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# INVESTMENT SECURITIES IN NEW YORK: STATUTORY TEXT AND COMMERCIAL PRACTICE

*Carlos L. Israels*†

The subject matter of article 8 of the Uniform Commercial Code is “securities” as defined in section 8-102:<sup>1</sup>

A. as “negotiable instruments” in the historic sense; and

B. with respect to the obligation of an issuer of registered form securities (*e.g.*, the typical stock certificate) to register changes of ownership on transfer books.

Perhaps no assumption is more generally made in our free securities markets than that all instruments which would fit within the catchall phrase “commonly known as a ‘security’ ”<sup>2</sup> are “negotiable,” so that a bona fide purchaser for value and without notice—even a purchaser from a thief—would take the instrument free of defenses of the issuer and equally free of claims or equities of prior ownership.<sup>3</sup> Against the factual background in which the question arises, the assumption is usually justified today. The need for legislation to confirm it on a broad basis arose from the restrictive definition of a “negotiable instrument” in the Uniform Negotiable Instruments Law<sup>4</sup> which effectively excluded from the category all nonmoney paper, all registered form securities, income bonds, revenue bonds and other forms of investment media of demonstrated usefulness in the economy.

As to the most important species of nonmoney paper—the conventional certificate of stock—the situation was largely met by the promulgation

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<sup>1</sup> Section 8-102 (a) A “security” is an instrument which

- (i) is issued in bearer or registered form; and
- (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; and
- (iii) is either one of a class or series or by its terms is divisible into a class or series of instruments; and
- (iv) evidences a share, participation or other interest in property or in an enterprise or evidences an obligation of the issuer.

<sup>2</sup> Securities Act of 1933, 48 Stat. 74, 15 U.S.C. § 77b(1) (1959).

<sup>3</sup> These two aspects of negotiability were first clearly distinguished by Chafee, “Rights in Overdue Paper,” 31 Harv. L. Rev. 1104 (1918). Their separate treatment is basic to Uniform Commercial Code articles 3 (Commercial Paper) and 8 (Investment Securities).

<sup>4</sup> Herein cited as “NIL”; requiring that an instrument “to be negotiable” must among other things “contain an unconditional promise or order to pay a sum certain in money . . . on demand, or at a fixed or determinable future time; . . . to order or to bearer” NIL § 1, N.Y. Negotiable Instr. Law § 20.

and nationwide adoption of the Uniform Stock Transfer Act. New York adopted that act in 1913.<sup>5</sup> Under the USTA the negotiability of stock certificates as to claims or equities of ownership is clearly established. As to issuer's defenses the USTA is silent, but in New York at least, case law appears to protect the innocent purchaser for value.<sup>6</sup> The problem remained ubiquitous in the Empire State as to other types of instruments until *President and Directors of the Manhattan Co. v. Morgan* was decided.<sup>7</sup> In the *Morgan* case the court of appeals clearly negated the power to create "negotiability by contract." The legislative reaction was prompt and sweeping. It took the form of an amendment to the Personal Property Law<sup>8</sup> providing that "security receipts," "equipment trust certificates," and "corporate bonds" [each defined in terms, which taken in the aggregate, substantially blanket the field] transferred in bearer form or properly indorsed confer upon a purchaser for value "without notice of prior defenses or equities or claims of ownership . . . absolute title thereto free of any defenses enforceable against or claims of ownership of the signer or any prior holder."<sup>9</sup>

With respect to the issuer's obligation to register transfers, the need for legislation arose from a long history of American case law holding the issuer responsible (a) for the genuineness of the signature of the indorser, and where he signs for another, for his authority to sign; and (b) for the rightfulness of the transfer for the purposes of which change of registration was sought.

As to genuineness of signature and authority to sign, the issuer's liability was absolute and, in the organized securities markets, came to be insured against by the universal requirement of a "guaranty of signature" by a securities broker or dealer or a bank.<sup>10</sup> The warranty of the guarantor of signature covers both genuineness and authority to sign.<sup>11</sup> The system has worked well and is specifically codified in article 8 which states the guarantor's warranties, and permits the issuer to require as to each necessary indorsement "a guarantee of the signature . . . signed

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<sup>5</sup> N.Y. Pers. Prop. Law §§ 162-85 herein cited as "USTA."

<sup>6</sup> See *Kent v. Quicksilver Mining Co.*, 78 N.Y. 159 (1879); *Holbrook v. New Jersey Zinc Co.*, 57 N.Y. 616 (1874). Cf. *Goldan v. Delaware & E. Ry.*, 144 App. Div. 78, 128 N.Y. Supp. 936 (1st Dep't 1911).

<sup>7</sup> 242 N.Y. 38, 150 N.E. 594 (1926).

<sup>8</sup> N.Y. Pers. Prop. Law §§ 260-62. A year later, "bearer shares" were by statute (N.Y. Pers. Prop. Law § 186) equated to registered form certificates governed by the USTA.

<sup>9</sup> N.Y. Pers. Prop. Law § 261(3).

<sup>10</sup> Rule 209 of the Rules of the Board of Governors of the N.Y. Stock Exch. for the Settlement of Contracts requires that the guarantor be a firm or corporation which is a member of the Exchange, or a New York City bank. In practice however the guarantee is often placed on the security by correspondent banks or brokers at whose request the member firm or New York bank adds its own guarantee.

<sup>11</sup> *Jennie Clarkson Home for Children v. Missouri K. & T. R.R.*, 182 N.Y. 47, 74 N.E. 571 (1905).

by or on behalf of a person reasonably believed by the issuer to be responsible."<sup>12</sup>

As to rightfulness of transfer the liability of either purchaser or issuer was conditional, attaching only when "actual" or "constructive" notice, *e.g.*, of potential delivery in breach of fiduciary obligation could be found. The NIL purports to protect the purchaser unless he had "knowledge of such facts that his action in taking the instrument amounted to bad faith."<sup>13</sup> The rule of the case law, however, particularly in the fiduciary situation, was more stringent: the mere fact of fiduciary ownership known to purchaser or issuer (*a fortiori*, appearing on the face of the certificate as from registration in the name of "Richard Roe, Trustee") or of signature of the indorsement by an agent was in and of itself effective to require the fullest practical investigation, and to charge the purchaser or issuer as the case might be with knowledge of all facts which such investigation would have disclosed.<sup>14</sup>

In 1937 New York adopted sections 3 and 4 of the Uniform Fiduciaries Act<sup>15</sup> purporting to relieve the issuer of any duty of inquiry where registration is into or out of fiduciary name unless it had "knowledge of such facts that the action in registering the transfer amounts to bad faith."<sup>16</sup> The decisions, however, indicated little if any relaxation of the pre-statutory rules.<sup>17</sup>

Finally in 1959 New York enacted the Uniform Act for Simplification of Fiduciary Security Transfers<sup>18</sup>—a broad "exoneration" statute under which no issuer is bound to make inquiry as to the rightfulness of any transfer into or out of fiduciary name unless it receives timely written notice of "a claim of beneficial interest adverse to the transfer." Having received such notice the issuer registers the transfer at its peril unless it notifies the adverse claimant by registered or certified mail at the

<sup>12</sup> Sections 8-312, 8-402(1)(a) and (2). The issuer may adopt standards as to responsibility, provided they are not "manifestly unreasonable." § 8-402(2).

<sup>13</sup> Section 56; assuming, of course, compliance with the other requirements for "holder in due course" status as set forth in § 52.

<sup>14</sup> Many cases could be cited in illustration. Some of the clearest are *First Nat'l Bank v. National Broadway Bank*, 156 N.Y. 459, 51 N.E. 398 (1898); *West v. Tintic Standard Mining Co.*, 71 Utah 158, 263 P. 490 (1928); *Geyser Marion Gold Mining Co. v. Stark*, 106 Fed. 558 (8th Cir. 1901); *Clark & Wilson Lumber Co. v. McAllister*, 101 F.2d 709 (9th Cir. 1939); *Jennie Clarkson Home for Children v. Missouri, K. & T. R.R.*, *supra* note 11. A nonuniform provision of N.Y. Negotiable Instr. Law § 95 protects a bank honoring a corporate check or other instrument drawn by an officer to his own order where his authority to do so is evidenced by a resolution filed with the bank.

<sup>15</sup> N.Y. Gen. Bus. Law §§ 359j-k, N.Y. Sess. Laws 1937 ch. 344, repealed by N.Y. Sess. Laws 1959, ch. 150.

<sup>16</sup> The language appears in each of former §§ 359j and 359k.

<sup>17</sup> See, *e.g.*, *Seymour v. National Biscuit Co.*, 107 F.2d 58 (3d Cir. 1939), and *Harris v. General Motors Corp.*, 263 App. Div. 261, 32 N.Y.S.2d 556 (4th Dep't), *aff'd*, 288 N.Y. 691, 43 N.E.2d 84 (1942).

<sup>18</sup> N.Y. Gen. Bus. Law §§ 359m-w.

address given by him and withholds the registration for a thirty day period after mailing to permit the obtaining of a restraining order.<sup>19</sup> This enactment permitted and in fact resulted in considerable relaxation of New York issuers and transfer agents of the strict requirements of New York issuers and transfer agents for documentation to attest to the rightfulness of transfer, but it does not go beyond the defined fiduciary situations.

Thus in New York a considerable area of the coverage of article 8 had been the subject of pre-Code legislation. Nonetheless in the writer's view the article adds considerably in substance as well as clarity to the law of investment securities in our state. Section by section analysis would serve no useful purpose but it should be worthwhile to point up some highlights, and incidentally to note some changes made in the uniform text of the article by the Legislature at the suggestion of the New York Commissioners on Uniform State Laws who in turn proposed them "to meet criticisms of the 1958 Official Text stated in the Report of the New York [City] Clearing House Association dated December 1, 1961."<sup>20</sup>

In the writer's view several of these "New York Amendments" to article 8 are particularly badly drawn, ill advised from a policy standpoint, or both. Along with other nonuniform amendments adopted or proposed in other states which have enacted or are currently considering enactment of the Code, they were reviewed this Fall by the Permanent Editorial Board of the Sponsors of the Code.<sup>21</sup> Comment as to some of the areas dealt with by the New York Amendments and related action taken by the Permanent Editorial Board appears seriatim in the following discussion.

#### DEFINITIONS

The definition of "Security" in article 8 covers both money and non-money paper ["evidences a share, participation or other interest in prop-

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<sup>19</sup> N.Y. Gen. Bus. Law §§ 359q(a),(b).

<sup>20</sup> The quotation is from the Letter of Transmittal of the Supplementary Report of the New York Comm'n to the Legislature dated January 24, 1962 (herein cited as "Supplementary Report"). In two instances the changes were suggested by counsel for the N.Y. Stock Exch. As to these New York Amendments see generally Penney, "New York Revisits the Code, Some Variations in the New York Enactment of the Uniform Commercial Code," 62 Colum. L. Rev. 992, 998-1000, 1007-13.

<sup>21</sup> The American Law Inst. and the Conference of Comm'rs on Uniform State Laws. New York is represented on the Board by Professor John W. MacDonald, Chairman of the New York Law Revision Commission. Board action takes the form of adopting or rejecting a proposed amendment to the uniform text. In a few instances (for examples see the discussion of §§ 1-201(27) and 8-107 *infra*) the Board itself has drafted amendments in areas of policy suggested by proposed amendments the specific texts of which appear to the Board inadequate to solve the problems sought to be dealt with.

erty or in an enterprise . . . or . . . an obligation of the issuer"] and it is basically functional ["of a type commonly dealt in upon securities exchanges or markets or commonly recognized . . . as a medium for investment."]<sup>22</sup>

It may be noted that it is entirely possible for the organizers of a business enterprise even in corporate form to create investment media which will not fit the definition, *e.g.*, by the use of instruments in order form, or stating the name of the owner without provision for registration of transfer, and for the noncorporate business entity such as a limited partnership to finance itself and function without issuing securities at all. Nonetheless the obligations of or interests in these enterprises (even though not embodied in a specific "instrument") will be "investment contracts" and thus "securities" for regulatory purposes under the Federal Securities Act of 1933 and State Blue Sky Laws.<sup>23</sup>

There are "legal investment" statutes in some jurisdictions requiring that securities purchased be "negotiable instruments." Since article 8 removes bearer bonds (probably the most prolific type of legal investment) from the Uniform NIL definition, it was thought best to include a specific statutory declaration that "securities governed by this article are negotiable instruments." A New York amendment adds "and are fungible."<sup>24</sup> The addition seems to the writer clearly an overstatement.<sup>25</sup>

#### INCORPORATION BY REFERENCE; ISSUER'S DEFENSES

Article 8 clarifies the situation as to incorporation of additional terms by reference to extrinsic documents (*e.g.*, a constitution, a statute, regulatory orders, a mortgage or trust indenture or the like), sanctioning the practice "to the extent that the terms so referred to do not conflict with the stated terms";<sup>26</sup> and it extends to all types of securities the long-standing NIL rule that all defenses of the issuer except lack of genuineness of the security "are ineffective against a purchaser for value who has taken without notice of the particular defense."<sup>27</sup>

<sup>22</sup> Section 8-102(1)(a).

<sup>23</sup> See, *e.g.*, SEC v. W. J. Howey Co., 328 U.S. 293 (1946), and cases cited therein; SEC v. Payne, 35 F. Supp. 873 (S.D.N.Y. 1940). See generally 1 Loss, Securities Regulation (2d ed. 1962).

<sup>24</sup> Section 8-105. But see, N.Y. U.C.C. § 8-105(1), N.Y. Sess. Laws 1962 ch. 553, eff. Sept. 27, 1964.

<sup>25</sup> See text accompanying notes 62-76 *infra*.

<sup>26</sup> Section 8-202(1). Cf. *Enoch v. Brandon*, 249 N.Y. 263, 164 N.E. 45 (1928); N.Y. Stock Corp. Law § 65 and the new N.Y. Bus. Corp. Law § 508(b) (N.Y. Sess. Laws 1961 ch. 885, now eff. Sept. 1, 1963). The "fine line" [Penney, *supra* note 20, at 995] between *Enoch* and *Old Colony Trust Co. v. Stumpel*, 247 N.Y. 538, 161 N.E. 173 (1928), thus fortunately becomes academic.

<sup>27</sup> Section 8-202(4).

## PROCEDURES ON ISSUANCE

In the field of commercial paper the principle of *caveat emptor* generally has been considered applicable. Not so as to securities. The cases have applied strict rules, *e.g.*, estopping the issuer to question the binding effect of a corporate signature placed on the security by any employee who could be shown to have had any reasonable semblance of authority to issue.<sup>28</sup>

Purchasers of securities (particularly investment bankers) are accustomed to require of the issuer strict proof of validity and the classic opinion of counsel to the effect that the securities "are duly issued and outstanding"; that debt securities "are the valid and subsisting obligations of the issuer in accordance with their terms"; and that shares of stock are "fully paid and nonassessable."

Moreover the indenture trustee authenticating bonds or debentures and the transfer agents and registrars issuing stock certificates have historically been held responsible at least for genuineness and proper form of the security<sup>29</sup> and for the prevention of overissue;<sup>30</sup> and the registration provisions of the Securities Act of 1933 are so phrased that action of an indenture trustee, transfer agent or registrar in causing transmission of unregistered securities in interstate commerce may violate the Act.<sup>31</sup>

Against this background counsel for indenture trustees and transfer agents are accustomed to make an independent check.<sup>32</sup> One of the New York amendments would substantially cut down the responsibilities assumed by trustees, transfer agents and the like under the case law by omitting from section 8-102 the definition of "proper form" and amending section 8-208(1)(a) to require certification not as in the Uniform text "that (a) the security is genuine and in proper form"; but merely that it is genuine and "in the form which such person has been authorized to authenticate, sign or countersign."

In the 1952 official draft of the Code the obligation of the authenticating trustee, registrar or transfer agent with respect to overissue was

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<sup>28</sup> *Hudson Trust Co. v. American Linseed Co.*, 232 N.Y. 350, 134 N.E. 178 (1922); *Knox v. Eden Musee American Co.*, 148 N.Y. 441, 42 N.E. 988 (1896). Article 8 codifies if not extends the doctrine by giving full effect to signature by an employee "entrusted with the responsible handling of the security." § 8-205.

<sup>29</sup> *Jarvis v. Manhattan Beach Co.*, 148 N.Y. 652, 43 N.E. 68 (1896); *Fifth Ave. Bank v. 42d Street & Grand St. Ferry R.R.*, 137 N.Y. 231, 240, 33 N.E. 378, 380 (1893).

<sup>30</sup> *Doyle v. Chatham & Phenix Nat'l Bank*, 253 N.Y. 369, 171 N.E. 574 (1930).

<sup>31</sup> Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly— . . .

(2) to carry or cause to be carried through the mails or in interstate commerce . . . any such security . . . for delivery after sale.

Securities Act of 1933 § 5(a)(2), 48 Stat. 77, 15 U.S.C. § 77e(a)(2) (1959).

<sup>32</sup> This includes a careful review of the opinion of counsel for the issuer as to registration, or as to the availability of an exemption from the registration requirements of the Securities Act.

limited to certification that the security is within the amount specified in the authorization received from the issuer.<sup>33</sup> In recognition of the confidence properly placed by the investing public in the banking institutions which serve as indenture trustees, transfer agents, etc., this language was changed in 1956 to that which appears in the 1958 text, namely a certification that the trustee or transfer agent "has reasonable grounds to believe that the security is within the amount the issuer is authorized to issue."<sup>34</sup>

The Permanent Editorial Board has determined that the scope of the certification as to "proper form" should be similarly stated; specifically that since the definition of that term in section 8-102 serves no purpose other than cross reference to section 8-208 it may well be omitted, but that section 8-208(1)(c) should read "He has reasonable grounds to believe that the security is *in the form* and within the amount the issuer is authorized to issue." Thus the obligation to make independent check clearly will be preserved in terms of due care, and the institution relieved of what might otherwise conceivably amount to the liability of an insurer in these areas.

#### BONA FIDE PURCHASE; ADVERSE CLAIM

Article 8 defines "bona fide purchaser" as one who "for value in good faith and without notice of any adverse claim . . . takes delivery of a security in bearer form or of one in registered form issued to him or indorsed to him or in blank."<sup>35</sup>

The definition of "adverse claim" is comprehensive. It "includes a claim that a transfer was or would be wrongful or that a particular adverse person is the owner of or has an interest in the security. . . ."<sup>36</sup>

Claims of either legal or equitable title are clearly covered, as are claims of beneficial interest or that a transfer made or contemplated would be in violation of a valid restriction such as one imposed by a certificate of incorporation or a by-law, by an agreement among stockholders or otherwise by the issuer, *e.g.*, to guard against possible violation of the registration provisions of the Securities Act of 1933 by purchasers of its securities "for investment."<sup>37</sup>

<sup>33</sup> UCC Official Draft, Text and Comments Ed. 1952, §§ 8-208(1)(b) and (c).

<sup>34</sup> 1958 Official Text § 8-208(1)(c).

<sup>35</sup> Section 8-302. The classic NIL term "holder in due course" is discarded. The bona fide purchaser "acquires the security free of any adverse claim," § 8-301(2). Under appropriate conditions one not a bona fide purchaser in his own right may none the less (as under NIL § 58) be "sheltered" and entitled to the benefits of that status. § 8-301(1), and see *Gruntal v. United States Fid. & Guar. Co.*, 254 N.Y. 468, 173 N.E. 682 (1930).

<sup>36</sup> Section 8-301(1).

<sup>37</sup> Section 8-204 carries over the rule of the USTA that a restriction on transfer imposed by the issuer is ineffective unless conspicuously noted on the certificate. There is an excep-

A New York amendment adds to the definition "and in the case of a purchase of a limited interest includes only a claim adverse to the interest purchased." In support the Supplementary Report urges that there are situations in which there is a valid transfer of ownership of a number of shares of stock less than the total represented by a particular certificate.<sup>38</sup> Article 8 therefore specifically negates the NIL Rule that "the indorsement must be . . . of the entire instrument"<sup>39</sup> substituting "an indorsement purporting to be only of part of a security representing units intended by the issuer to be separately transferable is effective to the extent of the indorsement."<sup>40</sup>

Under section 8-301(3), a purchaser of a limited interest acquires rights only to the extent of the interest purchased. If A acquires a fifty per cent interest and B a fifty per cent interest, each interest is so limited that neither conflicts with the other. Moreover, since the adverse claimant must be "a *particular* adverse person" (emphasis added), a claim to any complementary interest, *e.g.*, a noncompeting fifty per cent interest or that of a remainderman as against a life tenant or a beneficiary as against a trustee is not "adverse" and does not produce an adverse claim. The term itself connotes adversity. Necessarily in the case of a purchase of a limited interest such adversity must be to the specific limited interest acquired. On this basis, the Permanent Editorial Board has rejected this Amendment and it will not be included in the text of the Uniform Code.

#### EFFECT OF "MATURITY"; "STALENESS"

Article 8 rejects as to the bona fide purchaser of securities the NIL requirement that the instrument be acquired "before it was overdue."<sup>41</sup> The overdue bond (whether or not the obligor has defaulted) or the stock issue called for redemption, or for exchange in course of a merger or consolidation, may quite legitimately be traded on the market for a considerable period of time after maturity or even after money or new securities are available for payment or delivery.<sup>42</sup>

#### REPARATION IN KIND

Article 8 contemplates reparation in kind for one improperly deprived of a security, *e.g.*, by loss, theft, or transfer upon forged indorsement<sup>43</sup>

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tion, particularly important in the securities regulation field, as to persons taking the security with "actual knowledge" of the restriction. See Israel, "Stop-Transfer Procedures and the Securities Act of 1933—Addendum to Article 8," 17 Rutgers L. Rev. — (1962).

<sup>38</sup> Supplementary Report, *supra* note 20, at p. 15.

<sup>39</sup> NIL § 32.

<sup>40</sup> Section 8-308(5).

<sup>41</sup> NIL § 52(2). Cf. the concomitant N.Y. Pers. Prop. Law provision in § 261(4).

<sup>42</sup> See § 8-203 as to notice of issuer's defenses, and § 8-305 as to notice of adverse claims.

<sup>43</sup> Section 8-315. Cf. *Prince v. Childs Co.*, 23 F.2d 605 (2d Cir. 1928).

subject only to the limitations necessarily imposed by the time honored concept that "overissue" of corporate shares is "absolutely void."<sup>44</sup>

Even where overissue is involved, article 8 requires that the security be replaced in kind in any case where "an identical security which does not constitute an overissue is reasonably available for purchase," and only where such a purchase cannot be made does it relegate the claimant to a suit for damages.<sup>45</sup>

#### INDORSEMENT

Article 8 lays the ghost of secondary liability on the part of the indorser of a security, specifically providing that "Unless otherwise agreed the indorser by his indorsement assumes no obligation that the security will be honored by the issuer."<sup>46</sup> It defines the "appropriate person" to indorse a registered form security and makes clear distinction between power to indorse and power to deliver—and thus complete a transfer—by providing that (i) "Whether the person signing is appropriate is determined as of the date of signing and an indorsement by such a person does not become unauthorized . . . by virtue of any subsequent change of circumstances"; and (ii) failure of a fiduciary to comply with a controlling instrument or with state law, including any law requiring him to obtain a court approval of a transfer "does not render his indorsement unauthorized for purposes of this Article."<sup>47</sup> Thus a security indorsed by a decedent, by a duly authorized agent or by a fiduciary may be validly delivered though death or other termination of authority or of relationship has intervened. More important, where, for example, a court order is required to validate a "transfer," "sale" or "disposition" of securities, that requirement is a restriction not upon power to indorse, but upon the propriety or rightfulness of the delivery.

On the other hand, signature by any person other than the registered owner (*e.g.*, an agent or a corporate officer) after termination of his tenure as such is "unauthorized" and ineffective as part of a valid transfer. The issuer who registers the transfer in such a case is liable

<sup>44</sup> Section 8-104. The 1865 decision in *New York & N.H. R.R. v. Schuyler*, 34 N.Y. 30 (1865) is still the leading case.

<sup>45</sup> Section 8-104(1)(2). Damages recoverable are fixed at the price which the plaintiff or the last purchaser for value paid for the security, with interest from the date of demand. What the pre-Code New York law would be in such situation is not clear under the cases. *E.g.*, *Bank of Buffalo v. Kortright*, 22 Wend. 347 (N.Y. Ct. of Err. 1839); *Baker v. Drake*, 53 N.Y. 211 (1873) and see *Mayer v. Monzo*, 221 N.Y. 442, 446, 117 N.E. 948, 949 (1917).

<sup>46</sup> Section 8-308(4).

<sup>47</sup> Sections 8-308(6) and (7). The term "unauthorized signature" includes "forgery" and has the classic consequences of a forged indorsement, except that the security can no longer be recovered 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." §§ 8-311, 8-404.

for improper registration as he would be in a case of outright forgery<sup>48</sup> but has full recourse to the guarantor of signature who has specifically warranted that "at the time of signing (a) the signature was genuine; and (b) the signer was an appropriate person to indorse; and (c) the signer had legal capacity to sign."<sup>49</sup>

Where the question is the propriety of the delivery, whether the purchaser can obtain bona fide status and whether the issuer may properly register transfer are dependent upon whether they have or are chargeable with "notice" of the particular adverse claim which is sought to be enforced. Nor is there in such case recourse to the guarantor of signature who "does *not* otherwise warrant the rightfulness of the particular transfer."<sup>50</sup> (Emphasis added.)

#### WARRANTIES ON TRANSFER

Related to the concept of secondary liability of the indorser are the warranties made by transferor to transferee. Under article 8 warranties are made only to a purchaser for value and their scope is strictly limited: the transferor warrants the genuineness of the security; that his transfer of it is effective and rightful and that he knows of no fact which might impair the validity of the security.<sup>51</sup>

Where the transferor is an "intermediary" he "warrants only his own good faith and authority," but a broker "is not an intermediary within the meaning of this subsection."<sup>52</sup> There has been some semantic difficulty as to whether or not a securities dealer generally, or an institution such as a bank, which by reason of the function it sometimes performs in other securities transactions may fall within the Code definition of "broker,"<sup>53</sup> can qualify for the protection given to an "intermediary"

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<sup>48</sup> Sections 8-311, 8-404.

<sup>49</sup> Section 8-312(1). One case that may be considered an exception to this rule is that of the removed or resigned fiduciary in whose name as such the security was registered. As to such a registered owner the issuer may assume continuing tenure of office until it receives "written notice that the fiduciary is no longer acting as such with respect to the particular security," § 8-403(3)(a). Thus the signature of the removed or resigned fiduciary never becomes "unauthorized" so long as he remains the registered owner of the security and thus (like a thief) possibly still in a position to convey to a bona fide purchaser title to the security free of any adverse claim. The treatment of this case may work a change in substantive law. For example, Christy, *The Transfer of Stock* § 342 (3d ed. 1960) cites the signature of a resigned or removed trustee as an example of one which is "unauthorized." On the other hand the only case in the books which the writer has been able to find was decided in Mississippi in 1890. *Mobile & O. Ry. v. Humphries*, 7 So. 522 (Sup. Ct. Miss. 1890). The decision is not particularly helpful since it held the issuer, but not the purchaser, liable where neither had notice of the removal.

<sup>50</sup> Section 8-312(1).

<sup>51</sup> Section 8-306(2).

<sup>52</sup> Section 8-306(3).

<sup>53</sup> Section 8-303. "Broker" means a person engaged for all or part of his time in the business of buying and selling securities, who in the transaction concerned acts for, or buys a security from or sells a security to a customer. Nothing in this Article deter-

where in the particular transaction he does not function as a broker. It was intended that he should be able so to qualify, in line with the decision of a New York case which arose under a similar section of the USTA. In *Appenzellar v. McCall*,<sup>54</sup> a brokerage firm held as collateral for advances to its customer stock certificates which the customer had forged. At his instructions they delivered the collateral to another broker who paid off the debit balance and upon discovering the forgery sued for breach of warranty of genuineness. The court held that the firm had not in this instance functioned as a "broker" in a "sale" transaction but merely as an intermediary and had not, therefore, made the warranty. A New York amendment attempts to clarify this situation by revising the last sentence of section 8-306(3) to read "A broker acting as a broker in a *particular transaction* is not an intermediary within the meaning of this subsection." The Permanent Editorial Board determined to delete the sentence altogether. The writer is confident that with the *Appenzellar* decision on the books and the Code definition of "broker" phrased in terms of "the transaction concerned," the courts can be trusted to reach the appropriate results on a case by case basis.

#### DELIVERY

To begin with the various commercial practices which permit a transferor to make delivery by doing something less than placing the security physically in the possession of the transferee are recognized in article 8.<sup>55</sup>

Where no broker is involved the risk of loss in transit falls (unless otherwise agreed) on the transferor, not the transferee.<sup>56</sup>

Where brokers are involved the transferor fulfills his obligation by making delivery to his broker. The selling broker fulfills his obligation by delivering the specific security "or a like security" to the buying broker either physically or through the clearing processes of an organized market,<sup>57</sup> and the buying broker makes delivery to his customer either physically or by holding for him an instrument which by the form of its registration or "by book entry or otherwise" is specifically identified as belonging to the customer.<sup>58</sup>

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mines the capacity in which a person acts for purposes of any other statute or rule to which such person is subject.

<sup>54</sup> 150 Misc. 897, 270 N.Y. Supp. 748 (Sup. Ct. N.Y. County, 1934). Cf. *Gruntal v. United States Fid. & Guar. Co.*, 254 N.Y. 468, 173 N.E. 682 (1930) codified in § 8-318 under which full protection is given to "[a]n agent or bailee" acting in good faith on the instructions of a principal though the latter had no right to dispose of the securities.

<sup>55</sup> Sections 8-313 and 8-314 provide for delivery to a person "designated by" the transferee or by someone in possession of the security to acknowledge to the transferee that the security is held for him, and cf. § 8-320 added by New York Amendment and discussed *infra*.

<sup>56</sup> Section 8-314(2).

<sup>57</sup> Sections 8-314(1)(b), 8-320.

<sup>58</sup> Section 8-313(1).

With respect to deliveries as between brokers certain of the New York amendments have important and useful impact. As enacted in New York section 8-102(3) defines a "Clearing Corporation,"<sup>59</sup> section 8-102(4) defines a "Custodian Bank,"<sup>60</sup> and section 8-320 relates to "Transfer or Pledge within a Central Depository System." The two definitions are almost self explanatory and the writer would at most criticise the requirement that a "Clearing Corporation" must have all of its capital stock held by a national securities exchange registered as such under Federal statute. The Permanent Editorial Board has determined that the definition should be broadened to include a "Clearing Corporation" whose stock is held by an association of securities dealers registered as such under Federal statute so that the benefits of the procedure will be available in the over the counter market if desired.

Subsection 8-320(1) states the requirements for "transfer by book entry" in terms of possession of the affected security (in bearer form or appropriately indorsed) by a clearing corporation, a custodian bank, or the nominee of either; and subsection (2) contemplates the employment of "balance" certificates, e.g. by custodian banks which function as transfer agents for the particular issue. The key provision is that of subsection (3) which gives the procedures authorized in subsections (1) and (2) "the effect of a delivery of a security in bearer form or duly indorsed in blank."<sup>61</sup> Subsection (4) makes it clear that transfer or pledge under Section 8-320 does not of itself work any change in the registered ownership of the affected security, and subsection (5) states the accountability of a clearing corporation to persons adversely affected by entries made on its books which "are not appropriate."

In view of this language it would seem that a New York amendment which was added to section 8-302 becomes pure surplusage. Uniform section 8-302 defines a bona fide purchaser in terms of one "who takes delivery of a security in bearer form or of one in registered form issued to him or indorsed to him or in blank." The New York amendment adds "or who takes delivery in a manner specified in section 8-320." In other words (with due apology to Gertrude Stein), "A delivery is a delivery is a delivery." The Permanent Editorial Board agreed and has rejected this amendment.

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<sup>59</sup> Section 8-102(3) reads:

A "clearing corporation" is a corporation, all of the capital stock of which is held by or for a national securities exchange registered under a statute of the United States such as the Securities Exchange Act of 1934.

<sup>60</sup> Section 8-102(4) reads:

A "custodian bank" is any bank or trust company which is supervised and examined by state or federal authority having supervision over banks and which is acting as custodian for a clearing corporation.

<sup>61</sup> The conclusion is confirmed by the Board's addition of subsection (1)(e) to § 8-313, in effect merely a cross-reference to 8-320.

Special problems are presented in the margin account situation. The buying broker having advanced a substantial percentage of the purchase price of the security takes delivery in "Street name,"<sup>62</sup> placing it in a safe deposit box or pledging it with the bank from which he is currently borrowing as "part of a fungible bulk held for customers"<sup>63</sup> and expecting to honor his obligation to deliver only when the customer's indebtedness has been discharged—usually out of the proceeds of a later sale of the security. Historically it has been said that there are two "rules" as to property rights in such a situation; that under the so-called "New York" or majority rule the customer has "title" while the broker is a pledgee or lienholder; that under the "Massachusetts" rule the relationship is that of debtor and creditor, with "title" vesting in the broker.<sup>64</sup> Generally the Code does not deal with who may or who may not have "title";<sup>65</sup> but with who is or who is not a "holder," *i.e.*, the person in possession of the instrument who may or who may not have title, and with the status of the holder as a "purchaser" and in a proper case a "bona fide purchaser."<sup>66</sup> Consistent with this approach, Uniform section 8-313(2) states that in the margin account case the customer "is not the holder" of the security despite his "acquisition of a proportionate property interest in the fungible bulk." The important intended legal consequence is made clear in the Comment to the section.

Should a customer . . . receive notice of a defect in the security prior to . . . specific identification . . . he cannot become a bona fide purchaser. Therefore he is of course entitled to refuse to accept delivery of such a security from the broker.

With respect to this subsection the Supplementary Report states that:<sup>67</sup>

Concern has been expressed . . . [as to] the position of a buyer of securities as part of a fungible bulk as against adverse claimants and creditors of a broker, including a broker's trustee in bankruptcy, and the United States as a claimant under a Federal tax lien.

There was a danger that if a broker who purchased a security in good faith for the account of a customer received "notice" before "delivery" to the customer he would not be able to make good delivery to the cus-

<sup>62</sup> *I.e.*, his own name, or that of another broker or a bank nominee partnership. It is of course widely customary for securities so registered and indorsed in blank to circulate freely in the organized securities markets where the essential signatures are easily verified.

<sup>63</sup> Section 8-313(3). In such form securities do fit the definition of "fungible" in § 1-201(17); see the discussion at p. 122, *infra*.

<sup>64</sup> *Strickland v. Magoun*, 119 App. Div. 113, 104 N.Y. Supp. 425 (2d Dep't), *aff'd*, 190 N.Y. 545, 83 N.E. 1132 (1907). Whether there really ever was a "Massachusetts" rule is somewhat doubtful. See *Denton v. Gurnett & Co.*, 69 F.2d 750 (1st Cir. 1934).

<sup>65</sup> It has been colloquially observed that not even in article 2 (Sales) does the UCC play the ancient game of "Title, title, who's got the title?"

<sup>66</sup> "Holder" is defined in terms of possession only in § 1-201(20). "Purchase" and "purchaser" are defined in §§ 1-201(32) and (33), and bona fide purchaser as to securities in § 8-302.

<sup>67</sup> Supplementary Report, *supra* note 20, at pp. 17-18.

tomers and would have to suffer any loss resulting from a decline in the value of the securities in whose purchase he was merely carrying out the orders of the customer.

Consistent with these views, two New York amendments restate subsection 8-313(2) and add subsection (3) as follows:

(2) The purchaser is the owner of a security held for him by his broker, but is not the holder except as specified in subsections (b) and (c) of subsection (1). Where a security is part of a fungible bulk, the purchaser is the owner of a proportionate property interest in the fungible bulk and is a bona fide purchaser if when the broker takes delivery as a holder neither he nor the purchaser has notice of any adverse claim and the purchaser takes his interest for value.

(3) Notice of an adverse claim to the broker or to the purchaser after the broker takes delivery as a holder without notice of any adverse claim is not notice of the adverse claim to either the broker or the purchaser.

The language of the amendments is to say the least confusing and the tautology of New York subsection (3) that "Notice . . . is not notice" seems peculiarly inept. Concededly the text should, to the fullest possible extent, protect the position of the margin customer in a brokerage bankruptcy, but that there should be legitimate "concern" in that area seems to the writer a bit far-fetched.<sup>68</sup>

To the extent that the New York amendments attempt to put a buying broker in a position to pass on to his customer even the burden of defending against a completely groundless adverse claim, it seems completely indefensible. One of the things for which the customer pays his broker is the broker's expertise in obtaining a completely "clean" security. What is more the broker (as distinguished from the customer) is entitled to the benefit of the rules of the organized markets with respect to "Reclamations" under which any security as to which notice of an adverse claim is received "may be returned to the party who introduced it into the market."<sup>69</sup> Endeavor to reconcile these points of view led the Permanent Editorial Board to adopt new text for sections 8-313(2) and (3) designed to allay any legitimate fears with respect to the property rights of the purchaser in the fungible bulk, and to make completely clear the right of the purchaser as against his broker to demand delivery of an unquestionably "clean" security. The text of the subsections is revised as follows:

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<sup>68</sup> See, e.g., *Denton v. Gurnett & Co.*, *supra* note 64 and in the *Matter of Mills*, 125 App. Div. 130, 110 N.Y. Supp. 314 (1st Dep't 1908). Cf. Bankruptcy Act § 60(e), 52 Stat. 870 (1938), 11 U.S.C. § 96(e) (1958) and the writer's discussion of the problem in the context of an earlier text of article 8 in 16 *Law & Contemp. Prob.* 249, 258-60 (1951).

<sup>69</sup> See Rules of the Board of Governors of the N.Y. Stock Exch., "Reclamation" Rules 224-34, inclusive. The quotation is from Rule 231.

(2) The purchaser is the owner of a security held for him by his broker, but is not the holder except as specified in subparagraphs (b) and (c) of subsection (1). Where a security is part of a fungible bulk the purchaser is the owner of a proportionate property interest in the fungible bulk.

(3) Notice of an adverse claim received by the broker or by the purchaser after the broker takes delivery as a holder for value is not effective either as to the broker or as to the purchaser. However, as between the broker and the purchaser the purchaser may demand delivery of an equivalent security as to which no notice of an adverse claim has been received.

As we have noted, one of the New York amendments is the inclusion in section 8-105 of a statutory declaration that all securities "are fungible." The term "fungible" is defined in section 1-201(17) to include "securities of which any unit is, by nature or usage of trade the equivalent of any other like unit." Of course by either standard the rights and interests represented by each share of the common stock of United States Steel Corporation are the exact equivalent of those represented by every other such share. Not so as to the certificates which represent those shares. A security to begin with must be an "instrument"<sup>70</sup> and if it appears from the face of that instrument that it is registered in the name of John Doe, that instrument at least until indorsed by John Doe is not, either by nature or by usage of trade the equivalent of a certificate in the name of Richard Roe which Richard Roe has indorsed in blank, having his signature guaranteed by his bank or broker. The latter is in form to constitute "a delivery" under the Rules of the New York Stock Exchange; the former is not. If perchance, Richard Roe were designated as a trustee or the registration were in the name of Richard Roe, Inc., even the indorsement and guarantee of signature would not bring the certificate in question into the category of "delivery" as defined by the rules and practice of the organized markets.<sup>71</sup>

Another New York amendment related to problems of delivery deals with the right of the seller of securities to sue his buyer for the price. As enacted in New York section 8-107 provides:

Where, pursuant to a contract to sell or a sale, a security has been delivered or tendered to the purchaser, and the purchaser wrongfully fails to pay for the security according to the terms of the contract or the sale, the seller may in addition to any other remedy recover the agreed price of the security. This provision does not affect the remedy of a seller if the security has not been delivered or tendered.

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<sup>70</sup> Section 8-102(1)(a).

<sup>71</sup> See, e.g., N.Y. Stock Exch. Rules 186-214, et seq, respecting "Assignments." The rules are expressed in terms of what "shall be a delivery." For example it is specifically provided that a certificate bearing an assignment by a decedent, a trustee or other fiduciary, agent or attorney "shall not be a delivery." Rule 201.

The stated purpose was

to insure the continuance of the rule in *Agar v. Orda*, 264 N.Y. 248, 190 N.E. 479 (1934). The holding of that case was that where the buyer had refused to accept delivery of a security the seller . . . is limited to an action for damages. The dictum of that case was that where delivery of a security has been completed the seller may . . . recover the price.<sup>72</sup>

The most cursory examination of the text of New York's section 8-107 clearly indicates the variance. That text purports to give an action for the price not only where delivery has been completed but where it has been merely "tendered" and thus to overrule the holding of the *Agar* case. The policy is surely unwise unless clearly limited to securities for which there is no ready market.

To indicate forcefully the nature of the obligation of *any* transferor of securities to make delivery and to define properly the situation in which an action for the price will lie, the following revised text of section 8-107 has been adopted by the Permanent Editorial Board:

(1) Unless otherwise agreed, and subject to any applicable law or regulation respecting short sales, a person obligated to deliver securities may deliver any security of the specified issue, in bearer form, or registered in the name of the transferee, or indorsed to him or in blank.

(2) When the buyer fails to pay the price as it comes due under a contract of sale the seller may recover the price

(a) of securities accepted by the buyer; and

(b) of other securities if efforts at their resale would be unduly burdensome or if there is no readily available market for their resale.

Subsection (1) does the job intended by the epithetical phrase "and are fungible" included in the New York Amendment to section 8-105 which was rejected by the Permanent Editorial Board. Only to the extent that securities are available in form to be further transferred by the person to whom they are deliverable, are they properly treated as fungible. This is the concept generally accepted in the organized markets. "Unless otherwise agreed," the seller, bailee (including a broker acting as agent) or other "person obligated to deliver securities" need not deliver any specific instrument, but may select (e.g., from a "fungible bulk"<sup>73</sup>) any security of the proper issue, in bearer form or appropriately registered. The rules of the organized markets limiting the forms of registration in which securities are deliverable in transactions on such markets are matters "otherwise agreed," and the proviso respecting short sales has reference as well to statutory and administrative regulation of such markets. Cases<sup>74</sup> holding a solvent broker liable for conversion if he

<sup>72</sup> Supplementary Report, *supra* note 20, at p. 14.

<sup>73</sup> Section 8-313(2).

<sup>74</sup> Such as *Parsons v. Martin*, 77 Mass. (11 Gray) 111 (1858); *Rumery v. Brooks*, 205

registers transfer of a customer's securities held in "cash account" out of the customer's name or tenders on demand for delivery a different though equivalent security are rejected. However, the Section does not enlarge the rights of the broker as to such securities so as to permit him without the customer's consent to pledge them for his own indebtedness as he may properly do with securities held in a margin account and upon which he has acquired a lien for advances.<sup>75</sup>

Subsection (2) is designed roughly to equate the remedies available against a defaulting buyer of securities (including the guarantor of a loan who has given the lender a "put" in the form of his obligation to purchase the securities upon demand) to those available to the seller of goods under Section 2-709. Paragraph (b) is applicable where for example (i) securities are those of a closely held corporation not dealt in on any organized market; or (ii) because of the necessity for compliance with the registration requirements of the Securities Act of 1933 prior to offering the particular securities on the market, substantial delay and expense would be involved.<sup>76</sup>

#### NOTICE

Both as to issuers<sup>77</sup> and purchasers,<sup>78</sup> article 8 specifically rejects the case law with respect to the effect of knowledge of fiduciary ownership. Part 4 of article 8<sup>79</sup> is a complete codification of the rights and obligations of the issuer of registered form securities with respect to registration of transfer. It states the duty of the issuer to register on presentation in any case where (a) the indorsements are in order; and (b) there is no duty to inquire into adverse claims or any such duty which arose has been discharged.<sup>80</sup>

Conversely the same section clearly states the issuer's liability to the

App. Div. 283, 199 N.Y. Supp. 517 (1st Dep't 1923) and *Thorner v. Webster*, N.Y.L.J. November 8, 1933 p. 1668 (City Court Special Term).

<sup>75</sup> The distinction is carefully preserved in Statute (e.g., N.Y. Penal Law § 956) and case law. In the *Matter of Mills*, 125 App. Div. 730, 110 N.Y. Supp. 314 (1st Dep't 1908).

<sup>76</sup> The Securities and Exchange Commission interprets the 1960 decision of the Second Circuit in *SEC v. Guild Films Co.*, 279 F.2d 485 (2d Cir.) cert. denied, 364 U.S. 819 (1960) as drastically limiting the rights of creditors holding "control stock" as collateral security to liquidate the collateral without prior compliance with the registration requirements of the Securities Act. In such a situation the specific enforceability of the guarantor's obligation to accept and pay for securities "put" to him is of major importance.

<sup>77</sup> Section 8-403(3).

<sup>78</sup> Section 8-304(2). For this purpose the category of "purchaser" includes the seller's broker who ordinarily does not fall within it because when he takes in an agency capacity he acquires no "interest in property." § 1-201(32).

<sup>79</sup> Sections 8-401—8-406.

<sup>80</sup> Section 8-401(1) (a) (b). These are the essential elements. The duty to collect transfer or similar taxes is of course continued, and though not bound to inquire into the rightfulness of the particular transaction an issuer sued for refusal to register a transfer may nonetheless defend against anyone other than a bona fide purchaser on the ground that the transaction was in fact unrightful. §§ 8-401(1) (c) (d).

person presenting the security for registration for unreasonable delay or improper failure or refusal to register.<sup>81</sup>

As under pre-Code law, the issuer remains absolutely liable for registration of transfer on an unauthorized signature.<sup>82</sup> Since that is the case the issuer is entitled to demand "reasonable assurance"<sup>83</sup> "that each necessary indorsement is genuine and effective."<sup>84</sup> Such assurance properly includes (a) a guarantee of signature by a responsible guarantor; (b) where the signature is by an agent, evidence of authority to sign; and (c) where the signature is by a fiduciary "appropriate evidence of appointment or incumbency."<sup>85</sup>

With respect to evidence of authority to sign, article 8 in effect sanctions the standard commercial practice of requiring the production of documents such as powers of attorney or, with respect to a corporate officer, a certified resolution of the board of directors. Such documentation should of course have been obtained in the first instance by the guarantor of signature who will be liable to the issuer if by any chance the security was indorsed without authority or after termination of authority.<sup>86</sup>

Permitting the issuer to require such evidence was perhaps a slight concession to fears of the irresponsibility of local banks and securities dealers as guarantors of signature. Such documentation, however, is usually easily obtained, and even the requirement that it be submitted once to the guarantor and again to the issuer should not be overly burdensome. In the case of the fiduciary the requirement is easily met by the usual "short form certificate" dated within sixty days of presentation, or where the fiduciary is not court-appointed, by a document, certificate or other evidence "reasonably deemed by the issuer to be appropriate."<sup>87</sup>

In a sense the sixty day requirement gives assurance merely "that the grass still grows green," because as to a security registered in fiduciary name the issuer is entitled to assume continuing tenure of office until notified in writing of its termination.<sup>88</sup>

Nothing in article 8 specifically limits the issuer's requirements to the

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<sup>81</sup> Section 8-401(2).

<sup>82</sup> Sections 8-311, 8-404. Also as under pre-Code law, the owner may have ratified or become "otherwise precluded" from asserting the ineffectiveness of the signature, e.g., as by failure to notify the issuer of loss or theft within a reasonable time after discovery of it. § 8-405(1).

<sup>83</sup> Section 8-401(1)(b).

<sup>84</sup> Section 8-402(1).

<sup>85</sup> Section 8-402(1)(a)(b)(c).

<sup>86</sup> The guarantor of signature warrants the authority of the signer "at the time of signing" "to any person taking or dealing with the security in reliance on the guarantee." § 8-312(1) and (3).

<sup>87</sup> Sections 8-402(1)(c), (3)(a)(b).

<sup>88</sup> Section 8-403(3)(a).

items noted, all of which are listed in section 8-402(1)(2) and (3); but section 8-402(4) is a sort of *in terrorem* rule which should have the same effect. It permits the requirement of further "reasonable assurance", but provides that if, for any purpose other than checking appointment or incumbency of a fiduciary, the issuer "requires and obtains a copy of a will, trust, indenture, articles of co-partnership, by-laws, or other controlling instrument, it is charged with notice of all matters contained therein affecting the transfer."

An issuer's duty to inquire into adverse claims arises under article 8 *only* from (1) a sufficient written notification of the claim received in due time;<sup>89</sup> or (2) its own requirements and receipt of what might be termed "excess documentation."<sup>90</sup>

There are specific provisions overruling prior case law and relieving the issuer in any situation other than one of the two just listed from any duty to inquire as to compliance with a controlling instrument or with state law (including any requirement of court order to validate delivery of the security) or as to any court record or other document even though the transfer being registered is on the indorsement of a fiduciary to himself or to his nominee.

Nevertheless, once a duty of inquiry has arisen, that duty must be discharged "by any reasonable means" specifically including a thirty day notice by registered or certified mail to the claimant that a transfer will be registered at the end of the period unless either an appropriate restraining order is obtained or a sufficient indemnity bond furnished.

On the other side of the coin, article 8 states the liability of the issuer for improper, registration limited to a case where (a) transfer was registered on an unauthorized signature; or (b) a duty to inquire into adverse claims arose and was not properly discharged prior to the registration.<sup>91</sup>

Finally section 8-406 provides that the transfer agent, registrar, or similar agent of the issuer, with respect to the functions it performs, stands in the shoes of the issuer as accountable to the holders of the securities, and specifically that notice to the agent is notice to the issuer "with respect to the functions performed by the agent."<sup>92</sup>

As to purchasers it is specifically provided that knowledge of fiduciary ownership

does not create a duty of inquiry into the rightfulness of the transfer nor constitute notice of adverse claims . . . [unless there is] knowledge that

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<sup>89</sup> Section 8-403(1)(a). Such notification is colloquially referred to as a "stop transfer notice." It must identify the claimant, the registered owner of the security and the issue of which it is a part, and provide an address for communications directed to the claimant.

<sup>90</sup> Section 8-403(1)(b).

<sup>91</sup> Section 8-404.

<sup>92</sup> Section 8-406(2).

the proceeds are being used or that the transaction is for the individual benefit of the fiduciary or otherwise in breach of duty. . . .<sup>93</sup>

The use of the word "knowledge" is particularly important in this context under the Code definition of "Notice" contained in section 1-201(25):

- (25) A person has "notice" of a fact when
- (a) he has actual knowledge of it; or
  - (b) he has received a notice or notification of it; or
  - (c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.

The distinction between the case where there is "knowledge" of the ultimate fact and that where by reason of knowledge of evidentiary facts there is "reason to know" the ultimate fact, is basic and important. Thus, the knowledge that the proceeds of the transaction are being paid to a fiduciary individually does not charge the purchaser with notice of potential breach of trust by misuse of those proceeds, but knowledge that the proceeds were being applied in payment of a personal debt<sup>94</sup> would be another matter.

Surprisingly, one of the New York amendments incorporates a return to the classic NIL "good faith" language. Uniform section 8-304 [Notice to Purchaser of Adverse Claims] has two subsections. New York has added an additional subsection as to which the Supplementary Report states: "The first sentence . . . carries forward the present language of the Uniform Negotiable Instruments Law § 56, NYNIL § 95, and the standards which the New York courts have followed in determining the qualification of a holder in due course."<sup>95</sup>

Probably there has been no more prolific source of litigation in the field of negotiable instruments than the boundaries of the "good faith" rule.

The law may be regarded as settled, that a purchaser, for value advanced, of negotiable paper, including bonds, is not bound to exercise such care and caution as wary, prudent men would exercise. Negligence will not impair his title. It is a question simply of good faith in the purchaser. Unless the evidence makes out a case upon which a jury would be authorized to find fraud or bad faith in a purchaser, it is the duty of the court to direct a verdict.<sup>96</sup>

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<sup>93</sup> Section 8-304(2).

<sup>94</sup> Section 8-304(2). Cf. *State Bank v. Bache*, 162 Misc. 128, 293 N.Y. Supp. 667 (Sup. Ct. Broome County 1937).

<sup>95</sup> Supplementary Report, *supra* note 20, at p. 16.

<sup>96</sup> *Welch v. Sage*, 47 N.Y. 143, 146-47 (1872); *Accord, Cheever v. Pittsburgh S. & L. E. R.R.*, 150 N.Y. 59, 4 N.E. 701 (1896). "The requirement of the statute is good faith, and bad faith is not mere carelessness. It is nothing less than guilty knowledge or willful ignorance" *Thacher, J., in Manufacturers & Traders Trust Co. v. Sapowitch*, 296 N.Y. 226, 229, 72 N.E.2d, 166, 168 (1947).

On the other hand it has been held that "gross carelessness" will impair holder in due course status,<sup>97</sup> and the courts, construing similar "good faith" language of sections 3 and 4 of the Uniform Fiduciary Act, substantially ignored their exonerative provisions.<sup>98</sup> It is probably fair to state that it has not been possible for some years in New York for a bank, brokerage house or other relatively sophisticated purchaser successfully to defend its holder in due course status merely on the ground that, unfortunately for the claimant, the clerk who accepted the instrument ignoring facts at hand acted "with pure heart, though empty head." In effect our courts under the "good faith" language of the NIL have simply created a standard of "good faith" applicable to such purchasers higher than that applicable to a housewife or a farmer, or perhaps even an ordinary businessman.<sup>99</sup>

Against this background, the Code's intentional abandonment of the "good faith" language was clearly sound. Nor would its reinstatement help the banking institutions with their more serious problem—that of when and how notice to the institution as such shall become effective. In this area the law has never been particularly clear. The Code attempts a solution in section 1-201(27):

(27) Notice, knowledge or a notice or notification received by an organization is effective for a particular transaction from the time when it is brought to the attention of the individual conducting that transaction, and in any event from the time when it would have been brought to his attention if the organization had exercised due diligence.<sup>100</sup>

<sup>97</sup> *Canajoharie Nat'l Bank v. Diefendorf*, 123 N.Y. 191, 25 N.E. 402 (1890).

<sup>98</sup> See the cases cited note 17 *supra*.

<sup>99</sup> See, e.g., *United States Fid. & Guar. Co. v. Goetz*, 285 N.Y. 74, 78, 32 N.E.2d 798 (1941) citing failure of the defendant brokerage house

to use the standard of care prescribed by the rules of the stock exchange for brokers dealing with a new account . . . [and] . . . their failure to observe that some of the serial numbers forged upon the bonds were unusually high for such issues . . . [as] some evidence of the standard of care that should be maintained by persons dealing in securities belonging to others

and raising a question for decision by jury. Cf. *Kittridge v. Grannis*, 244 N.Y. 168, 155 N.E. 88 (1926), *Morris v. Muir*, 111 Misc. 739, 181 N.Y. Supp. 913 (N.Y.C. Munic. Ct. 1920), and the opinion of Judge Foster in *First Nat'l Bank v. Fazzari*, 10 N.Y.2d 394, 400, 179 N.E.2d 493, 496-97, 223 N.Y.S.2d 483, 488 (1961); 47 *Cornell L.Q.* 670 (1962):

A lapse of memory is too easily pleaded and too difficult to controvert to permit the doctrine [of 'forgotten notice'] to be applied automatically irrespective of the circumstances surrounding each transaction and the relationship of the parties. . . . The defendant was practically assured that his notice would be honored and the note would not be discounted by the plaintiff bank. Under such circumstances the bank should be precluded from invoking the doctrine of 'forgotten notice.'

<sup>100</sup> One of the few reported cases on the point, *Wiese v. Corn Exch. Bank Trust Co.*, 240 App. Div. 198, 269 N.Y. Supp., 740 (1st Dep't 1934) seems consistent with this provision. It refuses to charge the defendant bank with notice of the fact that bonds accepted as collateral for a loan were stolen though other branches of the bank (not the main office) had received a circular offering a reward for the bonds.

The "forgotten notice" cases sometimes also involve failure of communication within an organization. The leading case of course is *Graham v. White-Phillips Co.*, 296 U.S. 27 (1935), generally cited for the proposition that the mere fact that notice received by an organization was "forgotten" does not impugn "good faith" or the organization's status as

The second sentence of section 8-304(3) as enacted in New York attempts to interpret this by providing that:

If the purchaser is an organization and maintains within the organization reasonable routines for communicating significant information to the appropriate part of the organization apparently concerned, the individual conducting the transaction on behalf of the purchaser must have the knowledge.<sup>101</sup>

This seems to the writer a wholly unjustified protection of parochial interest. What useful purpose does it serve to require that routines be maintained unless failure to follow them clearly brings on the penalty of liability? The writer does not believe the consequence is clear by any means, the argument of the New York Commissioners<sup>102</sup> to the contrary notwithstanding. On the other hand he does concur that Uniform section 1-201(27) may be inadequate to the problem. The Permanent Editorial Board worked out a clear solution. It rejected New York sections 3-304(7) and 8-304(3) but expanded section 1-201(27) by adding:

An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and others acting for the organization reasonably comply with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.

Briefly, to summarize with respect to the "constructive notice" problem under article 8, the most important point is the distinctly different treatment accorded the issuer and the purchaser of a security. The "exoneration" of the issuer from any duty of inquiry with respect to adverse claims is broadly stated and the exceptions to it are specific. Thus, the policy sought to be implemented is that registration of transfer shall no longer be impeded by the delay involved in reaching abstruse determinations as to whether or not the particular facts at hand raise a necessity for further inquiry.<sup>103</sup>

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a holder in due course. Cf. *First Nat'l Bank v. Fazzari*, supra note 99, where the court refused to give the bank the benefit of the rules because the cashier who had "forgotten" the notice had originally told the claimant "not to worry."

The Code does not affect the incidence of the "forgotten notice" rule. Indeed, § 201(25) specifically states that "the time and circumstances under which a notice or notification may cease to be effective are not determined by this Act." On the other hand under § 4-403(2) a stop payment order directed to a bank lapses unless renewed every six months. The analogy may be useful.

<sup>101</sup> New York made a similar change in respect to commercial paper in § 3-304 adding subsection (7). See Supplementary Report, supra note 20, at pp. 6-7.

<sup>102</sup> Supplementary Report, supra note 20, at 16.

<sup>103</sup> Sections 8-403, 8-404. Of course it is possible to imagine a case where the issuer would

The position of the purchaser on the other hand is considerably different. Section 8-304 states certain specific circumstances<sup>104</sup> which are sufficient as a matter of law to charge the purchaser with notice of adverse claims, and certain classic situations which under the case law were held to be sufficient for that purpose, as to which the case law is overruled.<sup>105</sup> But there is no statement that there are no other circumstances under which the court or jury may properly find "notice" either in the sense of "knowledge" or "reason to know," and the writer would expect the trend of the cases<sup>106</sup> imposing somewhat more stringent standards upon sophisticated purchasers such as banks or brokerage houses than upon laymen to continue.

As to the New York amendments, the foregoing text includes comment on all of these except one relatively unimportant one.<sup>107</sup> In general the writer thinks that some of these amendments would be useful additions in substance if not in form to the Uniform text. Others, however, would simply add redundancy and at least two of the amendments seem designed to further the parochial interests of their proponents rather than the public interest, and therefore should be completely rejected. In general, the action of the Permanent Editorial Board on the amendments seems to confirm these views. Hopefully that action will have substantial influence with the New York Commissioners and at the 1963 session of our Legislature.

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have so much "actual knowledge" that any "inquiry" would be irrelevant, e.g., collusion between an absconding trustee and the officer of the issuer or its transfer agent responsible for registration of transfer of its securities. Conceivably, under such circumstances registration might breach the issuer's basic obligation of good faith ["Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." § 1-203.] and thus import liability. However the case is commercially a highly unlikely one.

<sup>104</sup> Indorsement "for collection" or the like or the writing on a bearer form security of "an unambiguous statement that it is the property of a person other than the transferor." § 8-304(1)(a)(b).

<sup>105</sup> Generally, the fiduciary ownership situation, short of knowledge that the proceeds of the transaction are being misapplied. § 8-304(2).

<sup>106</sup> See cases cited *supra* note 99.

<sup>107</sup> A change in § 8-202(5) with respect to the cancellation of "when issued" contracts.