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Investment Securities

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INVESTMENT SECURITIES

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The number of decisions applying Article 8 continues to accelerate. Comment will be made only on those decisions representing significant developments in areas of general interest.

Statute of Frauds

Section 8-319 continues in the forefront so far as production of litigation is concerned.

Stott v. *Greengos,* 95 N.J. Super 96, 230 A. 2d 154 (1967), involved the contention of the plaintiff, a broker, that he had accepted and executed a telephoned order for purchase of 100 shares of a listed stock. A few days after the purchase the value dropped substantially. The defendant, his customer, testified that the price at which the order was executed was in excess of the limit specified by him; that in placing the order he had also instructed sale if the stock went up or down 4 or 5 points; and that as soon as possible after receipt of a written confirmation he had by telephone repudiated the transaction. At that point the broker had disposed of the stock at a loss of over $5,000. The trial court, in holding the defendant liable for the loss, refused to consider section 8-319 as a defense and was upheld by the Appellate Division.

This holding is consistent with the law as it existed prior to the enactment of the Code. In MEYER, THE LAW OF STOCKBROKERS AND STOCK EXCHANGES 242 (1931), the author says, "A broker . . . does not sell to or buy from his customer, but acts as agent of the customer in effecting contracts of purchase or sale with third parties. His agreement with his customer is one of agency and not of sale." The court concluded, and it seems correctly, that the foregoing rule was not changed by section 8-319. This section purports to deal only with "a contract for sale of securities" and not with agency relationships.[1]

However, the issue is beclouded by various considerations, i.e.:

(1) If a customer telephones his "broker" (as the term is broadly defined in section 8-303) a market order to buy 100 shares of Stock A (listed on the New York Stock Exchange) and at the same time an order for 100 shares of Stock B (unlisted, but the broker is a market maker in Stock B) at 72, then the first transaction is governed by the oral expressions of the parties and the second must rest on a written

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1. Israels and Guttman, Modern Securities Transfers, App. 70-71 (1967).

contract or confirmation or other statute of frauds procedure. One may question whether this result represents what the law ought to be, under a Code designed to promote uniformity and simplicity in commercial transactions. Perhaps it can be argued that there is a greater incentive to work a fraud against the purchaser on the part of a broker (principal) because a substantial profit may be involved and therefore a writing should be required to support the sale contract; the temptation to overreach is much less where only a relatively small commission as agent is the incentive. The broker (agent) is also held to high standards of conduct as an exchange member. In looking at the over-all problem it also must be recognized that while transactions in securities by buyers and sellers outside regular market channels are relatively few in number, there is some merit in requiring their contracts to be formalized.

(2) Considering that section 8-319 applies only between buyer and seller, then the Comment to the section could be clarified. There is specific reference in the Comment to the double-barreled definition of "broker" in section 8-303 as one "who in the transaction concerned acts for, or buys a security from or sells a security to a customer." Also an exchange transaction is used as an example, although such a transaction would necessarily involve an agency between customer and broker. A cursory reading of section 8-319 in conjunction with the Comments, without reference to other sources, would lead one to think that the section had been designed to cover the broad field of broker-customer relationships encompassed by the definition above cited.

(3) The overwhelming preponderance of our securities transactions —millions of them—have been effected by word of mouth. Our markets cannot, at least in the present state of communications techniques, operate in any other manner. There are bound to be mistakes—some in good faith and some not.[2] There would seem to be no way of solving the problem of brokers' business risk by legislation. It has been strongly urged by Professor Guttman[3] that the statute of frauds as applied to securities should be abolished as an anachronism for which there is no rationale in modern times.

Issuer's Responsibility—Validity of Bonds

First Am. Nat'l Bank v. *Christian Foundation Life Ins. Co.,* 242 Ark. 177, 420 S.W. 2d 912 (1967), is an interesting case and seemingly the first one applying sections 8-202 and 8-205. In January, 1964, a church in Mena authorized by resolution a $90,000 bond issue to construct a new church and employed Institutional Finance Company as its fiscal agent to market the bonds. On the same day the church treasurer signed a blank sheet of paper to provide a facsimile signature

2. See Buy Now, Pay Never: More Cases Crop up at Brokerage Houses, Wall St. J., Sept. 15, 1966, p. 1, col. 4, p. 22, col. 1-2.

3. Guttman, Article 8—Investment Securities, 17 Rutgers L. Rev. 136, 144-45 (1962).

for the bonds and, in the presence of other church officials, delivered it to an officer of Institutional Finance who was to arrange for the printing (Springfield, its executive vice president). The issue was secured by a lien on the church property, and an officer of Institutional Finance (Springfield) held title to the property in trust to secure payment of the bonds. Bearer bonds in the amount of $94,000, numbered from 1 to 188, were initially printed under the authorization. (The record contained no explanation for the $4,000 excess.)[4] Institutional Finance sold $45,000 of these bonds to church members but encountered trouble finding buyers for the rest of the issue. In July, 1964, another officer of Institutional Finance (Hayes, its president) personally borrowed $25,000 from First American National Bank and pledged as collateral for this loan, among other securities, $28,800 of the church bonds. In early February, 1965, Hayes fraudulently ordered the printer to print $25,000 of numbered bonds that included duplicates[5] of some of those pledged to First American. In later February, 1965, Hayes, in order to complete a sale to Christian Foundation Life Insurance Company, had additional bonds printed in larger denominations requested by that insurance company. The bonds acquired by Christian Foundation and one Richards were among those obtained by Hayes in the two supplemental printings. The dishonesty of Hayes came to light when duplicate interest coupons were presented to the bank acting as paying agent, which refused to honor them until their validity had been established. Christian Foundation brought suit for a declaratory judgment concerning the validity of the bonds and the rights of the holders. Parties defendant to the suit were rival owners of duplicate bonds, the church and its trustees, the bank acting as paying agent, the estate of Hayes, the receiver for Institutional Finance, and the corporate surety on the latter's qualifying bonds as a securities dealer.

For convenience of reference, the bondholders may be divided into three groups: (1) the church members who bought $45,000; (2) First American, which made a loan of $25,000 with $28,800 of the bonds included among collateral therefor; and (3) Christian Foundation and Richards, whose bonds came from the two supplemental and fraudulent printings.

Three different views were expressed.

The lower court held, without explanation, that the bonds of group

4. The majority, by noting this fact parenthetically, apparently attached the element of mystery to it, and the dissent apparently attached the element of impropriety to it. To the contrary, an excess printing or overrun is a normal and prudent procedure. Bonds may become lost, and replacement may be requested on furnishing indemnity. Bonds of one denomination may be exchangeable for others of a different denomination. It could be prohibitively expensive to the issuer to run to the printer each time such an occasion might arise.

5. One must assume that the court is using the term "duplicate" as meaning that certain of the bonds bore the same identifying numbers. For the purpose of determining the rights of bona fide purchasers, the question of re-use of the same number would seem to have no significance.

(2) were void, but that those of groups (1) and (3) were valid.

The Supreme Court of Arkansas was unanimous in its view that the judgment should be reversed, but the unanimity ended at this point.

The majority held that all bonds held by bona fide purchasers were binding obligations of the church. The court cited section 8-202 for the proposition that the Code validated all the securities without preference of one over the other. The court found the church "careless in entrusting its treasurer's facsimile signature to Institutional Finance and in failing to take the precaution of requiring authentication of the bonds by a manual signature." The court rejected an argument of the church and its trustees that First American, the group (2) holder, acquired its bonds in violation of an Arkansas constitutional provision that "no private corporation shall issue stocks or bonds except for money or property actually received or labor done." The court held that even if the church were a private corporation (a question not necessary to decide), its agent actually received money for the bonds; and it was not the purchaser's fault that the money did not reach the church treasury.

It further found that the holders of the bonds acquired them in the ordinary course of business and under circumstances entitling them to the protection afforded to bona fide purchasers. In this connection it rejected arguments of the group (2) holder that other purchasers were not in good faith because they had bought the bonds at discounts of 10% and 15%, holding that there was no proof that the discounts "were so great as to arouse suspicion." It also rejected the argument of the group (2) holder that purchasers of the duplicate bonds should have been put under inquiry by the church's inability to market the entire issue within the period of about a year. The court also held that there was no sound basis (on facts appearing in the opinion) for questioning the group (2) holder's standing as a good faith purchaser for value.

The court also held that the case fell within section 8-205, which makes an unauthorized signature effective in favor of a purchaser for value without notice of the lack of authority if the signing has been done by a person entrusted by the issuer with the signing of the security:

> . . . By resolution the church employed Institutional Finance as its fiscal agent to handle the sale of the bonds. The first line of the printed prospectus for the bond issue identified that concern as the issuer's fiscal agent. There can hardly be any serious contention that Hayes's wrongful use of the treasurer's facsimile signature did not fall within the purview of the Code.

It would seem more accurate to say that the signature was that of the treasurer (and hence that of the church), whether she caused too many bonds to be signed by irresponsible motions of her pen or by irresponsible operation of a printing press. An unauthorized signature (section

1-201 (43)) is "one made without actual, implied or apparent authority." We must assume that the resolution conferred signing authority upon the treasurer for $90,000 of bonds. This would necessarily provide apparent authority for all her signatures. In this view the case does not properly fall under section 8-205.

A dissenting judge offered a still different (and an erroneous) view: the bonds held by group (3) at some point in the press run became "forgeries" and void as against the church.

Although the majority adopted a "no-preference" approach insofar as the bonds of the church were concerned, it concluded: ". . . It does not follow, however, that all bondholders stand in parity if it becomes necessary for them to foreclose the lien against the church property." It held that group (2) had a priority in time, and therefore a priority of lien, as against the holders of "duplicate bonds" under the "equitable maxim that as between equal equities the first in time must prevail." Cited for this proposition is an Arkansas case involving a controversy between a vendor's lien claimant and a subsequent mortgagee.

The court remanded the cause for a determination of the exact remedies of the bondholders and the development of remedies of the bondholders against Institutional Finance and its surety.

The conclusion of the court on the priority of the lien is in contradiction to the concept of "validity" embodied in section 8-202 and applied in the earlier portion of the court's opinion. Section 8-202(2)(a) provides, "A security . . . even though issued with a defect going to its validity is valid in the hands of a purchaser for value and without notice of the particular defect. . . ." The courts have repeatedly defined "valid" as meaning "incapable of being rightfully overthrown or set aside" or "efficacious in law."[6] While the opinion does not set out the text of the bonds, if we assume that all were of the same tenor and contained customary recitals that they were secured by a first lien on the church property, all such bonds in the hands of bona fide purchasers should be "valid" under the Code in the full sense of the word as against the issuer and as between the bondholders, and entitled to share in the lien.

Apart from these considerations, the problem of tracing time priorities between bonds could be a most difficult one in the case of a large issue. Fortunately in such case there would almost surely be a provision for a manual signature by a trustee or registrar to forestall an excess issue.

Definition of "Security"

In *Previti* v. *Rubenstein,* 3 U.C.C. Rep. 882 (N.Y. Sup. Ct. 1966), it was held that a certificate of stock in a closed corporation having only two stockholders was a "security" as defined in section 8-102, such

6. See 44 Words and Phrases 3-5 (1962).