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INVESTMENT SECURITIES

By

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Of the seven or eight cases reviewed by the Subcommittee, two are noteworthy.

Notice to Purchaser of Incomplete Stock Certificate

An important Article 8 case decided in late 1968 is *Dempsey-Tegeler & Co. v. Otis Oil & Gas Corp.*, 293 F. Supp. 1383 (D. Colo. 1968) in which plaintiff, a purchaser of 300,000 shares brought a diversity action in federal court to recover damages for the issuer's refusal to register transfer of the shares. The court denied all parties' motions for summary judgment and ordered trial. Plaintiff was thereafter successful on the merits, but the court's ultimate findings of fact and conclusions of law are evidently not reported. *Dempsey-Tegeler & Co. v. Otis Oil & Gas Corp.*, Civ. Act. No. C-709 (D. Colo. Jan. 17, 1969).

Tilton, the original owner of the shares and a defendant, directed plaintiff, a broker-dealer, to sell the shares and delivered the certificates to plaintiff. The latter arranged to sell the shares to a third party, and as the shares were sold, plaintiff remitted proceeds from time to time to Tilton, the owner. In accord with common market practice, plaintiff, prior to delivering the certificates to the third party, requested the issuer to register transfer of the shares into plaintiff's name. The issuer, however, refused, contending that (1) the shares had never been validly issued, and (2) in any event that plaintiff was not a purchaser for value and without notice of a defect to be described later. Plaintiff claimed damages because it could perform its delivery obligations to the third party only by purchasing shares on the open market at a price in excess of the contract price.

The affidavits supporting the summary judgment motions revealed that the stock certificates had been "wrongfully removed" from the issuer's stock book by the corporate secretary who had negotiated them without authority, with the result that they eventually came into Tilton's possession. The affidavits also showed that the stock certificates had facsimile rather than manual signatures, but carried no manual countersignatures, nor any statement that absence of manual countersignatures would invalidate the certificates. However, the Colorado

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corporation statute, which applied to the issuer, provides that the required signatures on a stock certificate may be facsimiles "if the certificate is countersigned by a transfer agent, or registered by a registrar, other than the corporation itself or an employee of the corporation."¹ The court tacitly assumed that manually affixed countersignatures are necessary to validate a certificate with facsimile signatures, since the statute provides that shares "shall be represented" by certificates signed by named officers, and then authorizes facsimile signatures if there are appropriate countersignatures.

The ultimate question was whether the issuer must register transfer of these shares. Under The Uniform Commercial Code, assuming compliance with certain formal requirements which were concededly met in this case, the issuer must register transfer of shares when presented by a "bona fide purchaser."² The operative issue was whether the purchaser of the shares was indeed a "bona fide purchaser." This turned upon section 8-202(2)(a)'s provision that a security with a "defect going to its validity," is nonetheless valid in the hands of a "purchaser for value and without notice of the particular defect." Since the stock certificate lacked the required countersignatures, the issuer claimed that the purchaser had notice of the defect, while the purchaser claimed that it knew nothing about the irregularity. The court held, as indeed the parties conceded, that neither the plaintiff nor Tilton had actual notice of the defect. In its published opinion the court analyzed the general definition of "notice" in section 1-201(25) and found that (1) the purchaser lacked "actual knowledge" of the defect, (2) it had not received "notification" of the defect, and (3) there were no "facts or circumstances" which would give the purchaser "reason to know" of the defect. In its unreported final judgment the court found as a fact that neither plaintiff nor Tilton had actual knowledge of any defect in the certificates nor of any facts or circumstances which would put them on notice of the unauthorized issue of the certificates or deficiency resulting from the lack of a manual countersignature (Finding No. 11). Moreover, neither had actual notice of the Colorado statute requiring such a countersignature (Finding No. 12).

Rather than grant summary judgment for the purchaser, the court called for trial because of a "residual troublesome question" whether notice of the irregularity in the certificates would be imputed to the purchaser because the Colorado statute requires that facsimile stock certificates carry manual countersignatures. "This is, after all, a matter of law as to which there is a presumption of knowledge."³

This cryptic statement, not elaborated in the opinion, raises many and settles few issues. It is obviously a holding that imputed knowledge of a legal requirement relating to the validity of a security may be

1. Colo. Rev. Stat. §31-4-8.

2. See §8-401(1)(e).

3. 293 F. Supp. at 1387.

equivalent to "notice" which precludes the protected status of a purchaser for value without notice, and thus will, in appropriate circumstances (not further defined), excuse the issuer from a duty to register transfer of securities into the name of the purchaser to whom the knowledge is imputed.

The implications of this proposition are disturbing. Logically, it could destroy the independent effectiveness of section 8-202(2)(a) which validates a security with a "defect going to its validity" if held by a purchaser for value without notice of the defect. Section 8-202(2)(a) obviously is intended to cover defects due to some non-conformity with a statutory requirement. If a purchaser for value ipso facto has "notice" of a defect because he is presumed to know the legal requirement giving rise to the defect, it would follow that no security with such a defect could be validated under section 8-202(2)(a). The court's proposition that one is charged with knowledge of a "matter of law" could imply that one always and necessarily has "notice" of a defect which takes the form of noncompliance with a statutory requirement. This violates the purpose of section 8-202(2)(a) which is intended to validate securities with various defects, and if sustained, it would gut section 8-202(2)(a) of that essential function. In order to give full effect to this provision, the courts should hold that the "presumption of knowledge" of matters of law is not the kind of "notice" which will preclude a holder from asserting the protection of section 8-202(2)(a). Instead, the proper inquiry should be whether the purchaser had "notice" in the sense of section 1-201(25), and that looks to actual knowledge, notification, or reason to know implied from facts and circumstances. Indeed, it was one of the purposes of the Code to get away from the uncertainties of pre-Code law which had so liberally recognized constructive notice of facts.

Although the court wrote no opinion on final judgment, there was a "finding" that the Colorado statute requiring manual countersignatures did not of itself give notice of the claimed defect in the certificates, since in the court's view, "the type of notice contemplated by" section 8-202(2)(a) "must be such as to be equivalent to actual notice" (Finding No. 13). Previously, the court had also "found" that lack of the statutorily required countersignature "does not constitute a deficiency which creates an absolute defense on the certificates and does not render the certificates void or bring a halt to their negotiability" (Finding No. 9).

Apparently the question of actual notice to the plaintiff was not urged. But the certificates delivered to the plaintiff, a firm presumably versed in securities handling, were anomalous on their face and should themselves have given rise to inquiry. The requirement of Colorado law that a certificate bearing facsimile signatures of corporate officers must be manually signed by a transfer agent or transfer clerk, and/or registrar, is by no means unusual. Putting it another way, there is no

State in the Union which permits the use of facsimile signatures of officers on stock certificates without at least one manual verifying countersignature. Thus it may be safely generalized that if the plaintiff, a reputable dealer in securities, and a member firm of the New York Stock Exchange, had handled a total of 10,000 stock certificates in its offices on the day it took in the Otis Oil & Gas Company certificates, these latter would have been the only certificates it handled which bore no manual signature. A diligent and experienced securities clerk should have challenged these certificates as out of line with basic requirements. Indeed, a meticulous layman might well have questioned the certificates as being the only ones having no manual signature anywhere he had ever seen in a lifetime of investing. It is submitted that the plaintiff as a professional serving the public in securities transactions should have been considered as in possession of facts giving reason to know that the certificate was defective, and thus was "on notice."

Of course, the question of notice to the plaintiff, actual or constructive, becomes moot in the face of the Court's conclusion that the seller, Tilton, was not on notice of any defect and that as a purchaser for value from Tilton the plaintiff had acquired all of Tilton's rights under the "umbrella" provision of section 8-301.

It was also contended that non-compliance with the statutory signature requirements made the securities non-genuine, so that the issuer would have an absolute defense against even a purchaser for value and without notice.⁴ The court, however, correctly rejected this argument. The certificates were clearly genuine, since they came from the issuer's stockbook, they carried facsimile signatures of the required officers, and there were no forged or counterfeit signatures. Issuance of even irregular certificates without authority does not mean that the certificates lack genuineness which, under the Code, means absence of forgery or counterfeiting.⁵

Irrespective of the technicalities of the Code, there are inescapable faults in the position of the corporation. It undertook the preparation of stock certificates bearing facsimile signatures, without customary language as to countersignature. To compound the difficulty, it failed to establish proper custodial and accounting control of the certificates, leaving them to be handed out at will by the Secretary. Estoppel doctrine, permitted by section 1-103, could well be invoked against the corporation, who bears the responsibility for allowing the certificates to be placed in circulation as commercial instruments. As between the corporation and Tilton, it having been established that the corporation was substantially connected with the certificates, Tilton should clearly prevail, having had no notice of the defect. As between the corporation and the plaintiff, it would seem that the plaintiff should likewise prevail. In balancing the equities between the person who negligently permitted

4. See section 8-303(3).

5. See section 1-201(18).

the certificates to be launched in commercial channels, and the person who negligently relied on the certificates, the assessment of blame should fall on the one who initiated the problem and was in the best position to control it.

Levy on Shares Without Surrender of Certificate

In *Progressive Forwarding Inc. v. Cander Realty Corp.*, N.Y. Law Journal May 6, 1969, p. 2, 6 UCC Rep. 390 (N.Y. Sup. Ct.), a judgment creditor was granted an order directing Cander Realty Corp. to cancel an unsurrendered certificate of its stock registered in the name of the judgment debtor and directing Cander to issue a new certificate and deliver it to the sheriff for sale at public auction.

The court found that the certificate bore a legend to the effect that sale or other transfer of the shares represented thereby was subject to the terms and conditions of an agreement of July 25, 1944, between the corporation and its stockholders. By virtue of this legend, and apparently without regard to what the terms of the agreement of July 25, 1944 might be, the court held inapplicable section 8-317 requiring seizure of the outstanding certificate, the location of the certificate being unknown and the principal defendant being outside the jurisdiction. The court said:

“However, where such a restrictive covenant as above set forth appears on the face of the document, the corporation is the proper garnishee as a *bona fide purchaser of the outstanding certificate* and would be thereby protected.” (emphasis supplied)

It is difficult to see how the issuer corporation can be denominated a “purchaser” of anything—least of all the outstanding certificate. The court cited a previous New York Supreme Court case, *Neidorf v. Neidorf*, 43 Misc. 2d 710, 252 N.Y.S. 2d 354 (1964), decided prior to the Code but under a similar statutory requirement for seizure of the certificate. But in that case the court had analyzed the agreement referred to in the legended certificate and found that the covenants therein made it impossible to transfer the shares without offering them first to the corporation and other stockholders. It was held that the purpose of the statute had been satisfied in that the transfer of the certificate had been effectively prevented. This proposition might be challenged; moreover it is not clear that in this action, which was one for sequestration of the stock in a matrimonial proceeding, there was to be any order for issuance of a replacement certificate as in *Cander*.

It is submitted that the decision in *Cander* is clearly wrong. The restriction on the debtor's right to transfer may have been minimal; minimal or not, a third party could have purchased the shares on the faith of the outstanding certificate taking them subject to whatever impediments or encumbrances might have existed under the agreement of July 25, 1944.

Indeed, the order making the new certificate (presumably subject to

the same restriction) available for sale on execution would necessarily contemplate that someone would be willing to purchase the shares subject to the restriction.

Section 8-105 provides "Securities governed by this Article are negotiable instruments." It would seem that the contract noticed in the legend would be nothing more than an "adverse claim" (section 8-301). A purchaser of the original certificate would not be a bona fide purchaser (section 8-302) but the judgment debtor as the person specified in the certificate as owner would have power to indorse (section 8-308) and upon delivery of the original certificate the purchaser would acquire his rights, whatever they might be (section 8-301). Also see section 8-202(4):

"All other defenses of the issuer including nondelivery and conditional delivery of the security are ineffective against a purchaser for value who has taken without notice of the particular defense."⁶

It is difficult to see how in *Cander* a new certificate could be issued without constituting an overissue. The same result would ensue in *Neidorf* if the Code were applicable thereto.

6. The rule under Article 8 is different from that under Article 3 (Commercial Paper). As to the latter, one cannot be a "holder in due course" unless he is without notice of *any* defense (section 3-302); having notice of a defense he is not a holder in due course and is subject to *all* defenses (section 3-306).