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The Uniform Commercial Code and the Certificateless Society

Thomas H. Jolls
William & Mary Law School

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By

THOMAS H. JOLLS*

Williamsburg, Virginia

As an advocate of the notion that the use of stock certificates should be eliminated altogether on all actively traded issues, I would like to be able to say that changes in the Uniform Commercial Code to make this possible would be very simple; however, this is by no means the case. While there seem to be no basic conceptual difficulties, the drafting task will not be completed overnight.

Keeping a set of books representing ownership of property interests is not exactly a novel activity. What is really questionable in the context of 1970 is the maintenance of the present stock certificate system where the issued certificates have an independent legal significance, in addition to the maintenance of the present bookkeeping system with independent legal significance of its own. Time is not available in brokerage houses, banks, exchanges and elsewhere to give service to both systems, nor to provide effective reconcilement between the two.

Reference will be made herein to the "Traditional System;" the no-certificate proposal will be called the "Bookkeeping System."

How it works

The Bookkeeping System will function similarly to the relationship between a depositor and his bank. When X first becomes a shareholder in corporation Y, he receives from Y's transfer agent an advice (like a deposit slip) showing the number of shares owned.[1] The advice is *not* a certificate—it cannot be sold or transferred but is (again like the deposit slip) simply informational. If the shareholder wishes to dispose of his shares he signs a transfer order (like a check) and delivers it to his broker just as he would have delivered an indorsed certificate under the Traditional System. The shareholder's account will be kept by the transfer agent on a computer (just as at present for most accounts and most shareholder records as well). Banks, brokers, stock clearing corporations and others having volume transactions will not use transfer orders but will have "on line" computer relationships with the transfer agent to provide speedy and economical handling of their accounts.[2]

Code Changes for a Bookkeeping System—Article 9

As Mr. Mulhern and Professor Steadman have pointed out, the

* Member of the Illinois Bar; Professor of Law, Marshall-Wythe School of Law, the College of William and Mary.

1. For proposed form of advice *see* Jolls, *Can We Do Without Stock Certificates,* 23 THE BUSINESS LAWYER 909 (1968).

2. For complete system details *see The Lybrand Study.*

lender under the Traditional System has protection by his possession of a stock certificate deposited by the borrower as collateral; under Article 9 the interest of a shareholder evidenced only by a Bookkeeping System would probably be a General Intangible and one making a loan thereon would be protected only by filing in the public records (Section 9-302). Compliance with such requirements in the case of hundreds of thousands of loans on share collateral would be completely impracticable, particularly when it is considered that search of the public records would be necessary before any proposed loan could be made. However it would take only a brief amendment to Article 9 to state that a security interest in a "Share Interest" (this term to be defined) may be perfected by transferring the interest into the name of the lender. This would eliminate the need for recording. Alternatively, Article 9 could confer perfection by providing for filing of a joint notice from debtor and creditor with the transfer agent, plus acknowledgment by the latter. It should be borne in mind that brokers' loans and other large lending transactions will be expedited and simplified by the receipt of wires from transfer agents "We credit your account 50,000 shares X Corp" rather than counting certificates in and out. This would place the handling of large securities transactions on the same plane as large cash transactions which make use of a wire rather than the delivery of a bale of currency.

Code Changes for a Bookkeeping System—Article 8

Now we have to look at some real changes. Article 8 simply will not fit—it deals with "securities" which are "instruments" and the word "security" appears in 40 of its 41 sections. It is suggested that there be set up a separate "Article 8A—Share Interests," which will establish a necessary segregation from "Article 8—Investment Securities" but at the same time maintain proximity for 8A as a cognate subject.

Obviously Article 8 needs to retain its own integrity for three reasons: (1) many corporations, particularly those with few shareholders, will prefer to use certificates and will not find a costly computerized system worthwhile; (2) there will be years of transition during which unsurrendered certificates for shares of major corporations will remain valid and outstanding; (3) we need Article 8 for debt securities, as to which 8A would seem inappropriate. Under (2) certificates will be eliminated gradually under a by-law provision, authorized by the state of incorporation, that upon any surrender of a certificate for transfer or exchange the new interest created need not be certificated.

Contrast the check procedure for transfer of funds, with the procedure for transfer of shares: the former a simple pay or return for cause; the latter, because of a wrong decision in 1848,[3] a matter of inquiry, notice, supporting papers and correspondence. We went part

3. What is here denominated a wrong decision is the case of Lowry v. Commercial Farmers' Bank, Fed. Cas. No. 8581 at p. 1047 (1848) wherein Justice Taney undertook to say that a corporation transferring shares from a trustee

way in the Simplification Acts and the Code to minimize the transfer agent's responsibilities; the time now seems at hand to go the whole way by incorporating into Article 8A something like the clear-cut language of the Uniform Fiduciaries Act dealing with checks, without describing every paper that might conceivably be presented to the agent.

Article 8-A might consist of only 12 or 15 sections. We would not have two confrontations to deal with. Today we have the confrontation at delivery and payment where the certificate holder deals with the purchaser, followed by another confrontation when the purchaser gets to the transfer agent who may, notwithstanding the purchaser's having bought the certificate, find a valid reason for refusing it. About 20 sections of Article 8 exist only to serve this dichotomy. Here in Article 8-A the issue will be tried just as it is on a check, when it is presented to the drawee (transfer agent). It will be either honored or dishonored and there will be a midnight deadline. Bear in mind that this document is *not* negotiable—there is no chain of collection process to make negotiability necessary. It is a peremptory order by A on transfer agent B to transfer to C.

As a beginning, the following provisions are suggested:

1. A definition of a "Share Interest;" a definition of a transfer order and its legal effect, just as Article 3 defines a check.

2. Provision for a signature guarantee and its legal effect, as in Article 8. The shareholder's bank and broker will be in the "know your customer" relationship with him; the transfer agent will not.

3. A provision for finality of the transfer agent's action in honoring the order—perhaps stating that when someone has changed his position in reliance on the action, it will not be subject to recall.

4. Provision for certification (acceptance) of the order by the transfer agent for the purpose of a closing, for example; such certification to expire in 30 days.

5. Provision for "stop transfer" by the record shareholder analagous to "stop payment." No provision for adverse claim notices—there is no such restriction as to cash subject to withdrawal by check—why should there be as to shares which are simply another form of property?

6. There could of course be no Section 8-317 requiring seizure of a certificate in order to validate a levy. As the corporate bar is well aware, Delaware refused to adopt this provision, and attachment there must be directed at the interest on the corporate books. The many large companies incorporated in Delaware have apparently learned to live with this Delaware rule, which would have to be embodied in Section 8-A.

7. Exculpation of the transfer agent.

8. Warranties of the signer of the order; presentment and time limit therefor.

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becomes itself a trustee to protect beneficiaries from a wrongful act by the transferor. This doctrine has no counterpart in English law and has been repudiated by the Simplification Acts and the Code.

Nothing has been said about registrars, or about issuers keeping their own books. These requirements are not dealt with in the Code and do not belong there. Traditionally, a registrar functions only as a control over *certificates*—it has nothing to do with the state of the transfer agents record-keeping. Perhaps computer experts could establish some kind of tamper-proof linkage between the transfer agent and a registrar which would tell the latter on a daily basis the amount of shares outstanding which the registrar could then verify to be authorized.

The foregoing list is by no means definitive, and is suggested only to indicate that while a new structure is required it need not be a massive one. Doubtless there are some ideas to be added from Article 3; however the omission of the concept of negotiability should make most of Article 3 irrelevant.

General

I have heard it stated firmly that it would take 8 years to effect the Code changes required for a certificateless society, but I choose not to believe this. Indeed, the system could become operative if the Code changes, and the minor changes necessary in the corporation laws, were effected in 8 or 10 leading states. Those of us who worked on the Simplification Acts for Fiduciary Transfers will remember that when we had Illinois, Connecticut, and Delaware, we were in business; in another year or two we had many important states under these or the Code and transfer agents were abandoning the conflict of laws fantasies with which they had been scaring themselves. The great bulk of enactments of the Uniform Commercial Code—a vast piece of legislation with innumerable areas of controversy—took place between 1961 and 1965. Section 8-320 of the Code, sanctioning Central Certificate Service, was widely adopted before the New York Stock Exchange was ready to make use of it. The time of preparation, and the time required for enactment will simply be inverse to the amount of talent and effort devoted to it. Three to five years should do the whole job. This compares favorably with already elapsed time on other plans (CCS and CUSIP) whose claimed benefits are still largely unrealized. Both of these systems have made advances which can be used to advantage in a Bookkeeping System, but further preoccupation with their refinement can only delay the demise of that 19th century creature, the stock certificate.[4]

Neither the drafting problems of the lawyers, nor the complex operational problems of the banks, brokers, and transfer agents, can be solved by quarterly committee meetings. Able, and probably expensive, task forces will be necessary, working, so far as the Code is concerned, with the Permanent Editorial Board.

4. *See* Dunne, *Financial paper: Variations on themes of McLuhan. Can the financial community bring its artifacts into the electronic age before the paper blizzard buries us all?* 48 HARV. BUS. REV. 90 (1970).