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## Article Eight: A Premise and Three Problems

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## ARTICLE EIGHT: A PREMISE AND THREE PROBLEMS

Ernest L. Folk, III\*

THIS essay concerns itself with a basic premise and three problems concerning investment securities under Article Eight of the Uniform Commercial Code (Code). Although some amount of relevant exposition is necessary to make the arguments intelligible, general familiarity with the essentials of the Code's treatment of investment securities is assumed.<sup>1</sup>

### I. THE NEGOTIABILITY PREMISE

Article Eight's overriding objective is to confer full negotiability upon all investment securities, as shown by section 8-105's avowal that "securities governed by this article are negotiable instruments."<sup>2</sup> While Article Eight represents the embodiment of pre-existing law, it also makes several important changes. Prior to the Code, no single statute governed all investment securities. Although shares of stock were implicitly made negotiable by the Uniform Stock Transfer Act, the status of many bonds, which were subject to the Uniform Negotiable Instruments Law (NIL), remained in doubt. This was so because bonds are often made payable only out of designated funds (such as, municipal bonds) or from earnings (income bonds), both of which violate the NIL requirement that a promise to pay be unconditional,<sup>3</sup> while other bonds which, on their face, bear an unconditional promise to pay are often accompanied by trust indentures to

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1. Writings dealing more specifically with exposition include Folk, *Article Eight: Investment Securities*, 44 N.C.L. REV. 654 (1966), and two excellent articles by Carlos Israels: *Investment Securities as Negotiable Paper—Article 8 of the Uniform Commercial Code*, 13 BUS. LAW. 676 (1958) and *Investment Securities Problems—Article 8 of the UCC*, 11 HOW. L.J. 120 (1965).

2. Uniform Commercial Code § 8-105 [hereinafter cited as U.C.C.]. It is interesting to note how this section dovetails with some state "legal investment statutes" which permit investment only in securities which are "negotiable instruments." See Israels, *Investment Securities in New York: Statutory Text and Commercial Practice*, 48 CORNELL L.Q. 108, 112 (1962).

3. UNIFORM NEGOTIABLE INSTRUMENTS LAW § 1(2) [hereinafter cited as N.I.L.]. Compare U.C.C. § 3-104(1)(b). The NIL retained the common law concept that a bond must contain an unconditional promise to pay in order to be negotiable. Most state legislatures, however, specifically conferred negotiability upon municipal, and other, bonds payable from designated revenues, taxes or other funds despite the fact that their payment was so conditioned.

which the bonds are declared "subject."<sup>4</sup> Additionally, the negotiability of registered-form bonds was placed in doubt by language in the registration provisions requiring transfer "on the books" of the corporation which seemingly contravenes the NIL's prescribed mode of negotiation.<sup>5</sup> Other securities, such as equipment trust securities, American Depositary Receipts, and interim receipts also probably were non-negotiable prior to the Code, absent special statutes enacted only in an occasional state.<sup>6</sup>

The near universal acclaim of Article Eight is grounded largely on its removing these (and other) impediments to full negotiability. In this respect, not only does Article Eight unify but it also culminates prior law by establishing broad negotiability and by viewing all securities as sufficiently similar in character that they can properly be governed by the same rules without distinction between equity and creditor securities. Although the latter assumption is certainly sound, the former and more basic premise—that all investment securities are and *should* be negotiable—has apparently never been seriously questioned. At this point, however, it is desirable to explore the validity of this premise in order to determine whether the Code strikes a fair balance between the underlying, indeed conflicting, policy objectives operating in the area of investment securities. In assessing such a policy balance, it is instructive, but not conclusive, to note that the trend has been toward negotiability of securities. The established and unquestioned negotiability of notes, and drafts, however, need not require that investment securities, which are substantially different from commercial paper in character and function, also carry the capacity to extinguish defenses of the issuer or claims of prior owners or of others having interests in the security.

The negotiability of investment securities necessarily means that, in the event of conflict, the interests of the "true owners"<sup>7</sup> are subordinated to those of the purchasers. However, since securities, unlike commercial paper, are either long-term (bonds and debentures) or permanent investments (stock and some other equity instruments), and presumably are acquired for the long haul, it is arguable that the

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4. See text accompanying notes 60-62 *infra*.

5. See text accompanying note 59 *infra*.

6. Security receipts and equipment trust certificates were declared negotiable by New York's Hofstadter Act, N.Y. PERS. PROP. LAW § 260 (McKinney 1962).

7. Throughout this article I shall use the term "true owner" to refer to the registered owner of a security who is in possession or has the right to possession of that security. In Article Eight the term is used only in § 8-404(2); usually, the unmodified word "owner" appears, e.g., U.C.C. §§ 8-311 & 8-315(2). Thus defined, "true owner's" interest in a security constitutes an "adverse claim" within the meaning of § 8-301(1) and therefore can be protected in various ways. See, e.g., U.C.C. §§ 8-403 & 8-405.

established ownership of securities merits greater protection than the ownership of short-term commercial paper. Unhampered or undelayed circulation of investment securities is not as essential as is the instant transferability of commercial paper which should approximate the free circulation of money. Moreover, all legitimate interests of both sellers and buyers would be served if purchasers of securities were obliged to observe the rights of others. Given a system of rules premised on the maximum protection of "true owners," mechanisms would undoubtedly be developed by which purchasers could guard themselves against loss from defenses or adverse claims unexpectedly asserted against them; for example, security prices might be adjusted downward in the marketplace to reflect such uncertainties, and forms of insurance, not easily pictured in the light of the present system, could evolve. Nor would the purchaser inevitably suffer, at least not in the long-run. For today's purchaser who loses out to the claim of a true owner under this hypothesized system of rules would, as tomorrow's "true owner," possess a title to securities which could not readily be divested by a purchaser who supposedly acquired superior rights. Perhaps speculators unable to acquire prior rights would suffer delays and other difficulties which would temper their enthusiasm, but this would not necessarily be an undesirable result. We could assume that, under such rules, securities transfers would be less swift and certain than at present, but still be substantially faster and easier than real estate transactions under current property laws.

A further reason which could be advanced in support of a system premised on non-negotiability is its inherent potential for compelling greater caution in the transfer of investment securities. Under this hypothetical system, a purchaser, who takes the security subject necessarily to any adverse claims whether or not known or knowable, would surely be entitled either to a clean security free of such claims,<sup>8</sup> or to damages. Whatever the remedy sought, the purchaser's demand would work its way back through the buying broker and transfer agent, and eventually come to the selling broker who handled the sale of the original tainted security. Presumably, the selling broker would sustain a converter's liability for participating in the wrongful transfer; therefore, he would probably insure against this liability, while retaining rights against the seller who perpetrated the original wrong. Or, more likely, since the market custom is for the

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8. Under the existing system, compare the New York Stock Exchange "Reclamation Rules," N.Y. Stock Exch. Rules 265-75, particularly Rule 272, permitting reclamation at any time "by reason of the fact: (1) That title to a security is called in question . . . ." CCH N.Y.S.E. GUIDE ¶¶ 2265-75.

selling broker promptly to register transfer of the security out of the seller's name and into a name acceptable for transfer under securities exchange rules,<sup>9</sup> special care would be exercised at the threshold to assure that a "clean" security goes into the market. Thus, a non-negotiability concept would compel brokers to exercise greater care than at present to assure the integrity of transactions—a result with which no one can quarrel.

It is evident, then, that we can establish on a premise of non-negotiability an entirely rational system which would generously serve important policy objectives. The questions that now must be considered are: what major interests are promoted by the existing system which rests on the opposite premise, and does the existing system sufficiently protect the "true owner."

Unfettered negotiability of securities reflects the custom and practice of the investment community which regards the principles that purchasers prevail over "true owners" and that issuer defenses be extinguished by the sale as indispensable to swift, easy, and standardized transactions. Clearly, the purchaser can be more confident if he knows he will not be bound by defenses and claims of which he is ignorant and, further, that he need not search them out. Hence, from the purchaser's standpoint, the reliability of securities transactions is increased. Moreover, the very fact that the purchasers are thus favored benefits the true owners as well, since they now know that they can sell their securities in a market which is broader, more certain, and better able to absorb their offerings; indeed, the existence of this ready market stabilizes and perhaps enhances the value of securities which are merely held as well as those which are sold. Thus, negotiability both promotes and reflects the quality of the market for investment securities.

Another consideration is that "true owners" and issuers are in the best position to protect their own interests. The issuer, for instance, can simply comply with all of the legal requirements when creating a security and thus obviate any need to assert "defenses" based on invalidity under statute or charter;<sup>10</sup> just as it can minimize the once-common risk of irresponsible employees issuing securities to themselves for personal gain.<sup>11</sup> "True owners" of securities can also best protect their interests: they can avoid indorsing securities and thereby

9. See N. Y. Stock Exch. Rules 199-201, CCH N.Y.S.E. GUIDE ¶¶ 2199-201.

10. The two principal provisions on issuer defenses are U.C.C. §§ 8-202 & 8-215.

11. See, e.g., *Hudson Trust Co. v. American Linseed Co.*, 232 N.Y. 350, 134 N.E. 178 (1922); *Jarvis v. Manhattan Beach Co.*, 148 N.Y. 652, 43 N.E. 68 (1896); *Havens v. Bank of Tarboro*, 132 N.C. 214, 43 S.E. 639 (1903). U.C.C. § 8-205 adopts the rule that the signature of a transfer agent, registrar, authenticating trustee or any of their employees "entrusted with the responsible handling of the security" will bind the issuer.

prevent thieves and unauthorized persons from passing title;<sup>12</sup> they can select honest, reliable, and bonded fiduciaries<sup>13</sup> and can bring to account trustees who wrongfully transfer securities; and when securities are lost or stolen, they can invoke standardized procedures to protect their interests.<sup>14</sup> Thus, the greater ability of "true owners" and issuers to minimize the risk of loss or harm to all concerned in large part supports the negotiability rule. In contrast to the "true owners" and issuers, purchasers are poorly situated to protect against such risks, particularly in the impersonal transactions on organized markets involving securities which are today viewed as fungible.<sup>15</sup>

Even further, I suggest that underlying all the arguments in support of negotiability there lies an unarticulated policy favoring the ready circulation of securities, as against the stagnancy of unchanged ownership. Policy seemingly favors the continuous, on-going process of exchanging property—for the myriad reasons people buy and sell property—and transactions in investment securities are certainly facilitated by negotiability concepts. Perhaps favoritism to any acquirer, including the bona fide purchaser of securities, is intrinsic to a capitalistic system or, even more generally, to a society which is restless physically, mentally, and economically. In all events, the law, as it has evolved, simply recognizes that negotiability inheres in the structure and technique of the organized securities markets as they exist today.

Even so, the existing system well protects the true owner when he most needs it, namely, when his indorsement is forged. Here, he may usually recover even from a bona fide purchaser<sup>16</sup> and, perhaps more important, he may always recover from the issuer or transfer agent who registered transfer on the forgery.<sup>17</sup> The latter are usually fiscally responsible and probably insured, and if they must respond in damages or issue a new security to the aggrieved owner, they also have rights over against the person, normally a bank or brokerage house, which guaranteed as genuine the signature which was in fact forged.<sup>18</sup>

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12. See generally, U.C.C. § 8-315.

13. See U.C.C. § 8-304(2) for the rule that purchasers need not inquire into the rightfulness of transfer of a security registered in a fiduciary name.

14. See U.C.C. §§ 8-403(1)(2)(a) (stop transfer notice) & 8-405(2) ("lost, destroyed or wrongfully taken" security).

15. For the view that securities of the same issue are fungible, see U.C.C. § 8-107(1) and comment I.

16. "Bona fide purchaser" is defined in U.C.C. § 8-302, and the right of recovery is stated in § 8-315(2). However, if the bona fide purchaser has received from the issuer or transfer agent a new, reissued, or re-registered security in his own name, he is protected even against the true owner. U.C.C. § 8-311(a).

17. U.C.C. § 8-311. Whether or not the true owner may go against the purchaser (see note 16 *supra*), he may still recover from the issuer. U.C.C. § 8-404(2).

18. U.C.C. § 8-312.

Admittedly, absent a forgery, but where delivery is improper for some other reason, the true owner has no rights against either the bona fide purchaser,<sup>19</sup> or in most cases the issuer or its transfer agent,<sup>20</sup> nor does he have rights against a signature guarantor.<sup>21</sup> Nevertheless, it is precisely in this situation that the true owner can most readily avoid the circumstances which cause or at least contribute to the loss. Thus, while the true owner lacks the preferences which he would be afforded under the hypothesized system based on non-negotiability, the protection he is afforded under the existing system is substantial.

Although these affirmative reasons, standing alone, sufficiently support full negotiability of securities, it is well to stress the extent to which a system of non-negotiability would inhibit the operations of the securities markets, especially where transactions have been, or are becoming, computerized. If a security is, in fact, non-negotiable—as is presently the case with some investment media not within the Code definition<sup>22</sup>—the purchaser takes it without confidence that he can ever prevail over the claim of the true owner, as indeed he cannot. It is no answer that he would have rights over against someone, however financially responsible and well-insured that person might be. At best, the state of his “title” to the security would be in doubt, and collection of damages or acquisition of a new security (whose purity might later be impugned) would be delayed, wholly apart from the expense of possible litigation over the matter. For the purchaser gains no immunity from adverse claims to a non-negotiable instrument merely because he does not and could not reasonably be expected to know of them. The taint would apply equally whether the purchaser acquired a certificate in the seller’s name or one registered into a nominee or even into the purchaser’s own name, since non-negotiability entails the adverse claim’s continuing in the new or reissued certificate. Indeed, far from coexisting with the view that the certificate subsumes all intangible rights,<sup>23</sup> non-negotiability would

19. U.C.C. § 8-315(1).

20. U.C.C. § 8-404(1). Of course, the issuer is still bound to discharge any limited duty of inquiry it might have under the immediate circumstances of the case (see U.C.C. § 8-403), and throughout the transaction it must act in “good faith.” U.C.C. § 1-203. A transfer agent or registrar has the same potential liability to third persons as does the issuer. U.C.C. § 8-406(1)(b).

21. The true owner has no claim under a signature guarantee since, under U.C.C. § 8-312(3), he is not a person “taking or dealing with the security in reliance on the guarantee . . .” *Love v. Pennsylvania R.R.*, 200 F. Supp. 561 (E.D. Pa. 1961); *Eulette v. Merrill Lynch, Pierce, Fenner & Beane*, 101 So. 2d 603, 666 (Fla. App. 1958). However, dictum in *Love* suggests that a true owner would have a claim against a signature guarantor who had “actual knowledge of the impropriety of the transaction.” 200 F. Supp. at 563. Similar rules would presumably apply to the indorsement guarantee recognized by § 8-312(2).

22. U.C.C. § 8-102(1)(a).

23. That the security itself subsumes and incorporates the intangible rights is well

demand priority for the true owner's intangible rights and their survival despite the issuance of a new certificate. Clearly, non-negotiability would bring the securities markets to a grinding halt: one cannot conceive how the markets could handle in a day's time several thousand transactions, let alone the ten million share day which has become increasingly frequent. Furthermore, the computerization of stock transfers, now adopted in large part by the New York Stock Exchange and recognized by the Code, would serve little purpose if effective delivery could not be made by "appropriate entries on the books of a clearing corporation."<sup>24</sup> The use of such facilities, which are virtually demanded by today's market volume, and their feasibility and economy, are premised on the certificates being the sole repository of the intangible rights to be transferred, on the fungibility of securities of the same issue, and on the eradication of issuer defenses and adverse claims through the very process of transferring securities within the organized markets.

Finally, the argument that non-negotiability would compel greater caution by selling brokers is only superficially persuasive. If a selling broker has a converter's liability for aiding in a wrongful transfer of a security, he could protect himself only by a full investigation, not merely of the seller's identity ("know thy customer"), but of the rightfulness of the seller's proposed transfer as well. One objective of the Code, and of the earlier Uniform Act for the Simplification of Fiduciary Security Transfers, is to eliminate the bottleneck under the old law, which resulted from the fact that a transfer agent could safely register transfer of a security, especially one held by a fiduciary, only after an often intensive, expensive, and time-consuming investigation. Under a non-negotiability premise, the selling

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recognized. *E.g.*, *United States v. Fidelity and Deposit Co.*, 244 F. Supp. 19, 24 (W.D. Mo. 1965); *Lesavoy Indus. Inc. v. Pennsylvania Gen. Paper Corp.*, 404 Pa. 161, 171 A.2d 148 (1961) (Uniform Commercial Code); *Mills v. Jacobs*, 333 Pa. 231, 4 A.2d 152 (1939) (Uniform Stock Transfer Act). U.C.C. § 8-317(1) carries this principle to its logical conclusion by making an attachment or levy on a security ineffective unless it is "actually seized" by the levying or attaching officer.

24. Section 8-320(2) provides for an effective transfer of securities by entries on the books of the clearing corporation, even though the entries identify no particular securities, but "refer merely to a quantity of a particular security" treated "as a part of a fungible bulk," and even though entries are made on a "net basis taking into account other transfers or pledges of the same security." As the text indicates, such entries can operate as a delivery under § 8-313(1)(e). The New York Stock Exchange currently utilizes a "central certificate" system by which ownership of shares is transferred between members of the NYSE Stock Clearing Corporation's Central Certificate Service by entries rather than by the pre-existing procedure of physical transfer of securities. To enable the system to begin operations, members delivered a designated number of shares to the clearing corporation, which then combined these into very large denomination certificates (worth as much as \$10,000,000 each). See *Wall Street Journal*, June 10, 1965, p. 10, col. 3; *id.*, June 2, 1966, p. 1, col. 1; *id.*, Sept. 7, 1966, p. 3, col. 2.



broker, because of his ultimate liability, would experience the same compulsion to inquire into the rightfulness of a transfer. Merely to state this proposition is to demonstrate the difficulty created at the very threshold of the transaction, for self-protection would force the broker to investigate each security transfer, not just selected or suspicious trades. Such inquiry, while simple and routine for many transfers, could become complicated and time-consuming and would introduce at an earlier stage in securities sales the burdensome obligations which the old law placed upon transfer agents. This would unduly inhibit the free flow of securities into the market. Insurance would be no answer, for insurers would pressure brokers to make the necessary inquiries; and if the risk experience proved bad, premiums would be high, perhaps prohibitively so, if indeed the insurance industry would accept the risk at all. Signature guarantees would also not help, since they go only to the genuineness of the signature.<sup>25</sup> It would be necessary for prudent brokers to procure indorsement guarantees<sup>26</sup> vouching for rightfulness of transfers, and no prudent indorsement guarantor would act without inquiring, even if he too had insurance.

Thus, it appears that the amount of protection that a non-negotiable system would provide to true owners is excessive. If it is a good policy to force selling brokers to use greater care, this should be accomplished, not with the blunt instrument of declaring securities non-negotiable, but rather with the fine chisel of redefining and thereby elevating certain specific duties of brokers. Arguably, within the existing system, some protection for brokers could be withdrawn by repealing section 8-315, which relieves brokers of liability for innocent conversion. Alternatively, the SEC, the self-regulatory agencies, or both could stiffen existing rules requiring brokers to scrutinize proposed transactions, without forcing on them a full dress investigation of adverse claims which the Code and the Simplification Act have rejected for transfer agents.

The negotiability concept, as it has worked itself out in the context of investment securities, is justifiable apart from arguments as to the desirability of destroying or basically altering the established nexus of customs, market practices, and legal rules. Sacrificing the extra margin of protection for true owners obtainable from a different set of premises does not seem to be an undue cost for the advantages to purchasers, and ultimately to sellers, which a market

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25. See U.C.C. § 8-312(1), whose postamble states that "the [signature] guarantor does not otherwise warrant the rightfulness of the particular transfer."

26. U.C.C. § 8-312(2).

grounded upon negotiability provides for everyone. Given the existing measure of protection for true owners, the balance of convenience seems properly struck and thus the underlying premise of Article Eight is, in my view, fully justified.<sup>27</sup>

## II. INADEQUACIES OF THE DEFINITION OF "SECURITY"

The ambit of Article Eight's coverage is fixed by its definition of "security."<sup>28</sup> Thus, the benefit of the Code rules, the liabilities and duties the Code imposes, and the corresponding clarity and certainty of this area of the law extend no further than this definition.<sup>29</sup> Differing markedly from the expansive meaning of "security" in federal and state securities statutes,<sup>30</sup> whose purpose is to encompass every means of defrauding investors, the object of the Code definition is to make negotiable only those instruments currently accepted in the markets as established investment media. In brief, a security under the Code is an "instrument"<sup>31</sup> meeting four conditions: (1) it is in bearer or registered form;<sup>32</sup> (2) it is one of (or divisible into) a class or series of instruments (as distinguished from being a unique instrument);<sup>33</sup> (3) it evidences either an issuer's obligation, a share, a par-

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27. It is apparent that courts construing Article Eight will draw on the Article Three rules which relate to commercial paper in order to supplement the former. For a recent and conspicuous instance, see *E. F. Hutton & Co. v. Manufacturer's Nat'l Bank*, 259 F. Supp. 513 (E.D. Mich. 1966), in which the court draws an analogy to the rule that one who discharges his own commercial paper does not become a holder in due course in the process and holds that an issuer reacquiring its own securities for cancellation (warrants, in this case) is neither a bona fide purchaser nor even a purchaser of the securities. *Id.* at 518. However, there is a delicate line which must be observed since both § 3-103(1) and § 8-102(1)(b) pretty clearly prevent the direct application of Article Three to investment securities. But this should be read as meaning only that Article Eight's provisions always govern securities—not as precluding recourse to Article Three for pertinent analogies on points not specifically covered by Article Eight and not inconsistent with the latter's purposes. On the contrary, this certainly is appropriate if only because both negotiable commercial and investment paper developed out of a common matrix of law merchant and common law and have more similarities than differences.

28. U.C.C. § 8-102(1)(a).

29. If a "writing" is a "security" within the definition, then it is governed by Article Eight and not by Article Three (Commercial Paper). U.C.C. § 8-102(1)(b). If the instrument is neither an Article Eight security nor Article Three commercial paper, it falls outside the Code. Presumably, in this event, rules could be formulated by analogy to Code concepts drawn from both articles and applied to such an instrument. However, the Code furnishes no guidance to analogical use of its rules for long-term investment instruments not covered by the definition of "security." In contrast is § 3-805 making certain Article Three rules applicable to commercial paper "otherwise negotiable . . . but which is not payable to order or to bearer."

30. *E.g.*, Securities Act of 1933, § 2(1), 48 Stat. 74, 15 U.S.C. § 77b(1) (1964); UNIFORM SECURITIES ACT § 401.

31. "Instrument" is an undefined term in the Code.

32. U.C.C. §§ 8-102(1)(a)(i), 8-102(1)(c) & (d).

33. U.C.C. § 8-102(1)(a)(iii).

ticipation, or some other interest in property or in an enterprise;<sup>34</sup> and (4) it "is of a type commonly dealt in upon securities exchanges or markets or commonly recognized . . . as a medium for investment."<sup>35</sup> Since the overall purpose of Article Eight is to make investment securities fully negotiable, rather than to bar the issue and sale of fraudulent investments, the Code definition favors not the unique and unusual instrument, but instead the relatively familiar security with which the organized markets feel comfortable as a result of custom and usage.<sup>36</sup> Significantly, the Code definition does not contain substantive restrictions such as the NIL applied to bonds and debentures,<sup>37</sup> but employs formal and functional criteria. It is not the purpose of this article to elaborate on these definitional conditions.<sup>38</sup> In general, however, the term "security" as used in the Code covers virtually all currently recognized investment securities. Without distinction at the definitional level, it includes both equity interests (such as shares of stock, voting trust certificates, stock options, warrants and scrip, mutual fund shares, and American Depositary Receipts) and creditor interests (such as bonds, debentures, and subordinated interests), as well as, presumably, many "hybrid" interests which teeter on the thin edge between creditor and equity securities. Included also are state and municipal securities, interests in and obligations of non-corporate entities such as limited partnerships and business trusts, fractional interests in oil and gas, and others. The term "security" does not, however, seem to embrace commodity investment contracts.<sup>39</sup>

Despite its breadth, the definition is, in my view, defective in two respects. First, although adequate in terms of existing markets, it is too rigid to permit "new" forms of investment securities readily to acquire negotiability through the traditional avenue of custom, that

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34. U.C.C. § 8-102(1)(a)(iv).

35. U.C.C. § 8-102(1)(a)(ii).

36. As Carlos Israel has expressed it, "uniqueness of form must logically militate against inclusion in the category [of securities, since] commercial justification for negotiability requires not uniqueness but familiarity." Israel, *Investment Securities as Negotiable Paper—Article 8 of the Uniform Commercial Code*, 13 BUS. LAW 676, 678 (1958).

37. E.g., the requirement in N.I.L. § 1 that the instrument carry an unconditional promise to pay a sum certain in money.

38. For a full analysis of the details of each part of the definition, see Folk, *Article 8: Investment Securities*, 44 N.C.L. REV. 654, 655-62 (1966).

39. Several factors point to this result. A security must be of a type traded "upon securities exchanges or markets" (U.C.C. § 8-102(1)(a)(ii)), and commodity investment contracts are not traded on securities exchanges or markets. Moreover, commodity contracts are not generally thought of as a "medium for investment" in the same sense as are listed or unlisted stocks or bonds. See also *Sinva Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359 (S.D.N.Y. 1966), which held that commodity contracts are not "investment contracts" and therefore not a "security" under the federal securities acts.

is, by gradual acceptance in the money markets. Second, the definition does not, as I think it should, recognize negotiability by contract.

#### A. *Repressing Negotiability by Custom*

It can generally be said, both as to commercial and investment paper, that, for the most part, instruments have come to be recognized as negotiable through the gradual accretion of customs which eventually have been accepted by the courts as binding or, if (as in some instances) rejected by the courts, have later been validated by statute. Of course, there is an element of chance in the court's acceptance of custom; the decision may depend even more than in other contexts upon the ability of counsel, the intelligence and responsiveness of the sitting judge, the character of the transaction, the factual context in which the negotiability issue is posed, the inherent equities of the situation, and other accidental factors. Yet, untrammelled by statutory definitions and aided by judicial receptiveness to custom, novel and developing investment securities gradually acquired negotiable status. This is especially evident in an impressive line of 19th century English decisions. In succession, the courts held the following to be negotiable: non-English government bonds actively traded in England;<sup>40</sup> scrip entitling the holder to definitive bonds of the issuer;<sup>41</sup> scrip entitling the bearer to become a registered shareholder in an English corporation;<sup>42</sup> and finally English<sup>43</sup> and non-English<sup>44</sup> corporate debentures. Possibilities of further development in England are not prevented by relevant statutory definitions of investment security, since the English Bills of Exchange Act does not deal with investment creditor securities.<sup>45</sup> The grossest example of a statute stifling the evolution of a recognized custom of negotiability for investment securities is the NIL's inclusion of bonds and debentures within its overly broad coverage, which resulted in the premature, and not very good, codification of an area of law still in the formative stage.

Two classic decisions, which are not dramatically different on

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40. *Heseltine v. Siggers*, 1 Exch. 856, 154 Eng. Rep. 365 (Ex. 1848); *Attorney General v. Bouwens*, 4 M. & W. 171, 150 Eng. Rep. 1390 (Ex. 1838); *Gorgier v. Mileville*, 3 B. & C. 45, 107 Eng. Rep. 651 (K.B. 1824).

41. *Goodwin v. Robarts*, [1875] L.R. 10 Ex. 337, aff'd [1876] 1 A.C. 476.

42. *Rumball v. Metropolitan Bank*, [1877] L.R. 2 Q.B. 194.

43. *Edelstein v. Schuler & Co.*, [1902] 2 K.B. 144; *Bechuanaland Exploration Co. v. London Trading Bank, Ltd.*, [1898] 2 Q.B. 658.

44. *London Joint Stock Bank v. Simmons*, [1892] 17 A.C. 201. See also *Bentinck v. London Joint Stock Bank*, [1893] 2 Ch. 120.

45. Bills of Exchange Act, 1882, 45 & 46 Vict. 292, c. 61.

their facts, highlight the issue. In *Goodwin v. Roberts*,<sup>46</sup> two English courts sustained the negotiability of underwriters' scrip for definitive bonds to be issued subsequently by the Russian government. A broker who held plaintiff's scrip wrongfully pledged it to secure a loan from defendants, who were bona fide purchasers without notice of plaintiff's interest. By all traditional doctrines of commercial paper, the scrip was non-negotiable because of the following facts: (1) it was payable not in money but in definitive bonds; (2) the underwriters obligated themselves only to transmit definitive bonds when they were received; (3) although the scrip was in form the obligation of the underwriters, it was viewed by the court as a direct obligation of the issuer; and (4) traditional promissory words were lacking, although the scrip stated that "the bearer will be entitled to receive a definitive bond or bonds."<sup>47</sup> In sustaining the pledgee's rights over those of the original owner, the court rested negotiability upon a finding of a more-than-fifty year custom by which scrip for foreign government obligations had passed solely by delivery. Repudiating any concept of the law merchant as "fixed and stereotyped and incapable of being expanded and enlarged,"<sup>48</sup> the court broadly affirmed the continuing vitality of the "process" by which "what before was usage only, unsanctioned by legal decision, has become engrafted upon, or incorporated into, the common law," and stressed the policy objectives of facilitating the ready transfer of securities rather than "requiring some more cumbrous method of assignment" that would "materially hamper the transactions of the money market . . . and cause great public inconvenience."<sup>49</sup>

*Manhattan Co. v. Morgan*<sup>50</sup> involved similar scrip. Here, the New York Court of Appeals held the instruments non-negotiable under the NIL; thus voiding plaintiff's claim as a bona-fide purchaser of instruments stolen from the true owner and later transferred to plaintiff. The thrust of the decision is the impossibility of holding that the scrip could be negotiable, in the teeth of the NIL's express prohibition.<sup>51</sup> Even assuming that, absent statute, the English view would prevail and that a sufficient custom existed in the New York investment community,<sup>52</sup> neither precedent nor custom could override positive law requirements. The New York legislature quickly corrected the result in this case by passing the not

46. [1875] L.R. 10 Ex. 337, *aff'd* [1876] 1 A.C. 476.

47. The text of the instrument appears at [1875] L.R. 10 Ex. 339.

48. *Id.* at 346.

49. *Id.* at 353.

50. 242 N.Y. 38, 150 N.E. 594 (1926).

51. *Id.* at 48, 150 N.E. at 597.

52. *Id.* at 53, 150 N.E. at 599.

wholly satisfactory Hofstadter Act,<sup>53</sup> which has since been superseded in that state by the Code. Such corrective measures, of course, in no way impair the principle of the *Manhattan* case that custom cannot lawfully controvert a statutory requirement.

This principle remains equally applicable under Article Eight's definition of securities which, I suggest, may serve to suppress the development through custom of the negotiability of new investment securities. The critical Code requirement is that a security be "of a type commonly dealt in upon" securities markets or "commonly recognized . . . as a medium for investment." This very language poses a dilemma. A new kind of investment paper—one which has just come into being or has been resurrected in response to some felt need—by hypothesis cannot be a "security" until it has come to be "commonly dealt in upon" markets or recognized as a proper "medium for investment." Yet such investment paper is not likely to meet these requirements if it cannot in the first instance meet the Code definition of "security," and thus be assured of negotiability. To criticize the Code's definition, one need not assert that new investment paper can *never* achieve the required recognition and acceptance; like the salmon, it may succeed in swimming upstream. Nevertheless, if the Code definition is likely to retard the recognition of new securities, and in particular to chill the climate in which the tender plant of incipient custom must grow, then the definition requires criticism and correction. At best, recognition as a negotiable security is needlessly uncertain if such an explicit Code condition virtually confines negotiable securities to those recognized at the time of enactment. For this reason, smart money is not apt to take the risk, other things being equal, of an instrument of uncertain character. As an example, suppose that at some early date American Depositary Receipts have just been introduced and that in all respects the receipts comply with the Code provisions, except that their hypothesized novelty means that they have not been traded in the securities markets or recognized as investment media. If the Code definition were in effect at that time, it is hard to see how American Depositary Receipts could have been securities when introduced, and the likely impairment of their sale and transfer would retard any growth in the custom which might later be translated into law.

Another illustration is the order bond. Assume a twenty-year written obligation for one million dollars issued by Corporation A and privately placed with Insurance Company B. It is made payable to B's order but is not registerable. Clearly, it is not a "security" since

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53. N.Y. PERS. PROP. LAW § 260 (McKinney 1962).

it is in neither registered nor bearer form.<sup>54</sup> Its negotiability will depend on its conformity with Article Three—Commercial Paper. If under the instrument the promise is conditional, it will not comply with Article Three and thus not be negotiable.<sup>55</sup> The same would be true if an issuer decided to market, rather than privately place, a class of order debentures or bonds. Not only does there appear to be no reason for excluding the order instrument from the definition of “security,” but, further, the restrictiveness of that definition seems compounded by the fact that, so far as is known, the order debenture or bond is probably not “of a type commonly dealt in upon securities exchanges or markets” or “commonly recognized . . . as a medium for investment.” Thus, should order bonds or debentures ever become, for reasons not apparent to us at this moment, an attractive means of raising long-term money, they would have to overcome the barrier of the Code definition.

None of this is to argue that codification of the law of investment securities is improper. Indeed, the law of investment securities has reached a stage of maturity where codification is appropriate. The values of certainty and clarity which are furthered by a good codification—and on a whole Article Eight is that—may sometimes outweigh the inhibitions imposed by statutory language upon judicial innovation. However, this is not true when the restrictive definition is of the most central term—“security”—in the codified law. For a restriction at this point virtually closes off the area of development, and makes of the Code provisions a set of house rules for an already established category of securities.

Nevertheless, the definition may not, in the long run, prove so restrictive in operation. Thus, legislatures, in response to the needs of the investment community, may enlarge the category of negotiable securities. However, such legislation is usually a reaction, often to a decision striking down negotiability, and thus is likely to be delayed. In the meanwhile, a needless degree of uncertainty will persist. Although there is inescapably some uncertainty while new instruments are evolving through mercantile custom toward legally cognizable negotiability, this differs from the much deeper doubt as to whether a particular kind of new instrument, however often traded, can ever be held to be negotiable. It is this latter mode of uncertainty which the Code definition needlessly creates; the other type can be, indeed should be, tolerated so that novel instruments can be put to the proof of the market.

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54. U.C.C. § 8-102(1)(a)(i).

55. U.C.C. § 3-104(1)(b) requires “an unconditional promise or order to pay a sum certain in money” for a writing to be “a negotiable instrument within this Article. . . .”

In addition, an area for interstitial development of custom may exist under the Code definition. The definition does not demand that instruments be commonly recognized as "negotiable securities" in the strict sense of instruments whose transfer to bona-fide purchasers extinguishes adverse claims and issuer defenses. Rather, they need only be "dealt in" on exchanges or otherwise recognized as a "medium for investment." This is a broader concept than "security," as defined, since an instrument may be a recognized investment medium but not a "security" for failure to comply with the other conditions of the definition. Although not explicit on this point, certain language in *Goodwin v. Roberts*<sup>56</sup> seemingly requires only proof of a mercantile custom of common acceptance and ready transfer, rather than of a conscious recognition by financiers and investors that the legal consequences of negotiability—extinguishing defenses and claims—will necessarily occur. If this approach can be carried over into the Code, then the definition of "security" may possibly leave an opening, however narrow, so that new forms of investments can mature (that is, come to comply with the other conditions of the definition of "security") into recognized securities. However, this subtlety is so refined, so evanescent, that it is at least doubtful that an instrument not already traded or recognized will be able to achieve the necessary measure of acceptance in the markets.

#### B. *Refusing To Recognize Negotiability by Contract*

Some years ago, a topic commanding interest was the possibility of making commercial paper negotiable "by contract." Probably no consensus was reached on this point in view of the rigidity of the NIL definitions and the weight of the *Manhattan*<sup>57</sup> decision, although one scholar concluded that a carefully worded clause which purports to make an instrument negotiable would be sustained.<sup>58</sup> There was little explicit discussion of the question in the context of investment securities, although many investment securities would have benefited from a clearly articulated principle favoring negotiability by contract terms. For instance, such a principle might have aided the development of the registered bond which was always shadowed by the fact that its registration provisions were, verbally at least, at variance with the doctrine of free and full transferability of negotiable paper.<sup>59</sup>

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56. [1875] L.R. 10 Ex. 337, *aff'd* [1876] 1 A.C. 476.

57. *Manhattan Co. v. Morgan*, 242 N.Y. 38, 150 N.E. 594 (1926).

58. Beutel, *Negotiability by Contract: A Problem in Statutory Interpretation*, 28 ILL. L. REV. 205 (1933).

59. For a valuable discussion, although long antedating the Code, see Steffen & Russell, *Registered Bonds and Negotiability*, 47 HARV. L. REV. 741 (1934).



Similar benefits would have accrued to other instruments, whose negotiability under separate statutes such as the Uniform Stock Transfer Act and the NIL, was not specifically recognized. Such instruments include interim receipts (of the *Manhattan*-case type), equipment trust instruments, voting trust certificates, and others.

It has been contended that the decision in *Enoch v. Brandon*<sup>60</sup> did recognize negotiability by contract in the context of investment securities,<sup>61</sup> although this reading of the case has not been generally accepted. In that case the New York Court of Appeals was confronted with the question of the negotiability of a bond which was explicitly made "subject" to the provisions of the mortgage indenture under which it was secured. The word "subject" appeared to make the bond's promise conditional.<sup>62</sup> However, the court construed this language as referring only to the security backing the promise to pay, and not as impairing the unconditional character of the bond's promise itself. Thus, the court's skilfully devised formula sustained the negotiability of bonds and debentures which, by the established practice of the investment community, employ elaborate and detailed indentures that set forth the particulars concerning the issue of securities. Obviously, policy considerations dictated this desirable result which was not readily justified by the literal language of the statute or the instrument. The bond in *Enoch v. Brandon* also contained a clause which provided that the bonds "are to be treated as negotiable and all persons are invited by the [issuer] to act accordingly"<sup>63</sup> and thus the possible alternative ground of "negotiability by contract" was suggested. However, this language at most seems to exhibit the parties' intention to make the instrument negotiable, and thus could be used as a counterweight to other clauses which possibly cast doubt on its negotiability. Certainly, the narrower and more defensible reading of the decision is the judicial formula which treats the "subject to" clause as stipulating rights to the security, rather than as conditioning the promise to pay.

It is now an academic question whether *Enoch v. Brandon* did endorse negotiability by contract, since indenture bonds are clearly negotiable under the Code. However, it is not an academic question whether negotiability by contract is congruent with the Code and whether as a matter of policy such freedom should be recognized by basic commercial law throughout the country.

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60. 249 N.Y. 263, 164 N.E. 45 (1928).

61. Beutel, *supra* note 58, at 221.

62. 249 N.Y. 263, 164 N.E. 45, 46 (1928).

63. *Ibid.*

1. *Policy Considerations in Favor of Making Investment Securities Negotiable by Contract*

The explicit acceptance and recognition that investment securities may be made negotiable by contract seems a logical outcome of the long-run trend toward full negotiability of securities. Assuming that there are possible dangers in making commercial paper negotiable by contract, it seems that many of these risks would not be present in the sphere of investment paper. By and large investment securities are handled by more sophisticated persons, if only because more people have occasion to execute or indorse notes and checks than to buy and sell investment paper. Moreover, the public policy of promoting the free transfer of investment paper is furthered by permitting the express acceptance of contract terms which have the effect of creating negotiability. In particular, under the Code definition of "security,"<sup>64</sup> negotiability clauses would make it easier for a "new" security to surmount the hurdle of the Code requirement of prior general acceptance as an investment medium. In short, the definition of "security" should provide that if an instrument meets all of the statutory conditions except for general acceptance as an investment medium, it is still a security if it contains terms which clearly declare that it is a negotiable instrument which is governed by the rules of Article Eight of the Uniform Commercial Code.

However, since such a clause is potentially dangerous, there should be safeguards against abuses. The instrument should note conspicuously that it is a "negotiable investment security."<sup>65</sup> In addition, the body of the instrument should spell out with clarity, though not necessarily with detail, that purchasers for value and without notice will enjoy immunity from issuer defenses,<sup>66</sup> while bona fide purchasers will acquire the security free from adverse claims as well.<sup>67</sup> However, too much detail is undesirable since it

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64. U.C.C. § 8-102(1)(a).

65. "Note conspicuously" is used as a term of art in the Code. For example, transfer restrictions must be "noted conspicuously" to be effective. U.C.C. § 8-204. "Conspicuous" is defined in § 1-201(10).

66. This phrase characterizes the transferee who may successfully resist an issuer's defenses on an investment security (see U.C.C. § 8-202(1), (3) & (4)), and it is to be distinguished from a "bona fide purchaser" (see U.C.C. § 8-302 which is discussed in note 67 *infra*), and from a "purchaser for value and without notice of adverse claims who has in good faith received a new, reissued or re-registered security on registration of transfer." U.C.C. § 8-311(a).

67. Under U.C.C. § 8-301(2), one who qualifies as a "bona fide purchaser" may extinguish adverse claims. In addition, if a "bona fide purchaser" acquires the security by a formally perfect transfer (*viz.*, by delivery of a bearer-form instrument, or by issue or indorsement of a registered-form security), then, by virtue of U.C.C. § 8-302, he qualifies as a purchaser for value in good faith and without notice of any adverse claim.

might conflict with the specific legal consequences that are spelled out by Article Eight. Yet the wording should be specific enough so that all persons who acquire the instrument can fairly be said to have intended that the instrument be treated as negotiable.<sup>68</sup> Since all trading in the investment community assumes the negotiability of investment securities, it seems that, as to "new" forms of securities, such negotiability by contract would accord with common experience and belief.

Although it should be apparent, it is worth stressing that negotiability by contract would neither impair enforcement of any fiduciary duty under corporate law nor affect liabilities under securities statutes. So far as the issuer is concerned, negotiability by contract, like the clauses of Article Eight means only that issuer defenses are extinguished in the hands of purchasers for value and without notice—not that liabilities of an issuer or its management are limited.

Moreover, any supposition that negotiability by contract would promote trading in unsound securities is unfounded. The issuer, in the unlikely event that it issues securities which it knows or thinks will create defenses, will not be likely to choose language which would eliminate such defenses. Furthermore, leaving aside some forms of securities which are peddled on the disreputable fringes of the investment business, the rather sober and calculating gray eminences of the investment world are unlikely to insert the language of negotiability into a new instrument unless they have affirmative business reasons for desiring negotiability and have doubts as to whether the instrument has that quality under existing law. As for the disreputable elements, it is doubtful that Ben-Jack Cage or others of that ilk would envision or perpetrate even more spectacular frauds—or that those who dream up investment contracts will create weirder forms of deceiving the public—simply because they are

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68. This position involves a tricky problem. It assumes that the explicit statement of negotiability is known to and accepted by the purchaser, who thus manifests his intent to treat the instrument as negotiable. But under standard transfer procedures, the purchaser may see his certificate only after the transaction (or not at all, if his broker keeps it) and so, realistically, he lacks notice. One approach would be to let him rescind the transaction upon discovering that his security is negotiable by contract. But this is overgenerous and would give him an undeserved means of recapturing paper losses. More reasonably, he could be deemed to take the security with notice and be bound by its negotiability clause if he does not object within a reasonable (perhaps a specified) time after he or his broker acquires the security. This is better, but arguably still too generous to investors who probably assume negotiability (if they ever think of it) and who are no more likely to be harmed by a security negotiable by contract than by one negotiable under the Code definition. Perhaps more to the point would be a right of rescission if the security varied in some material respect from what it was authoritatively represented to be.

credibly informed that what they choose to call a "security" may be made negotiable by contract terms.

2. *Does the Code Permit Negotiability by Contract for Investment Securities?*

The concept of pure negotiability by contract seems inconsistent with Article Eight's definition of "security,"<sup>69</sup> since it could result in an instrument being negotiable even though not "of a type commonly dealt in upon securities exchanges or markets or commonly recognized . . . as a medium for investment."<sup>70</sup> The relevant question, then, is whether Article One's general provisions, which are applicable to the entire Code, permit the results which negotiability by contract would create. Admittedly, it is doubtful that these general provisions accomplish this purpose or are even intended to do so, but if they do, the Code is undesirably unclear and round-about in authorizing this result.

Under section 1-102(3), any Code rule "may be varied by agreement" unless otherwise provided by the Code, "except that the obligations of good faith, diligence, reasonableness and care prescribed by [the Code] may not be disclaimed by agreement . . . ." Clearly, enlarging the definition of "security" does not itself violate the latter clause. Assuming that Article Eight's definition section is a "provision of this Act," it follows that the definition could be expanded. Yet it is by no means clear that so literal a reading is intended by section 1-102(3). Instead, "provision of this Act" may not refer to the basic definition sections but only to those sections that state legal consequences. The relevant Code comments, which use commercial paper illustrations, seemingly negate any enlargement of basic definitions. While piously disclaiming "the type of interference with evolutionary growth found in" the *Manhattan* case, the Code comments observe that "private parties cannot make an instrument negotiable within the meaning of Article 3 (Commercial Paper) except as provided in" the relevant definition section of Article Three.<sup>71</sup> Precisely the same comment could be made about the definition section of Article Eight. Thus, we have an instance of a comment, while not flatly contradicting Code language, at least limiting needlessly vague legislative terminology.

Nevertheless, the Code comment does seem inconsistent with the declared policy of the Code that it "shall be liberally construed and

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69. U.C.C. § 8-102(1)(a).

70. U.C.C. § 8-102(1)(a)(ii).

71. U.C.C. § 1-102, comment 2. See also note 50 *supra*.

applied . . . to permit the continued expansion of commercial practices through custom, usage and *agreement of the parties . . .*"<sup>72</sup> Yet, arguably, even this high-sounding "underlying purpose and policy" must be implemented within the defined coverage of the Code, so that "agreement of the parties" cannot enlarge the sweep of Article Eight beyond the definition of "security" any more than an agreement among the parties can confer subject-matter jurisdiction upon a court.

The fact is that, if negotiability by contract is appropriate for investment securities, it should be expressly authorized. Based on the language of the Code, we can only assume that the status of negotiability by contract is sufficiently ambiguous so as to make it, at best, an unreliable tool. Indeed, the Code language is probably inconsistent with such broad contractual freedom. The very comprehensiveness of the Code—and, more specifically, the admittedly broad scope of the definition of "security"—makes it appear pre-emptive of any efforts to go beyond the stated limits by contract provisions. Yet even if the Code's language in Article One can be read as giving a faint "go signal" for cautious moves toward instruments negotiable by contract, such an approach may be hypersubtle and at best confusing.

It is suggested, accordingly, that Article Eight expressly recognize negotiability by contract with certain safeguards as suggested above. One simple solution would be to reword the crucial clause of section 8-102(1)(a) as follows:

A "security" is an instrument which

. . .

- (ii) is of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment, *or by its explicitly stated terms conspicuously noted on the instrument is to be governed by this Article. . .*<sup>73</sup>

### III. THE CODE AND TRANSFER RESTRICTIONS

It is curious that, as full negotiability becomes the norm for investment securities, there has arisen concurrently the need to restrict the transfer and the registration of transfer<sup>74</sup> of investment

72. U.C.C. § 1-102(1) & (2). (Emphasis added.)

73. New matter is in italics.

74. In the Code, the undefined term "transfer" and its derivatives refer to the passage of a security or interest therein from one person to another; it roughly corresponds to, although it is broader than, the term "assign" which is customarily used in the securities industry and in some statutes. *E.g.*, UNIFORM ACT FOR SIMPLIFICATION OF FIDUCIARY SECURITY TRANSFERS § 1(a). "Registration of transfer" refers to the change of record ownership of a registered-form security by the act of the issuer or transfer

securities. In part, this reflects the increasing divergence between close and public corporations; the conventional view being that it is often desirable to limit or (if legally possible) preclude the transfer of equity interests in close corporations, while facilitating the trading in like interests in publicly held corporations. However, this is not the whole story, since even publicly held corporations routinely use certain transfer restrictions in financing through a sale of securities.

Transfer restrictions are not, in fact, a reaction against the enlarged negotiability of investment securities. Indeed, were the Code to declare that securities are *not* negotiable instruments, transfer restrictions would still be indispensable, since they are directed to objectives other than preventing bona fide purchasers from extinguishing issuer defenses and adverse claims. For small enterprises, transfer restrictions are designed to keep the equity interests from falling under hostile control or from going outside the limited group of original shareholders, or, at least, to limit the extent to which these undesired consequences may occur. Close corporations commonly employ the following types of transfer restrictions: first option arrangements, by which the corporation or one or more of the shareholders or some combination of these interests have an option to acquire the restricted shares; buy-and-sell arrangements, by which the restricted shares are subject to contractual obligations between shareholders and either the corporation or other shareholders or both; and consent restrictions, by which directors or shareholders must agree to an outside sale of shares.<sup>75</sup> Other more stringent restrictions are possible, but these are of doubtful validity.<sup>76</sup> For the publicly-owned corporation, the restrictions are usually desired to preserve the exempt status under securities regulations laws of transactions by which securities are "privately placed" with a limited number of "sophisticated," often institutional, investors<sup>77</sup> or are sold exclusively within the state in which the enterprise is incorporated and does its principal business.<sup>78</sup> Here the restrictions

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agent; confusingly enough, its counterpart term in other statutes is "transfer," e.g., SIMPLIFICATION ACT § 1(g).

75. First option and buy-and-sell arrangements are usually upheld by the courts. See O'NEAL, CLOSE CORPORATIONS §§ 7.09 & 7.10 (1958). The validity of consent restrictions is more difficult to predict, and even those jurisdictions which have sustained them usually impose rather strict requirements of reasonableness on their use.

76. These would include restrictions which bar any transfer of the restricted security, or confine transfer to designated transferees (or classes of transferees), or forbid transfer to all but designated persons or classes. See O'NEAL, *op. cit. supra* note 75, § 7.08 (1958).

77. Securities Act of 1933, § 4(2), 48 Stat. 77, 15 U.S.C. § 77d (1964).

78. Securities Act of 1933, § 3(a)(11), 48 Stat. 906, as amended, 15 U.S.C. § 77c (1964).

may take the form of a "stop transfer" notice, which will block or defer registration of transfer until the corporation is satisfied that transfer will not impair the exempt status of the transaction under which the securities were originally issued.

The Code neither enlarges nor limits the substantive validity of transfer restrictions, but does impose certain form and notice requirements.<sup>79</sup> Substantive validity is determined by corporate law, which, generally speaking, has looked askance at transfer restrictions both by strictly construing those forms which have been upheld and by striking down others—usually invoking policies rooted in property law which are opposed to restraints on alienation. Thus, the Code section operates only upon "otherwise lawful" restrictions. In a hypothetical jurisdiction outlawing all transfer restrictions,<sup>80</sup> the Code provision would have no role to perform. However, in an equally hypothetical jurisdiction sustaining every type of transfer restriction, the formal requirements of the Code would limit the effect of these restrictions.

#### A. "Noted Conspicuously" and "Actual Knowledge"

The Code denies legal effect to transfer restrictions which are not "noted conspicuously" on the security, that is, which are not "so written that a reasonable person against whom it is to operate ought to have noticed it."<sup>81</sup> This approach works quite effectively. Assuming that the original certificate with a conspicuously-noted restriction has been indorsed and delivered to the transferee, he can return it to his transferor and demand a "clean" certificate which is free of any such restriction. Moreover, the receipt of the certificate gives the transferee notice of an "adverse claim,"<sup>82</sup> namely, the issuer's claim that the transfer of the security is subject to certain controls, such as a first option or consent arrangement, or a stop transfer notice. If the transferee sends such a restricted certificate to be registered into his name—that is, to obtain record ownership—he cannot compel the corporation or its transfer agent to register transfer of the security. In this case, the restricted certificate would be returned to the transferee. The result, then, is that the

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79. U.C.C. § 8-204.

80. New Hampshire comes close to such a hypothetical jurisdiction in that its law bars any corporate by-law that restricts the sale of shares. N.H. REV. STAT. ANN. § 296:14 (1966).

81. U.C.C. § 1-201(10).

82. "'Adverse claim' includes a claim that a transfer was or would be wrongful . . ." U.C.C. § 8-301(1). A transfer restriction is deemed to be an "adverse claim." U.C.C. § 8-204, comment 1.

transferee could lawfully rescind the transaction or require the transferor to purchase shares on the market (possibly at a higher price) in order to furnish a clean certificate. In part this redress is based on the transferor's breach of his implied warranty that the transferee can obtain registration of transfer into his name.<sup>83</sup> Of course, there are limits inherent in rescission and related remedies: the transferor may be insolvent or absent from the jurisdiction or it may be impossible to obtain a clean certificate. However, the theory is that the issuer's concern to preserve its interests transcends the purchaser's desire to consummate the transaction at no loss to himself.

Usually, the purchaser does not receive the original indorsed certificate (whether restricted or not). At least on the organized markets, it is nearly universal practice for the seller's broker to register the securities out of the seller's name and into a name which is acceptable for ready transfer in the securities markets.<sup>84</sup> The result is that even if a broker was willing to handle a restricted certificate—an unlikely situation—the transaction still would not proceed, since the issuer or its transfer agent would refuse to register transfer out of the seller's name and into a name acceptable for market transactions. Thus, in practice, the sale of the security would be thwarted at the threshold. The restricted certificate would go back to the broker-dealer and thence to the seller. The latter would have to forget the sale, comply with the restriction, or seek to have the restriction invalidated.

A restriction which is not "noted conspicuously" is effective only against those who have "actual knowledge" of its existence.<sup>85</sup> At first glance, this seems, if not inconsistent with, at least inappropriate for, a commercial law system which avowedly subsumes the security-holder's intangible rights into a piece of negotiable paper to facilitate full and free transferability of the security.<sup>86</sup> Indeed, it would seem more congruent with these objectives for the

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83. See U.C.C. §§ 8-306(2) (warranties of the transferor that the transfer is "effective and rightful") & 8-316 (the transferor's obligation to assist the purchaser in obtaining registration of transfer).

84. See U.C.C. § 8-314(1) defining the point at which the selling customer and the selling broker fulfill their respective delivery obligations.

85. U.C.C. § 8-204.

86. U.C.C. § 8-317 takes the logical step of providing that a security cannot be effectively attached or levied on unless and until "actually seized" by the attaching official. The UNIFORM STOCK TRANSFER ACT §§ 13 & 14 had permitted attachment or levy by injunction, but since the enjoined owner still had the power to transfer the certificate to a bona fide purchaser, this attachment by injunction could be thwarted. Thus, the Code rule obviously goes farther than earlier uniform statutes in making the "security," in effect, the piece of paper.



transfer restriction to be effective *only* if duly noted on the paper itself. True, it would be strong medicine to allow a transferee to disregard a restriction of which he knew, to the detriment of those who desired and needed the restriction. Yet it is their misfortune or a result of their incompetence that they did not comply with the formal means of giving notice through a recital in the certificate.

Undoubtedly, the "actual knowledge" provision of the Code poses real difficulties. It is hard to pin down the contours of a concept which, in its application, has a disturbing tendency to waver back and forth between referring to information which was consciously present to one's mind and to information which the person ought to have had present. Problems of proof are not easy. The concept seems out of place in the otherwise fairly objective system of law embodied in Article Eight.

An illustration<sup>87</sup> suggests some of the difficulties of fitting the "actual knowledge" concept into the Code structure. A prospective purchaser of shares is told that the corporate by-laws contain a transfer restriction which is not noted on the certificate which is to be indorsed to him. Although the by-laws in fact contain such a restriction (and we assume it to be valid under corporate law), the purchaser is subsequently assured by responsible corporate personnel that there is no such restriction. Later, the purchaser closes the deal only to have the transfer agent either refuse to register transfer or insist upon continuing the restriction against him. We may assume that it is more profitable to hold the shares than to rescind, or that the seller is unable to perform if the purchaser elects rescission. The question, then, is whether the purchaser had "actual knowledge" of the restriction, which would be as binding on him as if the restriction had been "noted conspicuously" on the security. If he did, the purchaser loses; if not, he is entitled to registration of transfer and issuance of a clean certificate. In fact, the transferee probably would prevail in this situation, although it is not easy to work out his rights under Article Eight because of the complications created by the "actual knowledge" exception. Absent the assurances of no transfer restriction, the purchaser clearly had "actual knowledge" of an unnoted restriction. However, the assurances given him significantly change the picture. "The principles of law and equity, including . . . the law relative to . . . principal and agent, estoppel, fraud, misrepresentation . . . shall supplement" the Code provisions "unless displaced by the particular provisions

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87. I owe this provocative example to Professor Alfred F. Conard of the University of Michigan Law School.

of" the Code.<sup>88</sup> No relevant Code provision displaces normal agency rules in this situation, unless it can be said that "actual knowledge," once it has been acquired, can never be extinguished in its legal effect by denials or representations which happen to be false. However, the manifest injustice of giving such overriding effect to "actual knowledge" should require in this situation that the officer who disclaimed the transfer restriction be held to have bound the corporation in so representing, or that he be viewed as having had apparent authority to waive the restriction. Hence, the purchaser, misled as he was by the representations (or waiver) should be entitled to registration of transfer. Of course, registration could be delayed by the issuer or transfer agent. Under the Code, the obligation to register transfer is conditioned, *inter alia*, on two requirements: that the issuer either has no duty or has discharged its duty to investigate adverse claims (including unnoted transfer restrictions), and that the transfer is to a bona fide purchaser.<sup>89</sup> Although bona fide purchaser status depends on having no "notice of any adverse claim," it has been argued that in this situation there has been no such "notice," or at least that the apparent notice is legally ineffective. As for the duty to register transfer, assuming that the transfer agent's investigation discloses the situation that has just been described, the basic question again arises: whether the purchaser had "actual knowledge" of the restriction.<sup>90</sup>

To be fair and workable, the "actual knowledge" concept must be limited by legal concepts outside of the Code. Only in this way can we strike a fair balance between the interests of the misled purchaser and those of the corporation invoking an unnoted restriction. Otherwise stated, an unnoted restriction should be narrowly construed. Indeed, the very theory of the restriction that is not noted but is "actually known" to the purchaser—that he cannot justly be permitted knowingly to obliterate the rights of others—demands a similar limitation upon an issuer—that it cannot fairly disclaim the apparently authorized acts of its agents to the detriment of purchasers who have relied on those acts. Obviously, the desirable result of protecting the misled transferee could be more readily achieved if the Code was unencumbered with the "actual knowledge" rule. This would simply require holding the unnoted restriction to be ineffective as to the purchaser, regardless of the informa-

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88. U.C.C. § 1-103.

89. U.C.C. § 8-401-(1)(c) & (e).

90. It might be argued that technically a purchaser had no "actual knowledge" of a restriction if information to that effect, albeit true, had been specifically negated by authoritative representations.

tion which he received and which was subsequently denied. However, this is not enough to support a conclusion that the "actual knowledge" concept should be deleted. For one thing, it offends fairness to permit a person to trample on others' rights of which he is aware: he has the opportunity to take action which would protect those rights, and he should at least take subject to them.

An even more compelling situation justifying the Code provision for validating effective, though unnoted, restrictions arises in the case of transfer restrictions which are intended to preserve a securities act exemption. It may be impracticable to force a prospective purchaser of securities in an exempt transaction to accept a certificate with a legend restricting transfer.<sup>91</sup> The issuer may have to take some risk of losing the exemption and protect itself with an "investment letter" as well as a stop transfer notice of which the purchaser is informed.<sup>92</sup> Suppose that a purchaser of securities under such restrictions disregards his representations in the investment letter and sells the restricted securities under circumstances which may cause the issuer to lose his exemption. If the sale is through the organized markets, assuming that the unsuspecting selling broker sends the indorsed certificate to the transfer agent, then the stop transfer notice will be triggered, registration of transfer will be refused, and the certificate will be returned to the broker and thence to the seller. The seller is a "person with actual knowledge" of the unnoted restriction, that is, of the stop transfer notice,<sup>93</sup>

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91. Refusal to take a certificate with a restrictive legend does not necessarily show that the purchaser is taking the security "with a view to distribution" instead of with the required intent of investment for an indefinite period of time. On the contrary, several factors, in no way inconsistent with an investment purpose, can explain such a refusal. For example, changed circumstances may require a premature sale, and the purchaser may wish to avoid the delay involved in obtaining an unrestricted certificate from the corporation. Similarly, the fact that a restricted certificate may be unacceptable as collateral for a loan may underlie a purchaser's reluctance to accept a restricted certificate.

92. An investment letter is merely a writing, in no prescribed form, in which the purchaser states that, as of the time of purchase, he intends to hold the security for investment, and that he is not purchasing it with a view to distribution. The Securities and Exchange Commission, however, has stressed that an "investment letter" is no defense to an issuer faced with loss of its exemption because of a sale in violation of the terms upon which the exemption was granted. Securities Act Release No. 33-4552, at 3 (S.E.C. Nov. 6, 1962). A stop transfer notice with respect to a designated security remains with the issuer or its transfer agent, and if the certificate as to which such a notice applies comes in for registration of transfer, the issuer or transfer agent will postpone or refuse such registration. Thus an investment letter coupled with a stop transfer notice is an effective combination enabling the issuer to control transfers and thus protect the securities act exemption under which it made the original sales. The text indicates why this combination works so well.

93. I assume that the issuer informed the purchaser in the exempt transaction that a stop transfer notice affecting his certificate would be placed on file. Without such notification, the purchaser would not have "actual knowledge" of the restriction, and consequently, the restriction would not be effective against him.

and the restriction is good against him, as indeed it should be.<sup>94</sup> He must now, if he can, satisfy the issuer that the security may be sold without violating the law; this may mean securing opinions of counsel that such sale would not affect the status of the exemption or perhaps a no action letter or informal advice from the SEC. Thus, the actual knowledge phrase, narrowly construed, is an indispensable supplement to the general rule requiring conspicuous notation. It establishes a means by which issuers, who are unable to make use of the more rigid forms of transfer restrictions which are noted on the certificate, may protect themselves from wrongful transfers.

### B. *Scope of the Transfer Restriction Provision*

The Code section in terms, governs only those transfer restrictions which are "imposed by the issuer,"<sup>95</sup> and thus it does not apply to restraints which are imposed by shareholder agreements or other arrangements in which the issuer is not involved even though the purpose and effect of these arrangements may be identical. It is unclear why the Code, which supposedly aims at the maximum feasible coverage, fails to carry forward the rule in the broader form in which it appeared in the Uniform Stock Transfer Act.<sup>96</sup> Arguably, the Code's *casus omissus* was motivated by a desire to preserve the privacy of shareholder agreements which would be lost if any transfer restrictions which they impose must be "noted conspicuously" on the certificate. Another possible rationale is that the variety of non-issuer transfer restrictions is so great, and the incidental problems so varied, that it is better to leave private restrictions to case-law development.

The reasons for enlarging coverage seem more compelling. The privacy of shareholder-imposed restrictions, if this be a desideratum, simply cannot be maintained in fact. Transferees of restricted securities will inevitably learn of them, and, depending upon their prior knowledge of the restrictions, the transferees will or will not be bound by them. Moreover, corporation statutes are beginning to require certificate notations of various provisions which may sub-

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94. It could possibly be argued that an investment letter alone constitutes a "restriction imposed by the issuer," of which the purchaser who gave the letter had "actual knowledge," but I find this argument unpersuasive. First, it overextends the concept of a "restriction imposed by the issuer," since the letter is presumably a result of the purchaser's voluntary act, even though it may have been the only way in which he could get the security. Second, it violates the policy of strictly construing stock transfer restrictions.

95. U.C.C. § 8-204.

96. UNIFORM STOCK TRANSFER ACT § 15.

ject purchasers to unexpected burdens or obligations.<sup>97</sup> Thus, the arguments from a supposed "right of privacy" run counter to the trend toward the mandatory disclosure of all relevant restrictions on securities. Even if the secrecy of shareholder agreements could be more effectively protected than is now possible, this would be undesirable. The policy favoring free transferability of securities logically dictates that restrictions be noted whether exacted by the issuer or by "private" agreements. Whoever imposes them, undisclosed restrictions violate the fundamental assumption under which investment securities move about in today's markets.

A clearcut rule, which comprehensively covers all transfer restrictions, would promote certainty. In particular, it would adequately protect the interests of both those who impose transfer restrictions and those who may be subject to them. In the case of "privately" imposed restrictions, there is every reason to give the bona fide purchaser without notice the right, which is clearly defined in the Code, to take free and clear of undisclosed limitations on the marketability of the purchased securities. Such considerations seem especially compelling since Article Eight purports to be a comprehensive codification of the rules and customs which govern securities.

The expansion of the Code's limited rule can easily be achieved by deleting those words confining section 8-204 to restrictions "imposed by the issuer" and transferring the reworded section from part two of Article Eight, which governs issuance and issuers, to part one, which contains the general provisions of the Article. The new section would read as follows:

Unless noted conspicuously on the security, any restriction on transfer even though otherwise lawful is ineffective except against a person with actual knowledge of it.

#### IV. REGISTERING TRANSFER: THE ISSUER'S DUTIES, PRIVILEGES AND LIABILITIES

Transfers of registered-form securities are subject to certain special rules of Article Eight, which represent the first general attempt to codify issuer duties and liabilities in registering transfer of securities.<sup>98</sup> The Code objective is to simplify and expedite regis-

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97. See, e.g., N.Y. BUS. CORP. LAW §§ 609(h), 616(c), 620(g) & 1002(c) (McKinney 1963).

98. The Uniform Act for the Simplification of Fiduciary Security Transfers offered substantial protection to issuers registering transfers of fiduciary-owned securities, but it has not been adopted in all states. The Code provisions in part 4 of Article Eight essentially follow the rules established by the Simplification Act and apply them in the registration of transfers of *all* securities. For an excellent article dealing with various

tration of transfer by requiring the issuer to register transfer when certain specified conditions are fulfilled and, at the same time, by carefully circumscribing the issuer's liability.<sup>99</sup> The basic concept is this: if a security has been indorsed by an "appropriate person"<sup>100</sup> whose signature has been responsibly vouched for,<sup>101</sup> then a bona fide purchaser may have the security registered into his name even if its transfer was "wrongful"<sup>102</sup> (for example, in breach of trust),<sup>103</sup> and the issuer is no longer liable to the true owner for thus divesting him of his record title to the security.<sup>104</sup> If, however, the indorsement is unauthorized<sup>105</sup> (for example, a forgery), then even a bona fide purchaser is denied registration of transfer of the security, despite an indorsement by an "appropriate person" and a signature guarantee.<sup>106</sup> If the issuer does register transfer on a forged signature, it remains absolutely liable to the true owner, and must restore the security (or its equivalent) to him.<sup>107</sup> If the issuer is thus held liable, its recourse is against the signature guarantor, normally a financially responsible institution. However, the purchaser who has been refused registration of transfer because of a forgery also has rights against the signature guarantor, whose warranties run "to any person taking or dealing with the security in reliance on the guarantee . . . ."<sup>108</sup> Since Code rights and liabilities turn in large part upon the signature guarantee, it is obviously of great importance, especially to transfer agents but also to selling brokers, that the guarantee itself is genuine and that the guarantor is sufficiently responsible financially to meet any liabilities, which are potentially quite large, that might arise out of the particular transaction. Subject to refinements and qualifications, this is the nexus of legal rules within which the registration of transfer procedure works smoothly for the multitude of daily securities transactions.

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facets of this subject, see Conard, *A New Deal for Fiduciaries' Stock Transfers*, 56 MICH. L. REV. 843 (1958).

99. The Code rules as to the duties, privileges, and liabilities of an issuer in registering security transfers apply also to transfer agents, registrars, or others who act for the issuer. See U.C.C. §§ 8-201(3) & 8-406.

100. The phrase, "appropriate person," is defined in § 8-308(3) as corresponding roughly to the named owner of the security.

101. See U.C.C. § 8-312 for the effect of the signature guarantee which may be required by the issuer as a condition to registration of transfer pursuant to §§ 8-401(1)(b) & 8-402(1)(a).

102. U.C.C. § 8-401.

103. See especially U.C.C. § 8-403(3).

104. U.C.C. § 8-404(1).

105. "Unauthorized" is defined in § 1-201(43).

106. U.C.C. §§ 8-311 & 8-401(1).

107. U.C.C. § 8-404(2).

108. U.C.C. § 8-312(3).

A. *The Issuer's Duty To Register Transfer and Liabilities for Wrongfully Registering or Refusing To Register Transfer*

The issuer must register transfer if, among other conditions, an "appropriate person" has indorsed, the indorsements are guaranteed to be "genuine and effective," the issuer has no duty to inquire or has discharged that duty, and the transfer is "rightful or is to a bona fide purchaser."<sup>109</sup> Given these conditions, the issuer is liable for any loss which results from unreasonable delay or from failure or refusal to register.<sup>110</sup> The ease of statement of these rules conceals a variety of difficulties and uncertainties.

1. *When Is the Issuer Privileged Not To Register Transfer?*

In at least two situations, apart from non-compliance with the four conditions noted above, the issuer may refuse to register transfers. First, a stop transfer notice in the issuer's records allows it to suspend registration pending investigation of the "adverse claim" stated in the notice.<sup>111</sup> Second, if it knows or suspects that a necessary indorsement is unauthorized, it could certainly delay registration pending inquiry, or it could refuse registration entirely if it is satisfied that there is a forgery.<sup>112</sup> In other situations, however, the Code rules are harder to fathom.

(A) Suppose that the issuer has no duty to investigate adverse claims since it has neither received a stop transfer notice nor demanded excess documentation which would give it constructive notice of a wrongful transfer.<sup>113</sup> The issuer has no knowledge or information as to whether the presenter is a bona fide purchaser or whether the transfer is rightful. It has only a certificate which is duly indorsed by the appropriate person with a signature guarantee by a reputable institution. Assume that, in fact, the transfer is wrongful, that the presenter knows this,<sup>114</sup> and that such facts would be discovered if the issuer inquired. Clearly, the purchaser could not enforce registration of transfer; equally clearly, the issuer is not liable if it does register transfer in its ignorance. Yet,

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109. U.C.C. § 8-401(1).

110. U.C.C. § 8-401(2).

111. U.C.C. § 8-403(2) spells out a clear-cut method which issuers are likely to follow.

112. This is implied in §§ 8-401 & 8-404.

113. The Code seeks to dissuade issuers and transfer agents from continuing to demand excessive documentation by charging issuers with notice of "all matters" contained in such documents. U.C.C. § 8-402(4). The lesson is clearly that ignorance is the better part of prudence. *But cf.* Conard, *supra* note 98, at 860-61, criticizing the Code approach in this regard.

114. The presence of knowledge precludes this purchaser from obtaining bona fide purchaser status. U.C.C. § 8-302.

could the issuer, under circumstances which impose upon it no statutory duty to inquire, adopt a policy of routinely investigating the rightfulness of transfer or of the presenter's bona fide purchaser status? Although the old law in effect compelled just this sort of investigation, under the Code the issuer should not pursue such a policy. Granted, in this precise fact situation, the delay—indeed, a flat refusal—would be “privileged” since the presenter could not enforce registration. This, however, is the luck of the draw. The same issuer who safely refused registration on this occasion likely would be liable in other situations for “unreasonable delay in registration” as he pursued his private policy of policing transfers. Such inquiry would run contrary to the Code policy of expediting registration and is thus severely discouraged by the Code provisions.<sup>115</sup> The issuer should gratefully accept the protection tendered him and not undertake to do more than the Code requires.

(B) Suppose that an issuer is presented with a request to register transfer of a trustee-owned security. The issuer scrupulously observes the Code policy discouraging demands for excess documentation, and no stop transfer notice is outstanding. Nevertheless, as it routinely checks out the trustee's incumbency from documents permitted by the Code,<sup>116</sup> it accidentally, but unmistakably, discovers the transfer to be in breach of trust (for example, transfer is expressly forbidden by the trust instrument or there is no court approval despite its being expressly required). If the presenter is *not* a bona fide purchaser, there clearly is no enforceable duty to register transfer, and the issuer could lawfully refuse. However, if the presenter is a bona fide purchaser, a refusal to register would probably give him a right of action against the issuer. Given the presenter's uncertain status as a bona fide purchaser in the eyes of the issuer and the evident wrongfulness of the transfer, the issuer should be privileged to refuse participation in consummating such a wrongful transaction.<sup>117</sup> The desirable approach, however, is not a flat refusal to register, but a delay to investigate further. Although the Code does not deal with this precise situation, it does

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115. U.C.C. §§ 8-402(4) & 8-403(1)(b).

116. U.C.C. § 8-402(1)(c) permits the issuer to require “appropriate evidence of appointment” of a fiduciary.

117. *Welland Inv. Corp. v. First Nat'l Bank*, 81 N.J. Super. 180, 195 A.2d 210 (Ch. 1963) involved a transfer agent's refusal to register transfer of stock certificates where the sale would have violated the Securities Act of 1933. The precise nature of the restriction, whether a legend on the certificate or a stop transfer notice or both, is not stated in the court's opinion. The court approved the transfer agent's refusal to register transfer since the bona fide purchaser status of the purchaser was disputed, and denied summary judgment for the purchaser on that ground.



state that the issuer may discharge "any duty of inquiry by any reasonable means" including the use of a stop transfer notice.<sup>118</sup> The safest approach would be to follow this procedure and defer registration for the permitted thirty-day period which would not be an "unreasonable delay" creating liability.<sup>119</sup>

(C) Suppose that the issuer receives a transferred security which impeccably complies with the conditions for registration. However, it refused to register transfer because the transferor, a dominant figure in the issuer's management or among its shareholders, tries to veto the transaction—perhaps because the value of the securities has unexpectedly risen over the sale price—by placing a stop transfer notice between sale and presentment. Presumably the issuer must check out the "adverse claim." But is the delay privileged? Although the Code impliedly permits a "reasonable delay"—thirty days in the case of the stop transfer order—the purpose of this particular delay seems indefensible, since it results from a maneuver by a dominant figure using his control over the issuer to serve personal ends. Arguably, the issuer has acted (or has been forced to act) in bad faith and without reasonable grounds if the personal motives of officers or shareholders prompt its refusal or delay. Accordingly, the issuer probably would be liable for lending its strategic position and powers to further the interests of one claimant as against another. In short, an issuer's fiduciary duty running to the presenter should limit its privilege to refuse or delay registration of transfer. Under the Code, this might be worked out through the general requirement of "good faith"<sup>120</sup> defined rather limitedly as "honesty in fact in the conduct or transaction concerned."<sup>121</sup> It is arguable that this definition is too narrow to permit finding a breach of duty where an issuer or transfer agent aids one claimant in effecting a dubious power play. However, it is probably the most solid ground, under the Code, to attack such a manifest impropriety.<sup>122</sup>

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118. U.C.C. § 8-403(2). Strictly speaking, this provision applies only when there is a "duty of inquiry" which in turn arises only from the two situations noted in § 8-403(1).

119. See U.C.C. § 8-401(2).

120. An obligation of "good faith" applies to every transaction. U.C.C. § 1-203.

121. U.C.C. § 1-201(19).

122. The text example closely follows the facts in *Kanton v. United States Plastics, Inc.*, 248 F. Supp. 353 (D.N.J. 1965). This was not, strictly speaking, a Code case, since the Code was in effect in the forum state (New Jersey) and enacted but not at that time effective in the state whose law governed the disposition of the case (Florida). However, the court "prophesied" as to how Florida would decide the case in the future and used both Code and pre-Code law to hold that the transfer agent's refusal to register was wrongful, and that the issuer acted in bad faith and without reasonable grounds in refusing to register transfer where the personal interests of a controlling shareholder

## 2. *When Is the Issuer Privileged To Register Transfer?*

The Code imposes on the issuer duties to register with liabilities running both to the true owner for certain wrongful registrations and to the presenter for improper refusals or delays in registering. When does the issuer have some discretion, without incurring liability, to delay registration or to proceed promptly with the task? Under example (A) in the preceding section, the issuer clearly must register transfer and not poke about for some reason to hold up registration.

In example (B), when registration of transfer was questioned because of inadvertently obtained but reliable information as to the wrongfulness of a transfer, it was concluded that the issuer is privileged to defer registration pending an investigation. However, could a hard-nosed issuer simply ignore these facts, stand on the absence of a stop transfer notice, and register transfer into the purchaser's name without liability? I believe that it could do so even without inquiring into the presenter's bona fide purchaser status. Literally read, section 8-404(1) bars liability to the true owner if the security carries the necessary indorsements—and we assume that it does—and the issuer is not obligated to investigate adverse claims. Under section 8-403, the duty of inquiry arises only from two circumstances: timely receipt of a stop transfer notice or receipt of information of an adverse claim from additional documentation which the issuer is entitled to require under section 8-402(4). Nothing in section 8-403 indicates that an investigation is to be compelled by the mere possession of facts which impugn the rightfulness of transfer, and the thrust of the Code's policy supports this result. If the possession of facts *ipso facto* (other than those received under the transfer notice or from excess documentation) requires investigation on the pain of liability of the issuer to the true owner, an issuer, who has suspicions that are more or less well grounded, could not safely ignore any information and would feel compelled to inquire. This would subvert efforts to simplify security transfers and ease the issuer's liability, and would return about half-way to the older law imposing broad duties of inquiry. Arguably, the pervading obligation to act in "good faith"<sup>123</sup> might require investigation under these facts, but I think not for reasons later considered.<sup>124</sup>

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prompted the refusal. I have discussed the case in detail in a note at 44 N.C.L. REV. 854 (1966).

123. U.C.C. § 1-203.

124. See text preceding note 126 *infra*.

In example (C), when an issuer refused or delayed registration on the demand of a controlling shareholder-seller who sought to block registration for assumed personal motives, we concluded that the issuer's act was improper. However, could the issuer (or a transfer agent) go ahead and promptly register transfer without liability to the objecting seller? Assuming the issuer's willingness to flaunt the "request" of a dominant management figure, it likely would escape liability under section 8-404 since the security is properly indorsed. Once the issuer has determined that transfer registration is being held up to further a seller's personal interests, the issuer has discharged any duty of further inquiry—assuming, indeed, that a demand from the claimant for such a dubious purpose created any duty. Registering transfer under these circumstances, although risky, would probably be privileged.

A final example, example (D),<sup>125</sup> goes to the scope of the "good faith," which under the Code must pervade every transaction. Assume a corporation with 500 shareholders, all of whom are scattered small owners except for a controlling block held by a trustee for several beneficiaries. The corporation does its own transfer work. The shares are traded from time to time on local over-the-counter markets. On a particular day, a number of trust-owned share certificates come in duly and genuinely indorsed by the trustee (an "appropriate person") with proper signature guarantees, and other authenticating documents. The transfer clerk (1) knows the trustee socially, (2) knows for a fact that he is an active stock market trader, (3) has heard rumors that the trustee personally lost heavily during the 1966 bear market, and (4) has heard on good authority that the trustee is in Mexico. There are no stop transfer notices nor has the issuer sought excess documentation. Can the issuer honor the demands of the purchasers and their agents presenting the shares for registration of transfer? No one can assert a priori that an agent possessing such information acts in bad faith by registering transfer into the purchasers' names. Nonetheless, I think that the issuer must, under these circumstances, investigate in order to protect the true owners, and that only in this way can it act "honestly in fact." Moreover, to one who is calculating possible losses, the risk of liability for the delay which is needed to make the inquiry is much less than the risk of a much heavier liability for divesting the trust and its beneficiaries of title to the shares. Thus, the best approach

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125. This illustration was suggested to me by the slightly different example in *Isaacs, Investment Securities Problems—Article 8 of the UCC*, 11 *How. L.J.* 120, 140-41 (1965).

is to decline to register transfer immediately, pending an investigation. If sued by the purchasers for undue delay, the issuer may anticipate judicial sympathy for its reluctance to act peremptorily in such dubious circumstances.

This example highlights the difficulty inherent in the "good faith" test. The Code seeks to minimize burdensome duties of inquiry in order to facilitate security transfers to avoid delays and added expenses to transferees. That objective is frustrated if, under the guise of "good faith," the issuer is required to track down bits and pieces of information incidentally or accidentally acquired or to determine the presenter's bona fide purchaser status whenever the issuer suspects the transfer to be wrongful. Such investigations into potentially complicated and disputed factual matters are precisely what issuers and transfer agents should be able to avoid, and to require obliquely these inquiries revives the evils of the old law which compelled issuers to police security transfers. The "good faith" requirement should be invoked only in extreme and unusual circumstances. Thus, it would permit delay in example (D) but not in example (B); and I believe it could also be used to ground the issuer's fiduciary duty in example (C). Although the "good faith" test is basically a subjective one, in my view, it still must incorporate an objective component: that conduct which others who are skilled in the field would regard as decent and honest in the particular situation. Prevailing standards and attitudes should be respected both by the courts in determining "good faith" and by the issuers when they are confronted with an unusual and potentially explosive situation. However, "good faith" should be invoked sparingly so that issuers and transfer agents may safely rely on the reasonably clear-cut Code guidelines for performing their duties in registering securities transfers.

#### B. *Overissue of Securities*

Occasionally Article Eight, despite its generally forward-looking approach, retreats into earlier times, genuflecting as it goes, to ancient rules having an almost totemic character. The most conspicuous instance of this is the Code's tortured treatment of the problem of overissue of securities.<sup>126</sup> It enshrines not only the long established proposition that an issue of shares in excess of the number authorized by the charter is "void" and a "nullity,"<sup>127</sup> but

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126. U.C.C. § 8-104.

127. *Railway Co. v. Allerton*, 85 U.S. 233 (17 Wall.) (1873); *New York, N.H. & H. RR. v. Schuyler*, 34 N.Y. 30 (Ct. App. 1865).

also the concomitant but subordinate doctrine that overissued shares may not be cured even by retroactively amending the charter.<sup>128</sup> New securities could be authorized and exchanged for the void over-issue, although this would raise certain problems under existing law as to whether the old exchanged "void" shares are lawful consideration for the new "valid" issue. The Code's ritualistic deference is mildly absurd; it is not tragic, however, since the overissue question is not one over which a revolution (or even a Happening) can be staged.<sup>129</sup> Yet it does deserve exposure in the hope that a more rational approach may be forthcoming.

Apart from a deliberate charter violation, there is always a possibility that an issuer might be compelled to recognize both the bona fide purchaser of the security as well as the true owner, and that as a consequence an overissue could result. For instance, the issuer may be required both to issue a certificate to the bona fide purchaser for 100 shares and, because it negligently ignored the stop transfer notice on its records, also to issue a certificate to the true owner for 100 shares.<sup>130</sup> Thus, 200 shares would be outstanding where only 100 were before. A similar situation could arise when a certificate is apparently lost, stolen, or destroyed, and a replacement certificate is issued, and subsequently the missing certificate turns up.<sup>131</sup> Thus, in several instances, compulsory validation of securities could create an overissue.

Under a rational approach, issuers would have to validate securities in these circumstances regardless of an overissue in order to protect both the innocent purchaser and the true owners. This could be implemented by a statutory provision to the following effect: Whatever the charter says about the number of authorized shares, any additional number may be issued to validate an over-issue without securing a shareholder-approved amendment. This proposed provision would not violate policies underlying the old rule against overissue—protection against dilution of the outstanding share interests and against manipulation of the share structure. First, the likelihood of this form of manipulation, given all the others that are available to those so inclined, is too slight to matter;

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128. *Triplex Shoe Co. v. Rice & Hutchins*, 17 Del. Ch. 356, 152 Atl. 342 (Sup. Ct. 1930).

129. In the larger corporation there is at least an independent transfer agent, and more often, both a transfer agent and a registrar. The latter maintains a close watch on the relation between the total shares outstanding and the total number of authorized shares. The New York Stock Exchange rules require both a separate transfer agent and a registrar for securities listed on the "Big Board."

130. U.C.C. § 8-404(2).

131. U.C.C. § 8-405(2).

but if it did happen, the wrongdoing parties could be called to account. Second, substantial dilution of outstanding interests is also unlikely, but such dilution could as well occur if the corporation had to recognize two shareholders for one and had the authorized but unissued shares to do so. The problem, then, is not one peculiar to overissue. In addition, although compulsory validation of overissue might be harmful in a close corporation whose carefully devised balance of control might be upset, in this environment share transfers are relatively less frequent, some form of restriction on transfer usually is present, and the pertinent facts are likely to be known. Thus, there is no real barrier to validating overissues by statutory provision.

In lieu of this simple approach, the Code requires the corporation to purchase and deliver "an identical security which does not constitute an overissue"<sup>132</sup> and, if no such security is "immediately available for purchase," then to respond to the wronged security holder in damages.<sup>133</sup> However, there are difficulties here. Assuming a supply of securities which is "reasonably available for purchase," the corporation may be financially unable to purchase the shares. This financial difficulty may be due to many things, for example, indenture requirements for maintaining a specified cash position or limiting the purchase of shares, or perhaps, corporation law restrictions on the accounts out of which share purchases may be made.<sup>134</sup> No corporation law provision for share repurchases expressly recognizes the small but knotty problem these restrictions could pose, and certainly the Code does not. If the Code continues to stick to this procedure, corporation statutes should, in the case of stock acquisitions to validate an overissue, remove the normal limitations on use of corporate funds just as they do with regard to the corporate purchase of a shareholder's interest under the appraisal remedy.<sup>135</sup>

The Code provision has another complication. Assuming shares which are "reasonably available for purchase," and the existence of lawful corporate funds with which to make the purchase, the Code states that the holder of the overissue "may compel the issuer to purchase and deliver" the clean security.<sup>136</sup> Does this ambiguous phrase "may compel" mean that the holder has an option either to compel the purchase of a new security or to pursue some other, un-

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132. U.C.C. § 8-104(1)(a).

133. U.C.C. § 8-104(1).

134. *E.g.*, N.Y. BUS. CORP. LAW § 513(a) (McKinney 1963).

135. *E.g.*, N.Y. BUS. CORP. LAW § 513(b)(3) (McKinney 1963).

136. U.C.C. § 8-104(1)(a).

defined, remedy, such as the traditional remedy of damages? Assuming that the damage option is not pre-empted by a remedy of compulsory substitute purchase, the measure of damage is uncertain. Since, by hypothesis, the security is "reasonably available," clearly the measure of damages stated in section 8-104(1)(b) is inapplicable, since it applies only to securities *not* "reasonably available for purchase." If the Code is to pursue the section 8-104(1)(b) approach, it should have made clear that, if the security is "reasonably available," purchase is the exclusive remedy. Since the security holder's original intention was to obtain (and hold) the security, his reasonable expectations are fulfilled if his sole remedy is to get a "clean" security.

The Code remedy where the identical security is not available for purchase is recovery of the price which the security holder or the last purchaser for value paid for it with interest. Although intended to settle the case-law muddle over the measure of damages and to prevent speculation, this rule produces some curious results which, in fact, have just the opposite effect.<sup>137</sup> The upshot is that the overissue remedy is one of the less effective provisions of Article Eight, and that consequently it should be eliminated in favor of the clearcut and simple remedy of validation of overissued securities.<sup>138</sup>

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137. Suppose that A purchases part of a new stock issue at 20 in 1964 not knowing that his shares constituted part of an overissue. He learns of the defect in 1965 and demands that the corporation furnish him with a security which is not part of the overissue, but such a security is not "reasonably available for purchase." Under § 8-104(1)(b), he may "recover from the issuer the price he or the last purchaser for value paid for it. . . ." Suppose that, at the time of A's demand to the issuer, the shares are worth 10, whereas the last purchaser for value paid 14. If A can enforce his demand, he has a nice advantage over shareholders who received no part of the overissue, because he receives at least \$14.00—the price paid by the last purchaser for value. True, he has suffered a loss of \$6.00, but the other shareholders have a paper loss of \$10.00. The tables are turned, however, if the shares A bought in 1964 at 20 are now worth 50, with the last purchaser for value having paid 45. Under the Code rule, the corporation need only pay A \$45.00 at a time when the shares are worth \$50.00. Thus, while he has a "gain" of \$25.00 per share, the other shareholders have a paper profit of \$30.00 per share. Obviously, A would prefer to have shares rather than the \$45.00, especially if the stock is rising in value.

138. Some of the uncertainties in the present Code provision—bad as it is in concept—could be clarified by revising the language of § 8-104(1)(a) & (b) as follows:

- (a) if an identical security which does not constitute an overissue is reasonably available for purchase, *or is otherwise available for delivery, the exclusive remedy of the person entitled to issue or validation shall be to compel the issuer to deliver or purchase and deliver such a security to him against surrender of the security, if any, which he holds;*
- (b) if a security is not so available for purchase, *or otherwise available for delivery, the person entitled to issue or validation may recover from the issuer the fair value of an identical security which does not constitute an overissue with interest from the date of his demand.*

(New material in italics.)

*C. The Code and the Simplification Act*

The Uniform Commercial Code continues in force the Uniform Act for Simplification of Fiduciary Security Transfers, and indeed makes the latter's provisions controlling in the event of inconsistency.<sup>139</sup> The reason for so doing is unclear, since Article Eight of the Code seemingly adopts all of the Simplification Act provisions, admittedly with some language changes, and generalizes them into rules applicable to all security transfers and not just to fiduciary transactions. Thus, there appears to be no conflict between the two statutes on substantive questions. However, the parallel effectiveness of the two statutes raises a vexing problem. The Simplification Act is permissive; it purports to relieve issuers and transfer agents of the old common-law duty of policing the rightfulness of security transfers by fully investigating any proposed transfer of record of a fiduciary-owned security. Although the Code adopts the concepts of the Simplification Act, it is clearly much more than a merely permissive enactment. First, section 8-401 establishes the judicially enforceable duty of a transfer agent or issuer to register transfer of securities under precisely stated circumstances,<sup>140</sup> and it also defines and limits their liabilities when they have fulfilled that duty.<sup>141</sup> Thus, if a fiduciary security transfer is presented for registration and complies with the Code requirements—and thereby with the similar requirements of the Simplification Act—the transfer agent must act. Second, the Code affirmatively discourages transfer agents from seeking “excess” documentation as to the rightfulness of a transfer. For if they demand more than the Code calls for, they are considered to have constructive notice of everything contained in those “excess” documents which bears upon the rightfulness of the transfers, for example, non-compliance with the terms of a controlling instrument or court order or other breaches of trust.<sup>142</sup> Thus, the transfer agent can become liable to the true owner if he registers such a wrongful transfer.<sup>143</sup> The Simplification Act contains no such sanction.

Probably the Code draftsmen decided to continue the Simplification Act in force because it has become familiar to transfer agents in many states. It is also more comfortable for this cautious breed of people to work with a statute using their customary language

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139. U.C.C. § 10-104(2).

140. U.C.C. § 8-401(2) states the duty, while § 8-401(1), together with §§ 8-402 & 8-403, delimit the circumstances creating the duty.

141. U.C.C. § 8-404.

142. U.C.C. §§ 8-402(4) & 8-403(1)(b).

143. U.C.C. § 8-404.



rather than the new and somewhat artificial (although more accurate) Code terminology.<sup>144</sup> Thus, while the purpose was presumably benign, the relation between Code and Act is cloudy. Surely the Code draftsmen did not intend to relieve transfer agents and issuers of Code-imposed duties by giving strict priority to the Simplification Act's permissive provisions. Yet the saving clause contained in the Code can be construed as subordinating these duties, even though this construction does violence to Article Eight's objectives. For example, it would undermine the Code sanctions against requiring undue documentation if transfer agents could continue the old practices on the ground that the apparently overriding provisions of the Simplification Act lacked any such sanctions.

Thus the Code's clause saving the effectiveness of the Simplification Act contains a serious ambiguity. It is hoped that the courts will read it as giving pre-eminence to the Simplification Act only on those matters of substance as to which there is clear conflict, but not as relieving issuers and transfer agents of the specific duties and sanctions of the Code. Such a construction is reasonable. It can fairly be said that there is no "inconsistency" between the Code's duties and sanctions and the mere silence of the Simplification Act as to such duties and sanctions, but that the Code—a later and more refined statute—supplements the Act with certain additional provisions needed to implement the common purposes of the Code and the Act. Only on this reading can full effect be accorded to the Code's evident intention to put teeth into its efforts to simplify registration of transfer. Nevertheless, it would probably be a better solution to eliminate the saving clause altogether and repeal the Simplification Act; if this is unacceptable, the saving clause should be reworded to make clear that the duties, liabilities, and sanctions contained in Article Eight are effective even though the Simplification Act remains in force.

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144. *E.g.*, one who "transfers" a security (under the Code), "assigns" it (Simplification Act and transfer-agent-lingo), while when a transfer agent or issuer "registers transfer" of a security (Code), he simply "transfers" it (Simplification Act) or—to complicate matters further—transfers it "of record" so that the transferee becomes a "holder of record" (typical corporation statute).