owned shares. Where the question has been that of negotiability of share certificates, the state of transfer having adopted the Transfer Act while the state of incorporation had not adopted it, the courts of the latter state were likely to hold against the issuer,⁴⁵ but where

⁴³ *Hunt v. Drug*, 156 Atl. 384 (Del. Sup. Ct. 1931), *aff'd*, 168 Atl. 87 (Del. Sup. Ct. 1933).

the Transfer Act was in force in both jurisdictions the courts sitting in the jurisdiction of transfer have upheld the issuer's defense on the basis that the law of the state of incorporation is the same as its own, and the Transfer Act operates to fuse ownership of the shares with ownership of the certificate. What may be required, once the Code is adopted in the jurisdiction of transfer, is something more: Either (a) a holding that the law of the place of transfer governs either as such⁴⁶ or because the courts of the state of incorporation would under the Transfer Act apply the law of the state of transfer; or (b) a holding that under the law of the state of incorporation the right to registration of transfer is a contract right performable in any one of several jurisdictions and the law of the place chosen for performance of

⁴⁴ N. Y. GEN. BUS. LAW §359-j. Cf. also §359-k which covers securities in the name of a deceased person, minor, ward, or incompetent or a deceased or discharged fiduciary.

⁴⁵ *Direction der Disconto-Gesellschaft v. United States Steel Corp.*, 300 Fed. 741 (S. D. N. Y. 1924), *aff'd*, 267 U. S. 22 (1925).

⁴⁶ *The Bridgeport Bank v. The New York & N. H. R. R.*, 30 Conn. 231 (1861).

the contract governs. The Restatement of Conflict of Laws, Section 53, looks toward the first result, in view of the now countrywide adoption of the Transfer Act, by its provisions that "to the extent to which the law of the state in which the corporation was incorporated embodies the share in the certificate, the share is subject to the jurisdiction of the state which has jurisdiction over the certificate." The second theory is not so easily spelled out, but it is the logical concomitant of the first, and the writer would expect the combination of the Transfer Act fusion of the share with the certificate, plus the mandatory language of the Code, to produce the correct result. Even if suit is brought in the non-Code state, the issuer would answer that under the law of the state in which the certificate was presented to it, it not only did not have the duty, but also did not have the right to inquire into the rightfulness of the transfer. The obvious injustice under such circumstances of a decision against the issuer should lead easily to the suggested line of reasoning, holding the claimant bound by his imputed knowledge of the fact that the corporation had the right to provide for registration of transfer of its shares in other jurisdictions and exercised that right.

The new text is most specific in tagging the type of fact which in the fiduciary situation should give rise to suspicion once it be clear that the mere known existence of fiduciary obligation is no red flag. In the writer's view, considering the fact that the overwhelming majority of fiduciary transfers of registered securities are unquestionably proper, this is a distinct improvement.

In rough analogy, the issuer and transfer agent under the Code are no longer required to be policemen or insurers. They might more properly be described as firemen who, in the interest of the great majority of transferors of securities who are entitled to prompt compliance with their requests for transfer, need not seek to ferret out the obscure claim of ownership unless and until the alarm rings either in the form of actual notice of a claim, or some one or more of the simple indicia of it which under this Article would charge them with notice as a matter of law.

The final section of the Article (§8-406) is a particularly important one. It deals with the duty of the authenticating trustee or registrar (a) to the issuer, and (b) to the holder or owner of the security, to exercise good faith and due diligence in performing the allotted functions. Specifically, it rejects those cases which regard the transfer agent, for example, so much as an agent that it cannot be held liable for nonfeasance, *e.g.*, refusal to register a transfer.⁴⁷ As a practical matter, this Section should operate to concentrate suits respecting registration of transfer in the principal commercial jurisdictions where most of the transfer agencies will function and leaves to agreement between the transfer agent and the issuer or to the ordinary principles of the law of agency, the transfer agent's obvious right to indemnification by its principal except where the agent's failure to exercise good faith or due diligence has prejudiced the principal.

There can be no doubt that these six relatively short sections should greatly

⁴⁷ The cases are cited in the Comment.

simplify and speed up the process of registration of the transfer of securities, at least once the Code is fairly widely adopted. Much will depend upon its adoption in such important states of incorporation as Delaware, Maryland, and Maine, and more lately Nevada. Some of these (Delaware and Nevada for example) were very late in adopting the Transfer Act. It may be hoped that any interim period of confusion will be short.

X

This Article fairly cries out, as indeed do several others in the Code, for an "adverse claims" section analogous to that which appears in the New York Banking Law respecting bank deposits.⁴⁸ The inclusion of such a section was proposed by the reportorial staff at the September meeting. Opposition, on the ground that the Code should not include procedural matters, was overcome and the staff directed to prepare the text of such a section for inclusion in this Article, among others. Its potential usefulness is obvious. It will make available to the issuer, the transfer agent, the registrar, the broker, a clearly outlined method of placing upon the claimant to ownership of the security the burden of establishing his claim as against the alleged bona fide purchaser, without itself having to stand trial of the issue at its peril.

To some extent Article 8 unquestionably still contains "bugs" which only actual litigation will unearth. It seems clear, however, that it should perform at least these necessary tasks in the securities field:

- (1). Clearly establish the negotiability of securities as such on a pragmatic basis;
- (2). Minimize and circumscribe the field of issuer's defenses;
- (3). Clarify some aspects of broker-customer relationships; and
- (4). Speed up and simplify the process of registration of transfer by erasing from the law the concept of the issuer and transfer agent as a policeman or insurer.

In general the approach has been to follow the better commercial practice. To the extent that there is tightening (*e.g.*, on regard for notice of stolen securities), the rule suggested imposes no unreasonable burden, and the writer has no hesitancy in asserting that as it stands, Article 8 should go far toward doing its intended job.

⁴⁸ N. Y. BANKING LAW §34.