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Article Eight: Investment Securities

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ARTICLE EIGHT: INVESTMENT SECURITIES

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"Securities governed by . . . Article [8 of the Uniform Commercial Code] are negotiable instruments."¹ This declares a fundamental precondition to today's active securities markets, which could not function without the indispensable right of bona fide purchasers for value to extinguish issuer defenses² and adverse claims³ to securities. The breadth and ease of this statement conceals the fact that it climaxes a long and often tortuous development of statutory and decisional law. Implicit is the subordination of the intangible claims and interests of creditors and stockholders to the instrument so that under the Code such rights do not exist apart from the certificate;⁴ indeed, the key definition of a "security" is the "instrument"—a piece of paper—issued in bearer or registered form of a type commonly dealt in on the securities markets and recognized as an established investment medium.⁵ Also underlying this proposition is the Code's unitary treatment of all forms of securities, in contrast to the old law, which subjected creditor securities to the often inapposite provisions of the Negotiable Instruments

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¹ G.S. § 25-8-105(1).

² G.S. § 25-8-202.

³ G.S. § 25-8-301(2).

⁴ A good illustration is the Code's reversal of the Uniform Stock Transfer Act's provision which made an injunction against transfer a sufficient attachment of a security. Compare N.C. GEN. STATS. § 55-87 (1965) with G.S. § 25-8-317. The reason is the holder's continuing power, despite the injunction, to transfer the shares to a bona fide purchaser, a point long ago recognized by *Green v. Forsyth Furniture Lines*, 198 N.C. 104, 107, 150 S.E. 713, 715 (1929).

⁵ G.S. § 25-8-102(1)(a).

Law, treated shares under the Uniform Stock Transfer Act, and left other types of securities not subject to any statute but only to conflicting case law.⁶ Involved also is the Code's discrimination between "commercial paper" (Article 3) and "investment securities" (Article 8) the often divergent rules of which reflect basic differences between these instruments. And yet both are "negotiable instruments," so that the bona fide purchaser of investment paper, like the holder in due course of commercial paper, enjoys a unique, favored and sheltered status.⁷

I. COVERAGE OF ARTICLE 8

A. Definition of "Security"

Article 8's coverage is shaped by its crucial definition of "security"⁸—a definition that is broad, functional, and formal rather than substantive. Its object is to include all instruments currently accepted as investment paper as distinguished from commercial paper, which is traded in functionally different markets. At the least the Code term presently embraces shares of stock, bonds and debentures (whether fixed or contingent or "hybrid" obligations), voting trust certificates, stock options and warrants, and scrip. The term is not limited to corporate securities but includes interests in limited partnerships or business trusts, oil and gas fractional interests, state and municipal bonds, etc., so long as such investment media conform to the Code definition.

On the other hand, the Code definition is not so inclusive as counter-part terms in federal and state statutes policing the public sale of securities.⁹ Here the definition of "security" embraces not only all instruments covered by the Code concept but sweeps into its net every possible type of interest that a gullible public might be induced to take as an "investment." In securities regulation, emphasis upon form would invite unscrupulous promoters to fashion unique

⁶ That is, except for an occasional statute in scattered jurisdictions dealing with special situations, *e.g.*, New York's Hofstadter Act recognizing negotiability of interim security receipts, equipment trust certificates, and certain bonds secured under a trust indenture, N.Y. Sess. Laws 1926, ch. 704.

⁷ Compare G.S. § 25-8-105(1) with G.S. § 25-8-305.

⁸ G.S. § 25-8-102(1)(a).

⁹ N.C. GEN. STAT. § 78-2(g) (1965) (definition of "security" in blue sky law); N.C. GEN. STAT. § 33-68(1) (Supp. 1965) (definition of "security" in Uniform Gifts to Minors Act). Cf. Securities Act of 1933 § 2, 48 Stat. 74, 15 U.S.C. § 77b(1) (1964) (definition of "security" in the Federal Securities Act).

and unusual investment media falling outside any such definition.¹⁰ Necessarily, then, securities regulation must look to substance and reach the unusual, the odd, and the weird contract or arrangement whether or not traded in organized markets or ordinarily thought of as investment media. They do so through catchall phrases such as "investment contract" and "in general, any interest or instrument commonly known as a 'security.'"

Since the Code's objective is to confer the priceless gift of negotiability upon securities—not to bar issue and sale of fraudulent investments—the Code definition favors not the unique and unknown type of instrument, but the familiar security with which the organized markets feel comfortable through custom and experience.

The Code definition contrasts with the NIL in deleting many substantive restrictions. Thus it properly omits the NIL requirement of an unconditional promise to pay money;¹¹ applied to bonds and debentures, this wrought havoc with many governmental securities payable out of special funds until legislative aid put their negotiable status beyond question. So, too, the Code definition is not directly concerned with the substantive validity of a security under state law, although the definition assumes issue of shares or bonds in conformity with corporation law and charter requirements, and recognizes defenses of invalidity in certain situations. Thus, the Code definition is useful because it puts aside substantive requirements and looks instead to matters of form: is the security in bearer or registered form? is it part of or divisible into a class or series? is it of a type commonly dealt in on securities markets? These requirements will be analyzed in detail.

1. *The Recognized-Investment-Medium Requirement.*—Under the Code a security must be, among other things, "an instrument which . . . 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"¹² Several points deserve separate exposition.

¹⁰ As expressed by Carlos Israels, "uniqueness of form must logically militate against inclusion in the category [of securities, since] [c]ommercial justification for negotiability requires not uniqueness but familiarity." Israels, *Investment Securities as Negotiable Paper—Article 8 of the Uniform Commercial Code*, 13 BUS. LAW. 676, 678 (1958).

¹¹ UNIFORM NEGOTIABLE INSTRUMENTS LAW § 1(2) [hereinafter cited as NIL]; G.S. § 25-3-104(1)(6).

¹² G.S. § 25-8-102(1)(a)(ii).

A security need only be "of a type commonly dealt in" on securities markets. This does not mean that the particular security must in fact be listed on an exchange or even traded in any market.¹³ Indeed, because of transfer restrictions, it may never leave the hands of the original owners of a closely held corporation. But such common shares, although surrounded by purchase options and other transfer restrictions,¹⁴ are still "of a type" that could be traded should the corporation "go public." Thus, the test is whether the form of the security is such that it could be publicly traded, not whether it is or ever will be. This part of the definition thus covers, at the least, common and preferred shares, warrants and scrip, bonds and debentures, and perhaps a few variants of these. Other types of securities "commonly dealt in" the over-the-counter markets, besides those just mentioned, would include mutual fund shares, American depositary receipts, and a few others.

Since many recognized investment media are not traded in the organized markets, the Code definition would be incomplete if it did not recognize a security "of a type . . . commonly recognized in any area in which it is issued or dealt in as a medium for investment." Four possible combinations arise:

(a) The security is a recognized investment medium both where issued (say Delaware) and where it is dealt in (say North Carolina). This is the usual situation and presents no special problem.

(b) The security is not a recognized investment medium in either place. For instance, a contract between an "investor" and a promoter who will raise chinchillas and sell their pelts at a profit to the investor is not a "security" for Code purposes either where the contract is peddled (say North Carolina) or where the contract is

¹³ The term "securities exchanges" covers national and regional (and exempted) stock exchanges. It is difficult to determine whether the definition embraces commodity investment contracts. "Security exchanges" are certainly different from commodity exchanges, and such contracts are made, not on security, but on commodity exchanges. Cf. § 3(a)(1) of the Securities Exchange Act of 1934, 48 Stat. 882, 15 U.S.C. § 78(a)(1) (1964), defining "exchange" as an organization which affords a "market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood." The term "markets" in G.S. § 25-8-102(1)(a)(ii) must also be read as modified by "securities" so that it refers to the over-the-counter markets maintained by brokers and dealers in securities.

¹⁴ Issuer-imposed transfer restrictions are recognized in G.S. § 25-8-204.

to be performed (say South Carolina). No Code problem arises since it falls outside the definition of a "security."

(c) The security is a recognized investment medium in the place of issue but not in the place of dealing. The Code definition would apply, at least absent violation of any public policy in the place of dealing. Thus, bearer shares are "commonly recognized" in Europe as a proper "medium for investment," but probably not so in most of the United States, simply because bearer shares are seldom issued in this country¹⁵ and have never interested the investment community; European bearer shares are not directly traded because of the popularity of American depositary receipts. Assuming no actual public policy in a given state as to investing in bearer shares, the Code definition would apply and European bearer shares would be a "security" and negotiable. Although the bearer-share illustration is not startling, this could logically imply that an odd type of security having currency in a foreign country might automatically gain acceptance as a negotiable security in any and all American Code states lacking an affirmative policy objection to the type of security.

(d) The security is not a recognized investment medium where issued but is so regarded where traded. Such a situation would pose difficult conceptual problems of granting negotiability in the place of dealing where negotiability would not be recognized in the place of issue. Hence, the Code definition would mean that an instrument not negotiable in Spain could become negotiable in America if a custom of trading it here is sufficiently strong to establish it here as a recognized investment medium.

2. *The Requirement of Bearer or Registered Form.*—A second formal requisite for an investment security is that it be "an instrument . . . issued in bearer or registered form."¹⁶ This aptly describes most securities issued today, and it dispels a shadow, admittedly slight, cast over bonds by NIL requirements. For although the bearer bond's form was close enough to the bearer note to avoid difficulties under the NIL,¹⁷ the case as to registered-form bonds

¹⁵ Two American jurisdictions recognize bearer shares. CONN. GEN. STATS. ANN. § 33-345(a) (1961); MONT. REV. CODES ANN. §§ 15-608, -611 to -613 (1955).

¹⁶ G.S. § 25-8-102(1)(a)(i).

¹⁷ Thus in 1934 a leading authority recognized that bearer bonds are governed by the NIL and that an option to register the bond did not impair negotiability. Steffen & Russell, *Registered Bonds and Negotiability*, 47 HARV. L. REV. 741, 746 n.16, 744 n.11 (1934).

was vexing. Such bonds and debentures may be fully registered (that is, as to both principal and interest) or registered only as to principal (the interest being payable to the bearer of a coupon annexed to the instrument). When such an instrument is so registered, it was arguable under the NIL that the issuer's obligation runs only to the single registered holder, since usually the magic words "or order" will not be included in such long-term creditor instruments.¹⁸ Indeed, it is the issuer's intent to confine its obligation to the registered owner whom it can identify from its "books" and to account to no one else unless his ownership is registered on the "books."¹⁹ The absence of the talisman "or order" and the required "transfer on the books of the corporation" arguably contravenes the forms of transfer prescribed by the NIL. It is hard to say whether the issue was ever definitively settled under the NIL, but in all events the Code forecloses it by recognizing registered-form instruments as such and by omitting any language such as "to order" or its equivalent. Instead a security is in "registered form" if it "specifies a person entitled to the security or to the rights it evidences and when its transfer may be registered upon the books maintained for that purpose by or on behalf of an issuer. . . ." In addition a security may also be in "registered form" if "the security so states."²⁰

A security is in "bearer form" if "it runs to bearer according to its terms and not by reason of any indorsement."²¹ Unregistered bonds and, more familiarly, bond coupons may be properly transferred from hand to hand by delivery; so, too, in Europe the holder of bearer-form shares may vote at shareholder meetings or receive the current dividend on presenting his share certificate or some other appropriate instrument.²² Because a security is in bearer form only

¹⁸ Steffen & Russell, *supra* note 17, at 744, 759, 768, recognized that a "to order" clause in a registered bond might eliminate the uncertainty as to the full negotiability of registered-form bonds, but apparently the idea never caught on. Oddly enough, as noted later, an "order" bond or debenture, not required to be registered, would not be a "security" under the Code. See notes 25-29 *infra*.

¹⁹ See G.S. § 25-8-207(1) permitting but not requiring the issuer or an indenture trustee to treat the registered owner as the person solely entitled to all rights of the security holder.

²⁰ G.S. § 25-8-102(1)(c).

²¹ G.S. § 25-8-102(1)(d).

²² Assuming as a policy goal that shareholders should be encouraged to participate in meetings and like corporate activities and receive information through reports and proxy statements, it is well that bearer shares have

if the issuer so states in the instrument, indorsing such an instrument normally has no effect other than sometimes to give notice of adverse claims.²³ By implication, even a special indorsement would not preclude further negotiation by delivery alone. Certainly it gives the holder of the bearer-form security no rights to registration. Since the issuer's object is to avoid dealing with registered paper, no such obligation can be thrust upon him merely by indorsing bearer-form paper. In contrast to the Code's commercial-paper rule, which makes a special indorsement control further negotiation even of paper drawn payable to bearer,²⁴ an investment security's form of negotiation—whether by delivery or by indorsement plus delivery—is determined for the life of the instrument by the issuer and not by the accident of the form of transfer chosen by the owner. So, too, a purported indorsement in blank or expressly to bearer on a registered-form security does not convert it into a bearer-form instrument.²⁵ Although it may continue to pass by delivery, the issuer is not bound by the indorsement, but may ignore the holder who cannot show the necessary requisites for registration and continue to recognize only the holder of record.²⁶

By confining the definition to bearer and registered-form instruments, the Code excludes a few long-term investment media. Thus, a fifty-year note for ten million dollars issued by A Corporation to

never caught on in this country since the issuer would have no way of knowing where to send reports. The issuer's inability to send reports would frustrate this sort of regulatory objective. Perhaps issuers did not seek to evade sometimes unwelcome requirements of full disclosure by using bearer shares because of the problems of satisfying state-law quorum and vote requirements and the inability to locate share owners to get proxies needed for such purposes.

²³ G.S. § 25-8-310. Comment 1 to that section indicates that this will usually occur when the security bears some restrictive indorsement such as "for collection" or "for surrender" or the like. Presumably, other indorsements might also give notice of adverse claims.

²⁴ "Any instrument" governed by Article 3, if "specially indorsed becomes payable to the order of the special indorsee and may be further negotiated only by his indorsement." G.S. § 25-3-204(1).

²⁵ By clear implication from the words of G.S. § 25-8-102(1)(d) that a security is in bearer form when "it runs to bearer according to its terms and *not by reason of any indorsement.*" (Emphasis added.)

²⁶ Again, this contrasts with the commercial paper rule. Since "an instrument payable to order and indorsed in blank becomes payable to bearer and may be negotiated by delivery alone until specially indorsed," G.S. § 25-3-204(2), the holder, including "a person . . . in possession of . . . an instrument . . . indorsed . . . to bearer or in blank," G.S. § 25-1-201(20), may discharge the instrument or enforce payment in his own name, G.S. § 25-3-301.

B Insurance Co. and made payable to order but not registerable would not be governed by Article 8. Its negotiability will then depend on its conformity with the Code's requirements for commercial paper.²⁷ Thus, a long-term order note payable out of the issuer's income or subject to some other condition in the promise would not be negotiable.²⁸ This problem can be avoided by making the income note payable to bearer (instead of order) or by putting it in registered form, thus returning it to the shelter of Article 8. Even so, it is not clear why Article 8 should have excluded long-term securities payable to order but not in bearer or registered form, particularly since long-term notes have become popular in direct placements.²⁹

3. *The Class-or-Series Requirement.*—A third formal requisite is that the security be "either one of a class or series, or by its terms . . . divisible into a class or series."³⁰ Thus, a complicated corporate financial structure may include Series A, B, C, D, etc., of First Mortgage Bonds; Series L and M of Subordinated Debentures; Class A of Preferred Stock (of which Series T, U and V have been issued and are outstanding), and the Common Stock. A close corporation may issue common stock in Class A with voting rights, and in Class B with no vote, and conceivably (though improbably) subdivide the classes into series.

Although the "class or series" requirement is satisfied easily and routinely, it may occasionally exact limitations. For instance, warrants to buy new stock generally issued to outstanding shareholder or debenture-holder would comprise a security "class," and a particular warrant would be "one of a class." But a stock option issued to a single individual, perhaps incidental to his employment, would probably not be "one of a class" so that its unique character would remove it from the definition of a "security."³¹ In contrast, an employee stock-option plan with options to, say, 100 key employees would comprise a "class." As a second instance, a fifty-year

²⁷ The "formalities" of commercial paper appear in G.S. § 25-3-104(1).

²⁸ G.S. § 25-3-104(1)(b).

²⁹ Perhaps the reason is simply to afford an easy and convenient means to kill negotiability—do not make the instrument payable to order or bearer or in registered form—so as to protect the claims of the first holder from destruction by a holder in due course.

³⁰ G.S. § 25-8-102(a)(iii).

³¹ But the underlying stock would presumably satisfy the class or series requirement.

ten-million-dollar debenture privately and specially placed with an insurance company would seemingly not be a security because not "one of a class" of securities unless it is in fact one of a class of debentures or is divisible into smaller units.

The class-or-series requirement is thus consistent with the idea that a "security" under the Code definition is not a unique instrument but one "of a type" accepted in securities markets. It is not the Code's intent to confer negotiability as of course upon the unique tailor-made instrument. Thus, minimum compliance with this formality requires that there be at least two instruments in a specified class or series, or that the single instrument be divisible into at least one additional instrument, so that the security involved is "one of a class or series," and does not itself exhaust the class or series. Presumably, it is sufficient compliance with this requirement if Series A of Class B is outstanding although additional series are yet to be issued (but may never be issued). A formal recital in the instrument would probably be a sufficient compliance with the class-or-series requirement.

4. *Evidence of a Share or Obligation.*—The fourth requirement is that the security "evidence a share, participation or other interest in property or in an enterprise or evidence an obligation of the issuer."³² This language broadly embraces all familiar creditor and equity interests which pre-Code statutes treated separately. Other instruments are covered. For instance, a mutual fund certificate would be "a share . . . in property" owned by the fund; an American Depository Receipt would be an "interest in property" belonging to the issuing bank, which held the foreign shares backing up the receipts. Various investment contracts would satisfy this phase of the definition but usually will not be covered because they are not commonly accepted on markets or as investment media. It is doubtful that pre-incorporation stock subscriptions could meet the requisite, since, when made, they do not evidence any share or interest in property or in an enterprise, let alone an issuer obligation; rather they are an undertaking, binding or not as the case may be under state statutes, to become a shareholder if the corporation is formed and issues shares.³³

³² G.S. § 25-8-102(1)(a)(iv).

³³ Stock subscriptions are, of course, subject to federal and sometimes to state securities statutes. See Securities Act of 1933 § 2, 48 Stat. 74, 15 U.S.C. § 77b(1) (1964); *but see*, N.C. GEN. STAT. § 78-2(g) (1965).

B. The "Security" Definition and New Investment Media

A problem incident to codification of existing law is the possible freezing of new developments, which would first have appeared as new customs responding to newly felt needs and practices and which might then have passed over into rules of law. This is, of course, much of the story of the law of negotiable instruments (in the broad sense), both as to reception of the "law merchant" into the common law and as to rejection of other practices and customs. While there is a chancey element in a court's recognition of custom—depending upon the ability of counsel, the intelligence and responsiveness of the court, the character of the transaction, the factual context in which the issue is posed, the inherent equities of the situation, and other accidental factors—recognition is more easily achieved absent statutes preempting the area than when the court is free to act creatively. Investment securities illustrate this difficulty, since the NIL's overly broad definition of a "negotiable instrument" included bonds and debentures and thus prematurely codified an area of law that was still in the formative stage, and codified it in such a way as to trouble the financial community. In contrast, the English Bills of Exchange Act³⁴ did not include investment creditor securities, so that the English courts had a wide area of discretion, and exercised that discretion intelligently, in receiving into the law at the appropriate time the gradual accretion of custom relating to investment securities.

Two classic decisions point up the contrast. In *Goodwin v. Robarts*,³⁵ two English courts assayed the negotiability of scrip issued for definitive bonds of the Russian government. Scrip owned by the plaintiff was held by a broker who pledged it as security for a loan from defendants, who were bona fide purchasers of the scrip. On traditional principles governing commercial paper, such scrip could be challenged on several grounds: (1) the scrip was "payable" not in money but in definitive bonds; (2) the Rothschilds, who signed the scrip as agents of the Russian government, only obligated themselves to transmit definitive bonds to the scrip holder; (3) the script was at least in form that of the agents, the Rothschilds, although interpreted by the court as the direct obligation of the Russian government, as issuer; and (4) traditional promissory words

³⁴ 45 & 46 Vict. c. 61 (1882).

³⁵ (1875) L.R. 10 Ex. 337, *aff'd*, (1876) 1 App. Cas. 476.

were lacking, although the scrip stated that "the bearer will be entitled to receive a definitive bond or bonds."³⁶ The decision was in favor of negotiability so that the defendant pledgee prevailed over the true owner. The foundation of the decision was a finding of fact as to usage of more than fifty years by which scrip representing foreign government obligations had passed by mere delivery. After rejecting any conception of the law merchant as "fixed and stereotyped, and incapable of being expanded and enlarged,"³⁷ the Exchequer Chamber broadly affirmed the continuing vitality of the "process" by which "what before was usage only, unsanctioned by legal decision, has become engrafted upon, or incorporated into, the common law," and taking an advanced view, it emphasized the policy objectives of facilitating ready transfer of securities rather than "requiring some more cumbrous method of assignment" that would "materially hamper the transactions of the money market . . . and cause great public inconvenience."³⁸

More than fifty years later, *President & Directors of the Manhattan Co. v. J. P. Morgan*³⁹ considered the negotiability of scrip similar to that upheld in *Goodwin v. Roberts*, although its terms and conditions were more explicitly stated. Thus, the "interim receipts" for Belgian government bonds, issued by J. P. Morgan and Company, were "payable" not in money but in definitive bonds and contained explicitly conditional promises to deliver definitive bonds and pay interest only if, as and when bonds and interests were received. The court held these instruments nonnegotiable and thus voided plaintiff's claim as a bona fide purchaser of instruments that had been stolen and later transferred. The thrust of the decision is the impossibility of holding, in the teeth of the explicit and pervasive NIL "formal requirements," that such instruments could be negotiable. Even assuming that, absent statute, *Goodwin v. Roberts* would have governed, or that a sufficient custom in New York banking circles had been established, neither precedent nor custom could prevail over positive law requirements. The only recourse, promptly forthcoming, was New York's Hofstadter Act⁴⁰ making security

³⁶ The text of the instrument appears at (1875) L.R. 10 Ex. 337, at 339.

³⁷ *Id.* at 346.

³⁸ *Id.* at 353.

³⁹ 242 N.Y. 38, 150 N.E. 594 (1926).

⁴⁰ N.Y. Sess. Laws 1926, ch. 704.

receipts (and other instruments such as equipment trust certificates) negotiable.

Thus, new statutes are clearly the best means for assuring that new forms of investment securities will be negotiable, but at least two difficulties appear. First, such a statute will not usually be enacted except in response to a decision striking down the negotiability of a new type of instrument; and even so there may be delays in passing the corrective legislation. More deeply, there is a subtle problem as to how a new and untried security will be sufficiently accepted in financial circles to permit growth of a custom that can be the predicate for a judicial finding of negotiability—that is, assuming that courts still have some leeway to declare new securities to be negotiable.

This poses the problem of new securities and the Code definition. Crucial here is the requirement that a security be “of a type commonly dealt in upon” securities markets or “commonly recognized . . . as a medium for investment.”⁴¹ But a new type of security by hypothesis cannot be “of a type” specified by this requirement until sufficient time elapses for a custom to arise. Growth of a custom recognizing a new security not within the Code definition is retarded: its negotiability is at best uncertain, and investment and financial circles may not want to risk money on it. We can illustrate with a security which an intermediate appellate New York court held in 1938 was “not freely bought and sold in the market place and did not pass from hand to hand like certificates of stock.”⁴² These mortgage participation certificates would probably be regarded today as acceptable investment media and thus a “security” under the Code.⁴³ But if the Code definition had been in force in 1938, it is difficult to see how they could have been securities at that time, and the probable impairment of their sale and transfer would retard any growth in custom. Again, the order bond, not covered by Article 8, illustrates the problem. Although perhaps not used so extensively today, it may well prove at some time and in some situations to afford a better medium for money-raising than

⁴¹ G.S. § 25-8-102(1)(a)(ii).

⁴² *Oppenheimer v. Title Guarantee & Trust Co.*, 253 App. Div. 356, 2 N.Y.S.2d 181 (1938).

⁴³ Compare recent SEC litigation regarding a related type of “security” in *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162 (9th Cir. 1960).

conventional securities. But such an instrument is not under the Code definition a "security," and if it is payable out of income, it is not even commercial paper.

This is not to say that the Code definition is undesirable or that codification is improper at this time. Indeed, I suggest that much of the law of investment securities has reached a stage of maturity where codification, as worked out in Article 8, is appropriate; and that the values of certainty from a good codification—and Article 8 is certainly that—outweigh a possible yoke that statutory language may impose upon judicial innovation in this area. For one thing, it is not entirely bad that new forms of investment securities must prove themselves and may not too swiftly acquire the exalted status of negotiable securities, even as a matter of mercantile custom. Moreover, it cannot be said—or, at least, I cannot say—that a custom of free transfer by delivery of instruments may never be able to develop as to new types of securities even though there is no assurance that they will ultimately be held negotiable—a risk which presumably all forms of currently accepted investment securities ran at some time in their careers. Thus, it still remains possible that custom can develop within the interstices of the Code definition,⁴⁴ and thereby a security may come to be "of a type . . . commonly recognized . . . as a medium for investment." A subtle point is worth noting. The Code language does not require that securities be commonly recognized as *negotiable* securities in the strict sense of extinguishing adverse claims and issuer defenses. Rather they need only be recognized as a "medium for investment," a broader concept than "security" itself, since an instrument may be a recognized investment medium but not a "security" because it does not meet certain other requirements of the definition. Although not completely clear on this point, certain language in *Goodwin v. Roberts* intimates that proof of mercantile custom means proof of common acceptance and ready transfer, and not some ex-

⁴⁴ Because of the Code requirement that securities be commonly dealt in or recognized as investment media, the definition of security does not recognize "negotiability by contract," *i.e.*, negotiability resulting solely from the inclusion of clauses waiving defenses or adverse claims as to subsequent holders or negotiability by say-so. Thus the requirement still envisions "custom" as giving preliminary approval to securities as negotiable instruments before the courts make their final determination. Of course, clauses purporting to waive defenses and adverse claims as to subsequent holders, while not creating negotiability *ipso facto*, may contribute to the growth of the custom of accepting the instruments as negotiable.

plicit recognition in the minds of merchants and financiers that the legal consequences of negotiability—extinguishing defenses and claims—will necessarily occur. If developing custom means something like this, then the Code does provide moderate accommodation for custom to mature new forms of investments into securities suitable for full negotiable status.

Beyond that, a probable safeguard is the response of legislatures, though delayed, to confer negotiable status on instruments where needed. Examples include widely enacted legislation recognizing negotiability of government revenue and other bonds otherwise non-negotiable because payable from specified funds, and New York's Hofstadter Act, already noted as responsive to the *Manhattan* decision.

The conclusion, then, is that the definition of "security" is a good one. It is sufficiently limited to include instruments that deserve negotiability, and at the same time it has enough play in the joints to avoid inhibiting new developments. At the very least, because the concept of "security" has been radically dissociated from commercial money paper, and because substantive requirements appropriate to commercial paper are absent, there is greater flexibility for future growth.

II. ISSUER DEFENSES AND RESPONSIBILITIES

Ever since Chafee's pioneer work,⁴⁵ it has been customary to distinguish between defenses of the maker of a negotiable instrument and ownership interests or claims that others may assert as to the instrument. This distinction appears in Article 8, which separately treats issuer defenses and "adverse claims" and sometimes provides different rules.⁴⁶ Moreover, the "defenses" an issuer may raise as to an investment security are often significantly different from those arising in a commercial paper transaction. These defenses tend to cluster around the "power" of the issuer, whether

⁴⁵ Chafee, *Rights in Overdue Paper*, 31 HARV. L. REV. 1104, 1122 (1918).

⁴⁶ E.g., compare the "purchaser for value and without notice" who can extinguish issuer defenses under G.S. § 25-8-202 with the "bona fide purchaser"; see G.S. §§ 25-8-301(2), -302, and the "purchaser for value and without notice of adverse claims who has in good faith received a new . . . security on registration of transfer," G.S. § 25-8-311(a), both of whom can, in defined situations, extinguish claims of the "true owner" of the security. Compare also the different time periods which the Code's "stale security" rule specify for issuer defenses, G.S. § 25-8-203(1), and for adverse claims, G.S. § 25-8-305.

a "private corporation" or a governmental entity, to issue a particular security; the difficulties presented by "forged" certificates; and problems of recent vintage involving stock transfer restrictions designed either to keep small corporation shares "closely held" or to preserve some exemption under federal and state statutes regulating sale of securities. Here, as with commercial paper, the general proposition is that an issuer's defenses will fail if the security has come to rest with a purchaser for value and without notice of the particular defense⁴⁷—the analogue of the holder in due course of commercial paper.⁴⁸ Furthermore, the Code sometimes speaks of "validating" a security held by such a purchaser as a remedy used in lieu of damages or a right of rescission or some other form of relief. If validating the security would cause an overissue, the Code then affords alternative remedies: the issuer may be compelled to acquire and furnish a security,⁴⁹ or if no such security is readily available for purchase, the issuer must respond in damages.⁵⁰ Faced with the problem of an overissue of securities, which corporate law makes absolutely void,⁵¹ the Code unfortunately rejected the simple and rational method of compelling the corporation to amend its charter to validate the overissue; and instead adopted a clumsy procedure that contains some serious problems.⁵²

*A. Validity of Security—Private Issuer*⁵³

Suppose that a corporation issues shares of stock which do not comply with statutory requirements as to quality of consideration,⁵⁴ *e.g.*, the stock is watered⁵⁵ or perhaps was issued for no consideration at all. Or, perhaps, a corporation issued a type of security

⁴⁷ See generally G.S. § 25-8-202.

⁴⁸ Compare G.S. §§ 25-8-202 and -302 with G.S. § 25-3-302(1).

⁴⁹ G.S. § 25-8-104(1)(a).

⁵⁰ G.S. § 25-8-104(1)(b).

⁵¹ *Triplex Shoe Co. v. Rice & Hutchins, Inc.*, 17 Del. Ch. 356, 152 Atl. 342 (Sup. Ct. 1930); *New York & N.H.R.R. v. Schuyler*, 34 N.Y. 30 (1865); see G.S. § 25-8-104, comment 1.

⁵² For a detailed discussion of these matters see Folk, *Some Problems under Article 8 of the Uniform Commercial Code*, 5 ARIZ. L. REV. 193, 207-11 (1964).

⁵³ G.S. § 25-8-202(2)(a).

⁵⁴ See N.C. GEN. STAT. § 55-46(a) (1965) (lawful consideration for issue of shares); § 55-46(b) (1965) (forbidding promissory notes and like obligations as payment for shares).

⁵⁵ See N.C. GEN. STAT. § 55-53(b) (1965) imposing liability upon any "original holder" of "watered shares," a liability to make up the unpaid balance of the consideration that should have been received for the shares.

which, under applicable statutory requirements, it was not authorized to issue. Under the Code, defenses of this character, testing the validity of the issue, may be asserted against anyone other than a "purchaser for value and without notice of the particular defect."⁵⁶ Thus, an original purchaser of a new issue of shares would take the security free and clear of the corporation's defense as would a subsequent purchaser who acquired his shares on resale in securities markets. But the Code language obviously excludes a donee, even a subsequent donee, of a tainted security;⁵⁷ it also withholds protection from a purchaser for value who knew of the "particular defect"⁵⁸—an interesting and desirable modification of the old rule that any guilty knowledge opened up all defenses against the holder.⁵⁹ Thus, the issuer can assert only those defenses that the purchaser can be shown to have known about; his knowledge of an adverse claim would not allow the issuer also to assert a defense against the purchaser.

The Code states a stricter rule if the security is "invalid" because violating some constitutional requirement,⁶⁰ as in a state that enshrines the consideration requirement for stock in a constitutional clause.⁶¹ North Carolina is not one of those states; however, given such a situation, only "a *subsequent* purchaser for value and without notice of the defect" takes free of the defense, thus allowing the corporation to reclaim the securities when held only by the original purchasers, however innocent they may have been. The object is to give greater weight to a constitutional requirement and permit it to be overridden by the policy of free negotiability of securities only

⁵⁶ The code position is consistent with North Carolina's unique "watered stock" statute, see note 55 *supra*, which provides that "transferee of such shares shall not be liable thereon if he acquired them in good faith without knowledge or notice that they were watered shares or shares not fully paid as agreed or if he acquired them from a transferor similarly free from liability." N.C. GEN. STAT. § 55-53(f) (1965).

⁵⁷ However, the donee might be able to take such rights as his transferor had, including, if his transferor was a bona fide purchaser, immunity from an issuer's defense. See G.S. §§ 25-8-301(1), -1-201(32), -1-201(33) defining "purchase" and "purchaser" to include "taking by . . . gift or any other voluntary transaction creating an interest in property."

⁵⁸ Even such a holder might be able to claim the rights of a prior bona fide purchaser under G.S. § 25-8-301(1), at least so long as the holder was not a party to fraud or illegality affecting the security.

⁵⁹ NIL § 58, N.C. GEN. STAT. § 25-64 (1953).

⁶⁰ G.S. § 25-8-202(2) (a).

⁶¹ For instance, S.C. CONST. art. 9, § 10 specifies permissible consideration on issue of shares.

when shown that the security was in fact negotiated among holders and came to rest with an innocent purchaser.

Thus the Code technique, in dealing with "invalid" securities, is, as a general rule, to make them good when held by innocent purchasers for value rather than award damages, which may be an inadequate substitute for the security and which might also have a disrupting effect on a corporation's finances to the possible detriment of creditors. However, this validation approach is limited by the Code's special treatment of a particular type of invalidity—an overissue of securities.⁶²

*B. Validity of Security—Governmental Issuers*⁶³

The really acute problems of "validating" securities have typically arisen in the context of governmental rather than private issues, or here at least the legal concepts have been more explicitly formulated. Not only were governmental issues, usually bonds issued by states and their subdivisions, of suspect negotiability because they did not comply with the NIL formalities; but even where they were impeccable in this respect, they were often issued without conforming to special statutory requirements. Moreover, there were strong policy arguments that it would be wrong if not sinful to dissipate taxpayers' contributions through "illegally" issued bonds, however trivial the defect, and this laudable concern for governmental scrupulousness outweighed even the interests of innocent purchasers. The North Carolina decisions, of course, felt the tension of these opposing policies, but in general they resolved the question effectively and in accord with the dominant and quite pragmatic American view.⁶⁴ It is this prevailing approach which has been codified into the Code.

Stated generally, and rather abstractly, the Code "validates" governmental securities by imposing additional requirements looking to the protection of the taxpayers, upon those already exacted in connection with private issuers. Thus, the governmentally issued security must be held by an innocent purchaser for value or, if the defect is of constitutional origin, a subsequent innocent purchaser for value. In addition, the security is valid only if (1) the govern-

⁶² G.S. § 25-8-104, discussed in the text accompanying notes 49-52 *supra*.

⁶³ G.S. § 25-8-202(2) (b).

⁶⁴ G.S. § 25-8-202, comment 6.

mental agency has substantially conformed to the "legal requirements" applicable to the particular issue, or (2) it has received "substantial consideration" for the security *and* the "stated purpose of the issue is one for which the issuer has power to borrow money or issue the security." The first condition primarily seeks to sustain an issue against claims of some insubstantial defects, typically some defect at some stage of the process by which the issue is approved and, in particular, some defect in voting on the issue which has not misled the electorate.⁶⁵ Thus, the North Carolina court has held that as against a bona fide purchaser a municipality may not assert that the bonds were authorized at a special than a regular aldermen's meeting,⁶⁶ nor may it plead some nonsubstantial deficiency in the conduct or result of the election to approve the bond issue,⁶⁷ or that the bonds were issued by de facto rather than de jure town officers,⁶⁸ or were not signed by all of the incumbent commissioners required to certify them.⁶⁹ Under the Code, as under the North Carolina decisions—and the prevailing American view—the test is one of substantial conformity with the statutory formalities.⁷⁰

The second condition—substantial consideration received for securities within the agency's power to issue—also follows antecedent case law in giving effect, via an "estoppel" concept, to recitals in the bond issue, provided that agency had "power" to issue the securities. Thus, an issue may be validated in the hands of an innocent purchaser for value, even though there are substantial deviations from statutory requirements, *e.g.*, a seriously defective election, if money has been received and purchasers have relied upon the recitals. Thus, if a town were to have received funds for bonds issued for a sewage district authorized by statute and the bonds

⁶⁵ The South Carolina court noted as the relevant test whether the voters knew of the election and the question to be determined and had an adequate opportunity to express their will without being misled or misinformed because of the irregularities. *Phillips v. City of Rock Hill*, 188 S.C. 140, 198 S.E. 604 (1938).

⁶⁶ *Bankers Trust Co. v. City of Statesville*, 203 N.C. 399, 408, 166 S.E. 169, 174 (1932).

⁶⁷ *Reiger v. Commissioners of Town of Beaufort*, 70 N.C. 319 (1874).

⁶⁸ *Smith v. Town of Carolina Beach*, 206 N.C. 834, 175 S.E. 313 (1934).

⁶⁹ *Bank of Statesville v. Town of Statesville*, 84 N.C. 169 (1881).

⁷⁰ *Board of Comm'ns of City of Hendersonville v. C.N. Malone & Co.*, 179 N.C. 604, 103 S.E. 134 (1920); *Hill v. Skinner*, 169 N.C. 405, 86 S.E. 351 (1915); *Wilmington, O. & E.C.R.R. v. Commissioners of Onslow County*, 116 N.C. 563, 21 S.E. 205 (1895).

recited compliance with statutory formalities, these recitals would override the municipality's efforts to show a major defect in the election. But if under the same circumstances the bonds were issued for some purpose unauthorized by statute, *e.g.*, to acquire and donate land as a lure to a corporation to build a plant, they would be invalid no matter who held them and no matter how clean his hands and pure his heart. The North Carolina court once succinctly declared that

a careful distinction should be drawn between the want of power to issue bonds, and mere irregularities in the exercise of that power. The latter, under certain circumstances, may be cured by recitals, or eliminated by estoppel; but a want of power goes to the very root of the transaction, and destroys its vitality.⁷¹

In short, the purchaser can rely on the bond's recitals of proper purpose and thus preclude the city from asserting that the purpose was something else, so long as the city had the power to issue bonds for that purpose; but recitals of power do not work an estoppel. Thus, several North Carolina decisions have rejected a municipality's claim that the bond proceeds were used for an improper purpose.⁷²

In one respect, the Code rule appears to alter prior law. Old North Carolina decisions consistently held that defenses to municipal securities grounded on noncompliance with a constitutional requirement are available against any bona fide purchaser for value,⁷³ and even recognition of the obligation by paying interest does not preclude later assertion of the defense,⁷⁴ since "there can be no *bona fide* holders of unconstitutional obligations."⁷⁵ This rule was applied even to a nonconformity with some particular type of procedure that, fortuitously, was required by a constitutional rather than a mere statutory clause.⁷⁶ To this extent, the Code modifies the old

⁷¹ *Commissioners of Wilkes County v. Call*, 123 N.C. 308, 311, 31 S.E. 481, 482 (1898).

⁷² *Smith v. Town of Belhaven*, 150 N.C. 156, 63 S.E. 610 (1909); *Hightower v. City of Raleigh*, 150 N.C. 569, 65 S.E. 279 (1909).

⁷³ *Glenn v. Wray*, 126 N.C. 730, 36 S.E. 167 (1900); *Union Bank v. Commissioners of Town of Oxford*, 119 N.C. 214, 35 S.E. 966 (1896).

⁷⁴ *Commissioners of Stanly County v. Snuggs*, 121 N.C. 394, 28 S.E. 539 (1897).

⁷⁵ *Debnam v. Chitty*, 131 N.C. 657, 681, 43 S.E. 3, 10 (1902).

⁷⁶ *Glenn v. Wray*, 126 N.C. 730, 36 S.E. 167 (1900); *Commissioners of Stanly County v. Snuggs*, 121 N.C. 394, 28 S.E. 539 (1897); *Union Bank v. Commissioners of Town of Oxford*, 119 N.C. 214, 35 S.E. 966 (1896).

rule—which has not been applied in forty years—by perfecting a security held by a subsequent bona fide purchaser for value if there has been substantial consideration for the issue plus inherent power in the agency to issue a security for the purpose stated in the security.

The Code deals only with the validity of securities actually issued and in the hands of purchasers. To this extent, it codifies rules of law now well settled—and almost never applied today. For the routine but salutary practice of procuring firm opinions from skilled counsel as to the validity of municipal and other governmental issues has all but eliminated litigation on the problems that so troubled the courts from fifty to one hundred years ago. But since the Code deals only with already issued securities, it does not preclude or limit actions by taxpayers (or other interested persons with standing) from challenging the validity of a bond issue, whether for want of power or for violation of prescribed procedure or for any other reason. This is, of course, not a matter affecting the negotiability of securities and remains untouched by the Code rules.

C. Incorporation by Reference⁷⁷

Many investment securities are issued with terms stated not only on the face of the security—indeed some terms are required to be “conspicuously noted” to be effective⁷⁸—but also in a side instrument incorporated by reference into the security. Thus bonds, debentures, and occasionally preferred shares are issued under indentures describing in enormous detail the mortgage or other security for the instruments and typically vesting most of the rights of action for breach of the bond or the indenture in a trustee.⁷⁹ Rarely would it be physically possible to state these terms on the instrument itself, and even if someone accomplished such a tour de force—comparable to engraving a prayer on a pin head—“it would indeed be only a fictitious protection to insist that such provisions as this should be incorporated in the bonds. The investor who would read with so much care the whole of a bond so voluminous as it would become, were all the limitations included, would be as likely

⁷⁷ G.S. § 25-8-202(1).

⁷⁸ See G.S. § 25-8-204.

⁷⁹ If the issue is for more than one million dollars and will be sold through the mails or interstate commerce, and enjoys no federal exemption, it must qualify under the Trust Indenture Act of 1939.

to look at the mortgage, if the bond referred to the mortgage."⁸⁰ The old fear was that the voluminous terms of an indenture might be held to qualify the bond's fundamental promise to pay and thus destroy the negotiability of the bond; indeed, the very fact of reference to an extrinsic document, particularly through such naughty words as "subject to" or "goverend by,"⁸¹ alone threatened negotiability, even if the indenture's language in no way conditioned the promise to pay. These spectral, though nonetheless alarming, fears were largely dispelled when the New York Court of Appeals ruled in *Enoch v. Brandon*⁸² that the indenture's promises, conditions, limitations, and so forth related only to the security for the bond and not to the promise to pay, and thus upheld the bond's negotiability. New York's Hofstadter Act later sought to codify this rule.⁸³

The Code rule is to make both the terms of the security and an indenture incorporated by reference conclusive against any holder of the security regardless of his knowledge of the term. Of crucial importance is the absence of any substantive limitation on the kind of terms permissible in the indenture or the security itself. Thus, limitations and conditions on the promise to pay, or vesting an indenture trustee with rights of action under the security, do not impair negotiability. The test is a purely formal one: Is there any conflict between the "stated terms" of the security and indenture or any other terms incorporated by reference? Although the Code does not specify the consequences of a conflict, presumably the terms of the security would prevail over indenture terms. If the conflict is between the terms of the security and "those made part of the security by reference . . . to a constitution, statute, ordinance, rule, regulation, order or the like,"⁸⁴ the conflict would have to be resolved on the basis of other Code provisions already considered.⁸⁵

⁸⁰ Judge Learned Hand in *Babbitt v. Read*, 236 Fed. 42, 45 (2d Cir. 1916).

⁸¹ This rule has been preserved for commercial paper by G.S. § 25-3-105(2)(a). See also G.S. § 25-3-105, comment 8.

⁸² 249 N.Y. 263, 164 N.E. 45 (1928).

⁸³ N.Y. Sess. Laws 1926, ch. 704.

⁸⁴ G.S. § 25-8-202(1).

⁸⁵ Text accompanying notes 53-76 *supra*. G.S. § 25-8-202(1) also protects the innocent purchaser for value and without notice by providing that incorporation by reference gives no constructive notice of "a defect going to the validity of the security" despite an express recital that it does. Thus, the risk of the security's invalidity is shifted from purchaser to issuer who can most conveniently guarantee the security's validity or at least minimize the risk of invalidity.

*D. "Genuineness" and Unauthorized Signatures*⁸⁸

Under the Code, an issuer is not liable on a security, even to a bona fide purchaser unless it is "genuine,"⁸⁷ that is, "free of forgery or counterfeiting"⁸⁸ and to this extent it accords with established law both as to investment securities⁸⁹ and commercial paper,⁹⁰ which has never required one to honor an obligation which is not his own.⁹¹ However, the innocent purchaser, who carries the risk, has some possible protection in that any transfer agent, registrar or authenticating trustee who signs the security warrants that it is genuine and thus free of forgery or counterfeiting.⁹²

Much more common than outright counterfeits are genuine instruments issued with an unauthorized signature, typically by an employee who gains access to the securities and forges the corporate officer's signature, which must appear on the instrument; or perhaps facsimile signatures of officers are engraved on the certificate, as permitted by corporate law, and the dishonest employee forges any countersignatures necessary to make the certificate readily transferable. Without the special rule of the Code, section 8-205, the issuer would have a complete defense, since the signature in question was "made without actual, implied or apparent authority" and probably was a forgery.⁹³

Confronted with this quite common type of dishonesty, the courts rejected a flat rule either granting or denying the issuer a defense in all instances of unauthorized signatures on certificates. Rather, the overwhelming weight of authority validated the security held by an innocent purchaser for value if the signatures were made, however dishonestly and for whatever private purpose, by employees of the issuer (or its transfer agent or registrar) who were entrusted with the certificates; as to these, the corporation, on standard agency principles, assumed the risk of the erring employee. Thus, *Havens v. Bank of Tarboro*⁹⁴ sustained in favor of an inno-

⁸⁸ G.S. §§ 25-8-202(3), -205.

⁸⁷ G.S. § 25-8-202(3).

⁸⁸ G.S. § 25-1-201(18).

⁸⁹ G.S. § 25-8-202, comment 3.

⁹⁰ See G.S. § 25-3-404.

⁹¹ That is, apart from estoppel or ratification. Compare G.S. § 25-8-311 with G.S. § 25-3-404(1).

⁹² G.S. § 25-8-208(1)(a).

⁹³ This is the definition of the term "unauthorized" in G.S. § 25-1-201(43).

⁹⁴ 132 N.C. 214, 43 S.E. 639 (1903).

cent purchaser for value stock certificates that had been signed by the corporation's officers and entrusted to an employee who subsequently issued them to himself to use as collateral on a personal loan. The theory of the case was that the negligent corporation rather than the innocent purchaser (the pledgee bank)⁹⁵ should bear the risk of loss. On the other hand, as the New York cases have made clear, the issuer is not responsible if the employee is not one entrusted with the securities.⁹⁶ Thus, in *Hudson Trust Co. v. American Linseed Co.*,⁹⁷ the innocent purchaser for value lost when it was established that "a general clerk, particularly employed in the meal and transportation departments"⁹⁸ and occasionally called on to assist the head of the stock transfer department in a ministerial capacity, had taken from a vault stock certificates, previously signed by the appropriate officers, dated them, filled in his name as owner, forged countersignatures of the registrar, and obtained a loan; upon default, the securities were sold and passed into the hands of innocent purchasers who sought but were refused registration into their names. The Code provision adopts this distinction, for, in substance, it establishes a statutory rule of apparent authority entitling innocent purchasers for value to rely upon the appearance of regularity in the issue of securities. Stated otherwise, the issuer must assume the risk that its own employees or its transfer agent and its responsible employees will not exceed their actual authority in issuing securities. This fairly allocates risk between purchaser and issuer. The issuer can protect itself against malfeasance of its own or its transfer agent's employees by taking out appropriate fidelity bonds, requiring indemnification agreements from a transfer agent, and so on. In contrast, the innocent purchaser has little or no opportunity to determine whether a seemingly regular procedure is in fact vitiated by want of authority, especially in the mechanized and impersonal operations of stock transfers. At the same time the issuer is relieved from the consequences of misconduct by persons whose wrong-doing cannot reasonably be foreseen or guarded

⁹⁵ A pledgee is a purchaser under the Code. G.S. § 25-1-201(32).

⁹⁶ The leading cases are *Hudson Trust Co. v. American Linseed Co.*, 232 N.Y. 350, 134 N.E. 178 (1922); *Jarvis v. Manhattan Beach Co.*, 148 N.Y. 652, 43 N.E. 68 (1896); *Fifth Ave. Bank v. Forty-Second St. & G.S.F.R.R.*, 137 N.Y. 231, 33 N.E. 378 (1893).

⁹⁷ 232 N.Y. 350, 134 N.E. 178 (1922). The court distinguished *Havens v. Bank of Tarboro*.

⁹⁸ *Id.* at 353, 134 N.E. at 178.

against. Although admittedly the purchaser cannot tell whether the signer of his certificate was or was not "entrusted with" it, both case law and Code deem it unfair to saddle the issuer with the risk of loss in every situation and therefore reject any absolute issuer liability.⁹⁹

It is common practice for corporations to keep on hand a supply of stock or bond certificates already signed by authorized corporate personnel and thus ready for issue. Prior law established that this practice was not in itself negligent,¹⁰⁰ and the Code recognizes the effectiveness of a signature "placed on a security prior to . . . issue."¹⁰¹ Moreover, the Code rule takes account of the common practice, authorized by most corporation statutes, of engraving facsimile signatures of corporate officers on the certificate if it is to be countersigned by a transfer agent or registered by a registrar.¹⁰²

*E. Warranties of Authenticating Trustees and Others*¹⁰³

We have already noted that one signing or countersigning a security warrants its genuineness. In addition, the signer also warrants that his own participation in issuing the security is (1) within his capacity, *e.g.*, a bank would warrant its power under statute or charter to act as transfer agent, and (2) within the scope of his authority, which is substantially the agent's common-law warranty of authority. Thirdly, the signer warrants it has "reasonable grounds to believe that the security is in the form and within the amount the issuer is authorized to issue." Thus, the transfer agent would not warrant such facts to be true, but only its "reasonable" belief, which is to say that the transfer agent is liable only for its own lack of due care. This matter is routinely handled through counsel's opinion as to the proper form and authorized amount of the issue of stocks or bonds. Beyond these three warranties, a transfer agent certifies nothing else, and in particular it represents nothing as to

⁹⁹ Probably G.S. § 25-8-205 would not preclude issuer liability even on a signature by one not "entrusted with" the security, *e.g.*, by the clerk in *Hudson Trust Co. v. American Linseed Co.*, 232 N.Y. 350, 134 N.E. 178 (1922), on showing that the issuer's own negligence in leaving certificates readily available for misuse invited such a result. Estoppel concepts seemingly could be invoked. See G.S. § 25-1-103.

¹⁰⁰ This was specifically so held in *Hudson Trust Co. v. American Linseed Co.*, 232 N.Y. 350, 361, 134 N.E. 178, 181-82 (1922).

¹⁰¹ G.S. § 25-8-205 (preamble).

¹⁰² N.C. GEN. STAT. § 55-57(b) (1965).

¹⁰³ G.S. § 25-8-208.

the validity of the issue.¹⁰⁴ Thus, there is no right of action against a transfer agent by one who purchased municipal bonds held not to bind the city because of some substantial defect; nor would a purchaser have a right over against a transfer agent as to shares of stock held unenforceable for want of consideration required by a statutory or constitutional provision.

The Code does not indicate whether these warranties implied by law may be varied by contractual provision.¹⁰⁵ The pertinent test is whether the variance would purportedly waive a Code-imposed "obligation of good faith, diligence, reasonableness and care."¹⁰⁶ I suggest that none of these warranties may be curtailed by agreement. Thus it would be improper for the transfer agent who is in a better position to detect forgeries or counterfeiting to abridge its warranty of genuineness¹⁰⁷ and shift the risk to the innocent purchaser who is least able to detect or guard against them. Nor would it be proper to limit the transfer agent's warranty of capacity and authority,¹⁰⁸ which are intended to protect the investing public. Finally, it would clearly be improper for a transfer agent to disclaim its warranty of reasonable grounds of belief as to form and amount of the issue,¹⁰⁹ since this would impair a Code-imposed obligation of diligence and care.

F. Other Defenses of the Issuer

Several other possible issuer defenses may be briefly noted. The issuer cannot contest a security on the ground of no delivery or conditional delivery.¹¹⁰ When this provision is coupled with the Code rule that a duly signed but otherwise incomplete security may be filled up by "any person,"¹¹¹ the old NIL rule that nondelivery of an incomplete instrument constituted a real defense¹¹² is abolished both for investment and commercial paper.¹¹³ As with commercial

¹⁰⁴ G.S. § 25-8-208(2).

¹⁰⁵ Under G.S. § 25-1-102(3), Code provisions may be "varied by agreement," even when there is no specific permission in a given section indicating that it may be so varied. See G.S. § 25-1-102(4).

¹⁰⁶ Under G.S. § 25-1-102(3), such obligations "may not be disclaimed by agreement."

¹⁰⁷ G.S. § 25-8-208(1)(a).

¹⁰⁸ G.S. § 25-8-208(1)(b).

¹⁰⁹ G.S. § 25-8-208(1)(c).

¹¹⁰ G.S. § 25-8-202(4).

¹¹¹ G.S. § 25-8-206(1).

¹¹² N.C. GEN. STAT. § 25-21 (1953).

¹¹³ G.S. §§ 25-3-115, -305, -306(c). See also G.S. § 25-3-305, comment 3.

paper,¹¹⁴ completed but altered investment paper may be enforced according to its original terms;¹¹⁵ this accords with the view of the Uniform Stock Transfer Act,¹¹⁶ although it is contrary to the NIL rule,¹¹⁷ and thus states a uniform rule for all forms of investment securities.

Under the Code, issuer defenses are not available against the purchaser of an overdue or matured security if he acquired them within specified time periods after the maturity or performance date.¹¹⁸ Thus, the Code rule drastically departs from the NIL view that one could not be a holder in due course of an overdue instrument,¹¹⁹ and it is more liberal than the Code's commercial-paper rule, which precludes holder in due course status to one taking an instrument with notice that it is overdue or has been dishonored.¹²⁰ Thus, a creditor security immediately due because of some issuer default,¹²¹ or a security still circulating after a stated date for redemption or conversion,¹²² may still be taken free of issuer defenses for limited time periods after the event. This provision simply recognizes that investment securities continue in circulation after a default or some other event and states a rule consistent with market practice.¹²³ But once the security has become "stale," *i.e.*, the grace

¹¹⁴ G.S. § 25-3-407(2)(b).

¹¹⁵ G.S. § 25-8-206(2).

¹¹⁶ N.C. GEN. STAT. § 55-90 (1965).

¹¹⁷ N.C. GEN. STAT. § 25-131 (1953).

¹¹⁸ G.S. § 25-8-203(1). Interestingly enough, this rule accords with a pre-NIL view in North Carolina that one could be a holder in due course of overdue *commercial* paper, *Bradford v. Williams*, 91 N.C. 7 (1884); *Hill v. Shields*, 81 N.C. 250 (1879); *Parker v. Stallings*, 61 N.C. 590 (1868), a position warmly endorsed by the late Professor Chafee who argued that a bona fide purchaser for value of post-maturity paper should be able to extinguish adverse claims ("equities of ownership") but not defenses ("equities of defense"), Chafee, *supra* note 45, at 1104, 1108, 1129, although Chafee thought that the first two decisions cited above went too far in allowing the destruction of defenses, *id.* at 1129 n.70. Curiously enough, this "liberal" pre-NIL rule as to commercial paper was not adopted for investment securities where it might more logically apply, *Belo v. Commissioners of Forsyth County*, 76 N.C. 489, 494 (1877) (defenses to municipal bonds available against a purchaser of overdue bonds), and, of course, the NIL when enacted, precluded HDC status as to overdue paper, NIL § 58, N.C. GEN. STAT. § 25-64 (1953). Thus the Code adopts for investment paper the ancient North Carolina rule for commercial paper and rejects the corresponding rule previously applied to investment securities.

¹¹⁹ N.C. GEN. STAT. § 25-58 (1953).

¹²⁰ G.S. §§ 25-3-302(1)(c), -304(3).

¹²¹ See G.S. § 25-8-203(1)(b) (two-year grace period).

¹²² See G.S. § 25-8-305(1)(a) (one-year grace period).

¹²³ The most spectacular illustration is the circulation of Czarist Russian bonds until well after the Second World War.

periods for free circulation have expired, all defenses of the issuer may come in against even a purchaser for value without notice of the particular defect.

Finally, although it is not properly deemed a defense, the Code recognizes the issuer's established corporate-law privilege of looking solely to the person in whose name the security is registered and ignoring the beneficial owner who has not as yet had the security registered into his name.¹²⁴

G. Stock Transfer Restrictions

Of increasing importance today is the stock transfer restriction, which involves an interplay of the Code,¹²⁵ corporation law, securities regulation, and even corporate taxation. The classic use of the restriction occurs in close corporations that do not want their shares to go outside the original group or at least to persons not approved by the directors or shareholders. It can serve an ancillary purpose for electing "small business corporations" under Subchapter S of the Internal Revenue Code, for it is the most reliable way to insure that, during the period when the election is to remain in effect, there will be no more than ten individual shareholders—one of the prerequisites for claiming Subchapter S's special treatment.¹²⁶

More recently, varieties of transfer restrictions, with or without a so-called "stop transfer" notice with the issuer or its transfer agent,¹²⁷ have been used by large corporations seeking to preserve intact some exemption under federal (and occasionally state) securities statutes. Often the issuer will "privately place" an issue of securities, typically with some institutional investor, rather than make a public offering,¹²⁸ and it will wish to prevent the "placee"

¹²⁴ G.S. § 25-8-207(1), following the rule of the Uniform Stock Transfer Act, N.C. GEN. STAT. § 55-77 (1965), and of the provisions of the corporation law, N.C. GEN. STAT. §§ 55-59 (general rule), -60(a) (record date), -62(a) (notice of meetings), and -60(b) (dividends and other distributions).

¹²⁵ G.S. § 25-8-204 is, of course, not limited to stock, but applies to all securities. Almost always the question arises in connection with proposed or consummated stock transfers, but it could be equally important in the case of, say, bonds convertible into stock.

¹²⁶ INT. REV. CODE OF 1954, § 1371(a) requires that the corporation not have more than ten shareholders, all of whom are natural persons or an estate, and none of whom are nonresident aliens.

¹²⁷ See G.S. § 25-8-403. This is discussed in text accompanying notes 254-64 *infra*.

¹²⁸ Section 4(1) of the Securities Act of 1933, 48 Stat. 77, 15 U.S.C. § 77d(1) (1964), exempts from registration "transactions by an issuer not

from selling the securities to the public and thereby retroactively impose on the issuer possible liability under state and federal statutes for sale of unregistered securities. The restriction may also be useful in connection with an offering that must be confined to a single state to avoid federal registration, by preventing local purchasers from reselling the shares outside the state and thereby destroying the intrastate exemption.¹²⁹ So, too, the issuer may be concerned to see that a so-called "control person" does not bring about a sale of its shares without registration.¹³⁰ Accordingly, issuers often stamp certificates with a legend such as:

The shares represented by this certificate have not been registered under the Securities Act of 1933. The shares have been acquired for investment and may not be pledged or hypothecated, and may not be sold or transferred in the absence of an effective Registration Statement for the shares under the Securities Act of 1933, or an opinion of counsel for the Company that registration is not required under said Act.¹³¹

Even if it would not deter a holder from attempting to sell the stamped certificate, a broker would hesitate to participate in such a sale; the purchaser would take the certificate with notice of the restriction and would likely be unable to induce the transfer agent to register the shares in his name. A restriction of this sort has been held valid.¹³² The North Carolina court in *Altman v. American Foods, Inc.*¹³³ also was faced with such a restriction, imposed

involving any public offering." Somewhat similar exemptions appear in state "blue sky" statutes. See, e.g., N.C. GEN. STAT. § 78-4 (1965).

¹²⁹ Section 3(a)(11) of the Securities Act of 1933, 48 Stat. 75, 15 U.S.C. § 77c(a)(11) (1964), exempts from registration "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within such State or Territory."

¹³⁰ Under § 2(11) of the Securities Act of 1933, 48 Stat. 74, 15 U.S.C. § 77b(11) (1964), a person who controls an issuer (e.g., a corporation) is himself treated as an issuer, and those who sell for him become statutory underwriters. For a definition of the term "control," see Rule 405 of the Rules and Regulations of the Securities and Exchange Commission under the Securities Act of 1933.

¹³¹ Quoted from Israels, *When Corporations Go Public* 22-23 (1962). See the form of restriction in *Altman v. American Foods, Inc.*, 262 N.C. 671, 672, 138 S.E.2d 526, 528 (1964).

¹³² *General Dev. Corp. v. Catlin*, 139 So. 2d 901 (Fla. Dist. Ct. App. 1962) (sustaining corporation's right to stamp stock certificates with a legend that the shares were purchased "for investment and not with a view to distribution").

¹³³ 262 N.C. 671, 138 S.E.2d 526 (1964).

to preserve the intrastate exemption for certain securities, but did not have to pass on its validity. In that case, the court held that a purchaser of the restricted shares could rescind the transaction on a showing that the corporation had failed to disclose that the shares would not be registered and would be restricted as to sale; "its failure to discharge this duty made the stock it tendered [the purchaser] substantially different from the stock it had agreed to sell him."¹³⁴ Arguably, the court has impliedly approved the reasonableness of such a restriction in granting rescission instead of invalidating the restriction and recognizing a right to disregard it and sell the shares.

The Code provision¹³⁵ leaves the substantive validity of stock transfer restriction untouched. All it does is to provide, as did the Uniform Stock Transfer Act counterpart,¹³⁶ that any transfer restriction "otherwise lawful" must be "noted conspicuously on the security," although actual knowledge will be legally equivalent to the notation. Thus, a restriction, even though impeccably legal the common law (such as a first-option arrangement or a buy-and-sell agreement) will fail unless it complies with the Code formalities; but a restriction that is doubtlessly voidable at common law (for instance, an absolute restraint on alienation of shares) would gain nothing simply because it is "noted conspicuously" on the certificate. Substantive validity of any proposed restriction must be measured under local corporation and property rules governing restraints on alienation.¹³⁷ Even though a restriction is "noted conspicuously" as the Code requires, it is also important that the restrictions appear in the articles of incorporation and perhaps also in a written agreement among shareholders so that even if the provision in the articles is modified, the written agreement will stand unless all parties consent to its modification.¹³⁸

¹³⁴ *Id.* at 675, 138 S.E.2d at 530.

¹³⁵ G.S. § 25-8-204.

¹³⁶ N.C. GEN. STAT. § 55-89 (1965).

¹³⁷ North Carolina is fortunate in recognizing a broader spectrum of stock transfer restrictions than most states. Besides first options and buy-and-sell agreements, *Wright v. Iredell Tel. Co.*, 182 N.C. 308, 108 S.E. 744 (1921), upheld as reasonable a requirement that directors of a corporation consent to a proposed sale of shares, at least where the directors had come forward with other purchasers at the same price as offered to the proposed seller. The best study of stock transfer restrictions is found in 2 O'NEAL, *CLOSE CORPORATIONS: LAW AND PRACTICE* 1-80 (1958).

¹³⁸ G.S. § 25-8-204 does not apply to transfer restrictions other than those imposed by the issuer. Thus a private agreement among shareholders

III. PURCHASERS AND TRUE OWNERS: RIGHTS INTER SE

The Code treatment of disputes between the true owner and the purchaser of a security can be briefly stated; the balance of this part of the article merely elaborates these propositions. Adverse claims to a security—that is, property interests opposed to those of the transferee¹³⁹—are extinguished if the security is held by a bona fide purchaser.¹⁴⁰ Like the holder in due course of commercial paper, the bona fide purchaser (1) gives value, (2) purchases in good faith, (3) has no notice of adverse claim, and (4) acquires the security through a formally perfect transfer.¹⁴¹ If the security is in bearer form, delivery alone suffices.¹⁴² If it is in registered form, the security must be indorsed either in blank or specially by one who is an “appropriate person”¹⁴³ as of the date of signing,¹⁴⁴ and it must be delivered.¹⁴⁵ Even though the transfer is “wrongful,” *e.g.*, in breach of trust or without a necessary court order or the like, the transfer is effective if an “appropriate person” indorsed.¹⁴⁶ The transferee may be a bona fide purchaser if he meets the other requisites for that status; and, as we see later, the purchaser may compel the issuer to recognize him as owner by registering transfer of the security into the purchaser’s name.¹⁴⁷ But if, instead of a merely wrongful transfer, the indorsement is “unauthorized”¹⁴⁸—usually because

need not be “noted conspicuously” on the certificate, although it would be good practice to do so in order to give notice to any person taking the security in violation of the agreement.

¹³⁹ See G.S. § 25-8-301(1) for the definition of “adverse claim” as including “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”; the adjective “adverse” is an undefined term. Compare the similar definition of “claim of beneficial interest” in the Simplification Act, N.C. GEN. STAT. § 32-14(2) (Supp. 1965).

¹⁴⁰ G.S. § 25-8-301(2). Pre-Code law was the same. See cases cited in G.S. § 25-8-301, N.C. comment, especially *Scottish Bank v. Atkinson*, 245 N.C. 563, 96 S.E.2d 837 (1957) (Stock Transfer Act).

¹⁴¹ This paraphrases the definition of bona fide purchaser in G.S. § 25-8-302. The formal requisites of a bona fide purchaser who may cut off claims, and of the “purchaser for value and without notice” who may extinguish issuer defenses, G.S. § 25-8-202(1), are the same except that the bona fide purchaser definition adds the language concerning a formally perfect transfer by delivery or by indorsement and delivery.

¹⁴² G.S. § 25-8-302.

¹⁴³ G.S. §§ 25-8-302, -308(1)

¹⁴⁴ G.S. § 25-8-308(6).

¹⁴⁵ G.S. §§ 25-8-302, -309 (indorsement without delivery).

¹⁴⁶ G.S. §§ 25-8-302, -308(1), -315(1).

¹⁴⁷ G.S. § 25-8-401.

¹⁴⁸ As defined in G.S. § 25-1-201(43).

forged—the transfer is ineffective despite indorsement and delivery,¹⁴⁹ and the “adverse claim” of the true owner will prevail, unless, as we later see, the issuer has in fact registered transfer into the innocent purchaser’s name and he has received a new certificate in his name,¹⁵⁰ in which case the issuer remains absolutely liable to the true owner.¹⁵¹ It is of central importance to grasp this distinction between the transfer that is wrongful because the indorsement is “unauthorized” and the transfer that is wrongful for reasons other than an “unauthorized” indorsement, for on this distinction hang most of the relevant law and prophets.

In this part of the article we examine the Code treatment of rights among various claimants of a security; in the following section we consider claimants’ rights against the issuer-transfer agent who holds a strategic position because of his traditional trustee-like obligation to police the rightfulness of all securities transfers—an obligation much modified by the Code and by several predecessor statutes of more specialized application.

Both here and later, we chiefly look to problems arising out of transfer of securities in registered form. Bearer-form securities are less important than those in registered form if only because all American shares are in registered form.¹⁵² Moreover, bearer-form securities are transferred by delivery alone; such few problems as they raise are dealt with when we examine Code concepts of “delivery.” Thus, the primary focus of the article is on securities in registered form.

A. Indorsements

1. *Form.*—If the security is in registered form, an indorsement is essential to complete the transfer between the transferor and

¹⁴⁹ G.S. §§ 25-8-311, -315(2).

¹⁵⁰ In particular, see G.S. § 25-8-311(a).

¹⁵¹ G.S. §§ 25-8-311(b), -404(2).

¹⁵² Apparently bearer bonds are less favored today. When one large bond issue gave bondholders an option of bearer or registered bonds, 80% of the buyers chose the latter. Apparently, institutional investors in a “private placement” prefer a single registered security over coupon bonds. Efficiency and cost savings are sometimes suggested as reasons that both issuers and banks now back the trend to fully registered bonds. Although at one time registered bonds sold at a slight discount from their coupon counterparts, apparently reflecting some vague feeling that registered bonds might be less freely negotiable, one prominent figure at the time predicted that this differential would soon be eliminated. Wall Street Journal, July 9, 1963.

transferee, at least so as to constitute the transferee a bona fide purchaser.¹⁵³ Indeed, even though the security has been delivered to the transferee, the latter cannot become a bona fide purchaser until indorsement is furnished, but the purchaser may compel the seller to furnish the necessary indorsement.¹⁵⁴ Not only is the indorsement necessary to perfect the transfer between the parties, but also to enable the purchaser to have the issuer register the transfer into his name. Since the transfer agent will properly refuse registration without the indorsement of the owner,¹⁵⁵ the purchaser may compel the seller to furnish the indorsement to him with this "requisite which may be [and clearly is] necessary to obtain registration of the transfer of the security."¹⁵⁶

So far as the form of indorsement is concerned, it may be either special or in blank¹⁵⁷ as is true of commercial paper.¹⁵⁸ Unlike commercial paper,¹⁵⁹ however, a security may be duly indorsed on a separate unattached document,¹⁶⁰ and, indeed, sometimes a man of caution will send a security forward without signing the "stock power" on the back of the certificate, and separately mail the document formally transferring it—a practice consistent with the Code.

2. *Effect.*—In another respect, indorsing a security is different from indorsing commercial paper. Unless indorsed without recourse, the indorser of commercial paper undertakes to pay the instrument if it is dishonored and due process on dishonor are taken.¹⁶¹ Al-

¹⁵³ G.S. § 25-8-302.

¹⁵⁴ G.S. § 25-8-307. As a consequence, a purchaser may receive notice of an adverse claim between delivery and indorsement, and since bona fide-purchaser status is fixed as of the indorsement date, the delay may preclude the purchaser from becoming a bona fide purchaser and thus prevailing over the true owner. In that case, the purchaser (if he gave value) would have a right over on the transferor's warranty that the transfer is "effective and rightful," *i.e.*, is not subject to adverse claims. G.S. § 25-8-306(2)(a). Presumably, if the unindorsed but already delivered security carried a so-called "indorsement guarantee," see G.S. § 25-8-312(2), the purchaser would have a right against the guarantor since this warranty runs "to any person taking or dealing with the security in reliance on the guarantee." G.S. § 25-8-312(3).

¹⁵⁵ G.S. §§ 25-8-401(1)(a) ("the issuer is under a duty to register the transfer as requested if (a) the security is indorsed by the appropriate person or persons"), -404(1)(a) ("the issuer is not liable to the owner . . . as a result of the registration of a transfer of a security if (a) there were on or with the security the necessary indorsements").

¹⁵⁶ G.S. § 25-8-316.

¹⁵⁷ G.S. § 25-8-308(2).

¹⁵⁸ G.S. § 25-3-204.

¹⁵⁹ G.S. § 25-3-202(2).

¹⁶⁰ G.S. § 25-8-308(1).

¹⁶¹ G.S. § 25-3-414(1).

though never previously expressed in prior statutes, the common understanding was that indorsing a security was equivalent to a qualified indorsement, even though the transferor did not so limit his liability. Obviously, the seller of a bond would not wish to guarantee the issuer's payment of interest and principal. Accordingly, the Code expressly states that indorsement implies no understanding as to honoring the security, "unless otherwise agreed,"¹⁶² an unlikely event.

3. *"Appropriate Person."*—In order effectively to transfer a registered form security it must be indorsed, in the words of the Uniform Stock Transfer Act, "by the person appearing by the certificate to be the owner of the shares represented thereby"¹⁶³ or, as the Code expresses the same idea, by the "appropriate person."¹⁶⁴ The Code then gives a comprehensive list of "appropriate persons" whose signatures on the security are effective as indorsements.¹⁶⁵ The most obvious and common situation is the person "specified by the security or by special indorsement to be entitled to the security,"¹⁶⁶ i.e., the true owner of the security. Therefore, the security may specify an individual, a partnership, a corporation, or fiduciaries of various sorts and descriptions. If so, the person named in the security, "or his successor," is an "appropriate person" to indorse. For instance, a certificate names "John Smith, trustee of a trust under the will of Samuel Settlor." Smith is an "appropriate person" to indorse the security. If Smith has been succeeded by Centerville National Bank as trustee, that bank is also an "appropriate person" to indorse. And if Centerville National Bank merges into Central Carolina Bank and Trust Company, the latter bank would be an "appropriate person" to indorse. These latter examples also point up the fact that, in many instances, an indorsement will be by agent, and the Code recognizes the appropriateness of the "authorized agent" of anyone who is otherwise an "appropriate person."¹⁶⁷ Accordingly, Central Carolina's indorsement by the duly authorized trust officer would clearly be sufficient under the Code. This is nonetheless true with holdings of securities by corporations other than banks. In an analogous situation, an executor, administrator,

¹⁶² G.S. § 25-8-308(4).

¹⁶³ N.C. GEN. STAT. § 55-80 (1965).

¹⁶⁴ G.S. § 25-8-308(1).

¹⁶⁵ G.S. § 25-8-308(3).

¹⁶⁶ G.S. § 8-308(3)(a).

¹⁶⁷ G.S. § 25-8-308(3)(g).

guardian, or similar fiduciary is an "appropriate person" to sign a security when the individual owner is unable to act because of his death, incompetence, infancy, etc.¹⁶⁸

The "appropriateness" of a person to indorse a security is determined when he signs and is not affected by subsequent events.¹⁶⁹ Thus, if a security registered in the name of Henry Harris is indorsed by Albert Atkins, his authorized agent, on January 1, termination of the agency on January 2 does not invalidate the indorsement and Atkins' signature must be accepted by the transfer agent as that of an "appropriate person" when it is presented for registration of transfer on January 15. So, too, the removal of a trustee immediately after he indorsed a security does not affect the "appropriateness" of his indorsement. Of course, such events as termination of the agency or removal of the trustee may make the delivery of the security wrongful, but this is a different problem. So long as the security has been indorsed by a person appropriate at that time, it is effective as an indorsement, and a bona fide purchaser will extinguish the claims of the "true owner."

If some signature other than that of an "appropriate person" appears on the security, it will be ineffective. Thus, a purchaser of shares under contract would properly refuse to take shares naming Henry T. Smith, Sr. as owner if indorsed "Henry T. Smith, Jr.," or "Mary Ann (Mrs. Henry T. Smith, Sr.)"; nor would one likely accept shares naming "First National Bank, as Trustee for Ezra Mannon," if the certificate was indorsed "Ezra Mannon." But even if a certificate so defectively indorsed got that far, the transfer agent would have no duty to register the transfer into the purchaser's name¹⁷⁰ and in refusing would incur no liability.¹⁷¹

¹⁶⁸ G.S. § 25-8-308(3)(d). The other subsections of G.S. § 25-8-308(3) state convenient rules for special situations. Thus, if shares are held by Smith and Jones as co-trustees, and Smith just died, Jones would still be an "appropriate person" to indorse even though a successor to Smith has not yet been named. G.S. § 25-8-308(3)(c). A special rule is stated for tenants by the entirety or with right of survivorship, so that the survivor may appropriately indorse. G.S. § 25-8-308(3)(e). Also under G.S. 25-8-308(3)(f), "a person having power to sign under applicable law or controlling instrument" is an "appropriate person." The Code comments cite as an example a "small estate statute" which authorizes a widow to transfer securities of her dead husband without administration proceedings. G.S. § 25-8-308, comment 4.

¹⁶⁹ G.S. § 25-8-308(6).

¹⁷⁰ G.S. § 25-8-401(1)(a).

¹⁷¹ G.S. § 25-8-404(1)(b).

Of course, the signature of an "appropriate person" may be forged, but here the fact of forgery would be controlling; the indorsement, purportedly that of the "appropriate person," is ineffective, and reliance by a purchaser or by a transfer agent would not preclude the true owner from asserting his rights. The concept of "appropriate person" and "unauthorized indorsement," are not congruent, for an appropriate person's signature may be "unauthorized" in the Code sense, which includes forgery.¹⁷²

B. Delivery

1. *Concept of Delivery.*—Although throughout the Code "delivery" carries its basic meaning of "voluntary transfer of possession,"¹⁷³ its content is more complex and subtle as applied to investment securities than as applied to commercial paper. Delivery alone transfers bearer-form securities: If a registered-form security has been indorsed, it is necessary to complete transfer. In a typical securities transaction, "delivery" of a security will occur several times. It is useful to work from the simpler to the more complex procedures, although in each instance we see the root idea of voluntary transfer of possession.

(1) *S* and *P* (seller and purchaser respectively) are friends and residents of Chapel Hill. *S* agrees to sell *P* 1000 shares of GM with a view to saving brokerage commissions of nearly 500 dollars. *S* indorses and simply hands over to *P* the indorsed GM certificates. This is good delivery under the Code, which recognizes physical transfer as the original elemental form of delivery.¹⁷⁴

(2) *P* tells his bank that he would like to have some bank stock. The bank tells him that although the stock is rarely traded, it usually hears of any stock available and will let him know. Later the bank learns that *S*'s estate wishes to sell 200 shares, notifies *P*, and gets his approval to buy. *S*'s executor indorses and delivers the certificates to the bank. Under the Code this is good delivery to the purchaser since "a person designated by him [has] acquire[d] possession" of the security;¹⁷⁵ physical transfer by the executor to

¹⁷² The two ideas come together in a confusing sort of way in considering when an "authorized agent" is an "appropriate person."

¹⁷³ G.S. § 25-1-201(14).

¹⁷⁴ G.S. § 25-8-313(1)(a). *S* also fulfills his duty of delivery. G.S. § 25-8-314(2).

¹⁷⁵ G.S. § 25-8-313(1)(a). For Code purposes a bank may be a "broker," G.S. § 25-8-303, in securities transactions for customers.

the bank fulfills *S*'s duty of delivery under the contract of sale.¹⁷⁶

(3) The preceding transaction, although somewhat unusual, resembles many over-the-counter trades. If *P* had ordered his broker to obtain the bank stock, delivery to the purchaser would be complete when the broker acquired possession of the security indorsed to or issued in the name of the purchaser,¹⁷⁷ and the seller's duty of delivery would also be completed at that point.¹⁷⁸ Furthermore, if the security were then lost or destroyed, *P* would bear the risk.

(4) The transaction can now be made more complicated (and more typical). *S* orders his broker in Charlotte to sell 1000 shares of GM on the New York Stock Exchange, while simultaneously *P* in Asheville orders his broker to buy 1000 GM shares. The chances are remote that *P* will get *S*'s certificate, but if it were to happen it would involve several acts of delivery. (a) In all events, *S* will deliver the certificate duly indorsed to his broker, the "selling broker," thus completing *S*'s Code duty of delivery.¹⁷⁹ (b) Conceivably but unlikely, the selling broker might deliver this very security to the "buying broker," in which case the former's duty of delivery is complete under the Code.¹⁸⁰ (c) Even less likely, the buying broker would deliver the certificate to *P* who would later present it to the issuer or its transfer agent for registration of transfer into *P*'s name.

(5) While this illustrates multiple deliveries, it is unlikely that either *P* or his broker would get *S*'s old certificate. In a typical exchange transaction, *S* will deliver his certificate to his broker indorsed in blank, thereby fulfilling his (*S*'s) duty of delivery.¹⁸¹ The selling broker will probably have the shares represented by this certificate registered into the name of a nominee acceptable under the rules of the New York Stock Exchange.¹⁸² It is this nominee certificate which is normally transferred between selling and buying brokers and among any correspondent brokers standing between them. Under the Code, *S*'s own broker and any corre-

¹⁷⁶ G.S. § 25-8-314(2).

¹⁷⁷ G.S. § 25-8-313(1)(b).

¹⁷⁸ G.S. § 25-8-314(1)(a).

¹⁷⁹ G.S. § 25-8-314(1)(a).

¹⁸⁰ G.S. § 25-8-314(1)(b).

¹⁸¹ G.S. § 25-8-314(1)(a).

¹⁸² See N.Y. STOCK EXCH. RULES 199-201. See also *Israel's, Investment Securities Problems—Article 8 of the UCC*, 11 How. L.J. 120, 123-25 (1965).

spondent brokers acting for *S* fulfill their respective duties of delivery when the security "or a like security" comes into the possession of the buying broker or someone acting for the buying broker.¹⁸³ Given this sequence of events, it is improbable that *S*'s certificate will travel through the entire transaction, since (a) it will likely be registered out of his name at an early stage, and (b) the selling broker (or a correspondent acting for him) need not deliver the nominee certificate obtained by the selling broker but instead a "like security," since under the Code securities of the same issuer and same class, *e.g.*, GM common, are treated as fungible.¹⁸⁴

In this typical transaction, at what point does delivery to the purchaser occur? This depends upon arrangements between *P* and the buying broker. Since *P* is entitled to a certificate issued to him in his name, delivery to *P* would occur when such a certificate is received by *P*'s broker.¹⁸⁵ But if *P*'s broker has custody of *P*'s securities, holding them in "street name," the act of delivery to *P* occurs when the broker sends *P* a confirmation of the purchase and "by book entry or otherwise identifies a specific security in the broker's possession as belonging to the purchaser."¹⁸⁶

(6) The Code also recognizes recent developments in processing the increasing number of stock transactions through stock clearance procedures analogous to familiar check clearing practices.¹⁸⁷ Under this arrangement securities are held by a "clearing corporation"¹⁸⁸ or a "custodian bank,"¹⁸⁹ either in bearer form or indorsed in blank or registered in the name of the clearing corporation or custodian bank.¹⁹⁰ Securities may then be transferred among members of the clearing corporation simply upon making entries on the clearing corporation's books, and, indeed, entries may be made on a net basis.¹⁹¹ Such a transfer of securities by book entry constitutes delivery to the purchaser of the security.¹⁹² Hence, delivery can

¹⁸³ G.S. § 25-8-314(1)(b).

¹⁸⁴ See G.S. § 25-1-201(17) defining "fungible" to include "securities of which any unit is, by . . . usage of trade, the equivalent of any other like unit."

¹⁸⁵ G.S. § 25-8-313(1)(b).

¹⁸⁶ G.S. § 25-8-313(1)(c).

¹⁸⁷ This is recognized by G.S. § 25-8-320.

¹⁸⁸ G.S. § 25-8-102(3).

¹⁸⁹ G.S. § 25-8-102(4).

¹⁹⁰ G.S. § 25-8-320(1).

¹⁹¹ G.S. §§ 25-8-320(1), (2).

¹⁹² G.S. §§ 25-8-313(1)(e), -320(3).

occur at an early step in the transfer proceedings and since, by hypothesis, it has already been indorsed, the purchaser may, at that time, become a bona fide purchaser of his security or at least of an interest in a fungible bulk of securities. The New York Stock Exchange established the Stock Clearing Corporation, to which many Exchange members belong, and its operations have become largely automated.¹⁹³

2. *Effect of Delivery.*—Under the Code, delivery is necessary to give the purchaser bona fide-purchaser status.¹⁹⁴ Moreover, after delivery, the purchaser is “owner” of the securities.¹⁹⁵ This may be significant if they are held by a broker who becomes insolvent, for the purchaser-owner may then be able to reclaim his securities rather than see them become a part of the broker’s insolvent estate.¹⁹⁶ The purchaser is also the “owner” of a proportionate property interest if his GM shares are retained by his broker along with the GM shares of other customers and these interests are represented by a single large denomination GM certificate in “street name.”¹⁹⁷ Moreover, the purchaser is “holder”¹⁹⁸ of the securities delivered to him even though they remain in the broker’s custody.¹⁹⁹

C. Unauthorized Indorsement v. Wrongful Transfer

1. *Unauthorized Indorsement.*—As a technical matter, under the Code one who has the misfortune to acquire a security with a forged or otherwise “unauthorized” indorsement may be a bona

¹⁹³ See CCH N.Y. STOCK EXCH. GUIDE ¶¶ 3001-324 (1959) for rules of the Stock Clearing Corp. Last summer the Exchange announced that by April 1966 “its computerized system for reducing physical delivery of stock certificates among member firms” will be “in full operation.” Wall Street Journal, June 10, 1965.

¹⁹⁴ G.S. § 25-8-302. Delivery of any security of itself gives the purchaser whatever “rights in the security which his transferor had or had actual authority to convey.” G.S. § 25-8-301(1). Of course, if the security is in registered form, the purchaser may compel an indorsement. G.S. §§ 25-8-307, -316.

¹⁹⁵ G.S. § 25-8-313(2).

¹⁹⁶ G.S. § 25-8-313, comment 3.

¹⁹⁷ G.S. § 25-8-313(2).

¹⁹⁸ G.S. § 25-1-201(20).

¹⁹⁹ G.S. § 25-8-313(2). If shares are margined, only the broker is “holder” of the securities (obviously necessary so that he can sell the shares if necessary), although the purchaser is still “owner.” See G.S. §§ 25-8-313(1)(d), -313(2).

fide purchaser,²⁰⁰ but even as to such a purchaser the demand of the true owner will prevail since he may reclaim the security, or obtain a new one in its place. In short, the bona fide purchaser loses. There are two possible methods of solution, but neither is wholly effective, however.

(a) If *B* the purchaser must restore the certificate, he may be able to recover on warranties.²⁰¹ Clearly, one of his warranty rights against the transferor—that the “transfer is effective and rightful”—would cover an unauthorized indorsement.²⁰² However, the recovery may not be worth much. Certainly, the seller, who we assume forged the indorsement, would be an unlikely source of recovery. If the transfer went through the organized markets—and assuming that the forger had not been caught earlier—recovery against the purchaser’s broker would also be improbable, since the broker as immediate transferor warrants only that “his transfer is effective and rightful” and that “he knows no fact which might impair the validity of the security.”²⁰³ A possible second warranty recovery, however, does appear more promising. If the security goes through the organized markets, it will routinely carry a signature guarantee confirming that the signature is genuine, the signer was an appropriate person to indorse, and had legal capacity to sign.²⁰⁴ Since this warranty runs to “any person taking . . . the security in reliance on the guarantee” and exacts liability “to such persons for any loss resulting from the breach of the warranties,”²⁰⁵ the purchaser would be able to recover; and since signature guarantees are normally given only by responsible institutions, recovery should be good.²⁰⁶ This is suggested as the proper construction of the Code provision; although “purchasers” are not mentioned, and the signature guarantee chiefly protects the transfer agent, the term

²⁰⁰ See G.S. § 25-8-315(2), which states that if the transfer is wrongful because of an unauthorized indorsement, the true owner may reclaim the security “even from a bona fide purchaser. . . .”

²⁰¹ See G.S. § 25-8-306(2) for the transferor’s warranties, which are similar to those under the Stock Transfer Act, N.C. GEN. STAT. § 55-85 (1965).

²⁰² G.S. § 25-8-306(2)(a).

²⁰³ G.S. § 25-8-306(2)(c).

²⁰⁴ These are the three warranties of the signature guarantor. G.S. § 25-8-312(1).

²⁰⁵ G.S. § 25-8-312(3).

²⁰⁶ Under G.S. § 25-8-402(2) the transfer agent may always require a signature guarantee “signed by or on behalf of a person reasonably believed by the issuer to be responsible.”

"any person"²⁰⁷ would include a purchaser, although not the true owner.²⁰⁸

(b) The bona fide purchaser may prevail over the true owner in the single situation²⁰⁹ where he presents the security to the transfer agent for registration into his own name, and thereafter receives a new certificate in his name.²¹⁰ The theory is that (i) the transfer agent will likely catch forgeries if anyone can, and (ii) if the forged certificate can pass muster with the transfer agent, the purchaser who receives a new certificate should keep it. In fact what happens is that at this point the liability of transfer agent is substituted for that of purchaser, so that the purchaser may keep his new security²¹¹ but the transfer agent is absolutely liable to give the true owner a new security.²¹² Since the old security will carry a signature guarantee, the institution guaranteeing the security ultimately carries the risk, which in turn can be insured against.

2. *Wrongful Transfer*.—Different consequences follow if the indorsement is authorized but the transfer is otherwise wrongful. For instance, an agent may be an "appropriate person" and also "authorized" to indorse a security,²¹³ but not privileged to deliver it, *e.g.*, to his own bank to secure his own loan, or to a broker to sell for him, etc. Similarly, a trustee may be an "appropriate person" and "authorized" to indorse a security in a fiduciary name,²¹⁴ but privileged to deliver it only on court order or in accordance with trust terms, etc. The Code view is that defective authority to deliver a security is less serious than an unauthorized indorsement. Accordingly, a bona fide purchaser takes free and clear of all "adverse claims" to the security,²¹⁵ such as that of the principal or the trust beneficiary or a successor trustee. This does not depend upon the pur-

²⁰⁷ G.S. § 25-8-312(1). "Person" includes an individual or an organization," G.S. § 25-1-201(30), and "organization" includes corporations, trusts, estates, partnerships, and several other entities or communities of interest, G.S. § 25-1-201(28).

²⁰⁸ *Love v. Pennsylvania R.R.*, 200 F. Supp. 561 (E.P. Pa. 1961); *Eulette v. Merrill Lynch, Pierce, Fenner & Beane*, 101 So. 2d 603, 606 (Fla. App. 1958).

²⁰⁹ Except that a true owner may have ratified an unauthorized indorsement or otherwise precluded himself from asserting its effectiveness. G.S. § 25-8-311 (preamble).

²¹⁰ G.S. §§ 25-8-311(a), -315(2).

²¹¹ G.S. § 25-8-311(a).

²¹² G.S. §§ 25-8-311(b), -404(2).

²¹³ G.S. § 25-8-308(3)(g).

²¹⁴ G.S. § 25-8-308(3)(a).

²¹⁵ G.S. § 25-8-315(1).

chaser's receiving a new security in his own name; indeed, as a bona fide purchaser, he is entitled to registration of transfer,²¹⁶ and the transfer agent would be liable for refusing to do so.²¹⁷

What, then, are the rights of the "true owner," the one asserting "adverse claims?" In general, they are against the wrongdoer, *e.g.*, the defaulting agent or trustee. The true owner obviously cannot claim under warranties of the seller²¹⁸ or the signature guarantor,²¹⁹ nor would the wrongdoer's broker be liable to the true owner.²²⁰ Thus, so long as the indorsement is authorized and by an appropriate person, the Code elevates its policy of promoting free transfer of securities over the interests of the true owner.

This is best illustrated by the fiduciary-owned security. Under the Code, neither purchaser nor any brokers need inquire whether a transfer is rightful even though they have notice that the security is registered or indorsed in the name of a fiduciary.²²¹ Thus, the purchaser may simply assume that the fiduciary is acting rightfully and need not raise doubts. The purchaser's protection is limited by (a) any knowledge that the fiduciary transaction is for the fiduciary's personal benefit or otherwise in breach of duty,²²² or (b) the overriding Code obligation of "good faith," that is, "honesty in fact in the conduct or transaction concerned."²²³

IV. PURCHASERS AND TRUE OWNERS: RIGHTS TO REGISTRATION OF TRANSFER

Part IV of Article 8 states for the first time in any uniform statutes of general application the duties and liabilities of the issuer²²⁴ in registering transfers of securities. The extent to which

²¹⁶ G.S. § 25-8-401(e).

²¹⁷ G.S. § 25-8-404(2).

²¹⁸ G.S. § 25-8-306(2).

²¹⁹ G.S. § 25-8-312. See note 208 *supra*.

²²⁰ G.S. § 25-8-318.

²²¹ G.S. § 25-8-304(2).

²²² G.S. § 25-8-304(2). The Simplification Act, N.C. GEN. STAT. § 32-20(a) (Supp. 1965), is in accord.

²²³ G.S. § 25-1-201(19). See *Israel's, Investment Securities Problem—Article 8 of the UCC*, 11 How. L.J. 120, 140-41 (1965), for a good hypothetical fact situation illustrating this point.

²²⁴ Throughout this part of the article, I have used the terms "issuer" and "transfer agent" interchangeably when discussing transfer registration. This accords with G.S. § 25-8-201(3), which form defines "issuer" as a "person on whose behalf transfer books are maintained." See also G.S. § 25-8-406(1), stating the duties of a transfer agent, registrar, or like person acting for an issuer in registering transfers of securities.

it alters prior law is less in North Carolina than elsewhere, since North Carolina previously enacted statutes facilitating transactions in fiduciary-owned securities, first by adopting in 1923 the Uniform Fiduciaries Act²²⁵ and then in 1959 the Uniform Act for Simplification of Fiduciary Security Transfers ("Simplification Act").²²⁶ Essentially, Part IV of Article 8 adapts the Simplification Act's theory to all securities transfers, whether or not owned by fiduciaries, and to that extent changes existing law outside of fiduciary security transfers. As to fiduciary security transfers, the Code and Simplification Act are substantively compatible although confusingly divergent in language; while the earlier act remains on the books (as recommended by the Code Commissioners), it can peacefully co-exist with the Code.²²⁷

A. The Common-Law Background

1. *Transfer on the Books of the Corporation.*—Many securities, especially stock, recite that they may be transferred on the books of the corporation (the issuer). This implied, and the theory came to be, that until the corporation's books were changed to show the new owner, the transfer of the shares was somehow incomplete. This logically implied that "transfer on the books" meant more than merely registering a completed transfer, but was integral to obtaining full and complete title to the shares.²²⁸ Characteristic language on stock certificates reflected this. The seller "assigned" his shares and appointed the purchaser (or someone else) as his "attorney" to bring about the "transfer" of the shares on the corporation's books. This terminology carries forward today so that, in the lingo of transfer agents and of some statutes such as the Simplification Act, a security is still "assigned"²²⁹ by its owner and then "transferred"²³⁰ when the corporation's books are changed to reflect the new owner.

²²⁵ In particular, see N.C. GEN. STAT. § 32-4 (1950).

²²⁶ N.C. GEN. STAT. §§ 32-14 to -24 (Supp. 1965).

²²⁷ G.S. § 25-10-104(2).

²²⁸ Of course, even today before stock has been registered into the purchaser's name, the "record title" still lodges in the seller who holds that record title in trust for the purchaser and subject to his instructions, including an obligation to give the purchaser a proxy.

²²⁹ N.C. GEN. STAT. § 32-14(1) (Supp. 1965) (definition of "assignment").

²³⁰ N.C. GEN. STAT. § 32-14(7) (Supp. 1965) (definition of "transfer" as "a change on the books of the corporation in the registered ownership of a security").

Despite the continued use of traditional terms, the underlying meaning has gradually changed. Since the Uniform Stock Transfer Act, delivery of the certificate duly indorsed has conveyed the seller's complete interest in the shares, whether or not this event has yet been recognized by the corporation.²³¹ This reveals more clearly the real meaning of (1) "transfer on the books of the corporation," and (2) the issuer's duty in connection with this act. Under the Stock Transfer Act²³² and corporation law,²³³ the issuer may exclusively rely on its records to determine stock ownership. This is to accommodate the issuer who must know, at any given time, to whom it must send out notices, whose vote or proxy it must honor, and who is entitled to dividends or interest or other distributions. Only collaterally is this intended to benefit the owner of the shares, although usually what is good for GM as issuer is good for the GM shareholder—to apply a famous aphorism in a more restricted context. Viewed this way, "transfer on the books" is logically immaterial to the actual transfer or conveyance of a property interest. Rather it is merely a matter of recording—"registering"—the transfer that has already occurred (if the seller has indorsed and delivered the certificate to the buyer or his agent), or is yet to occur (where the seller, or his agent, presents the certificate to the transfer agent for registration out of the seller's name, before sale—as in typical exchange transactions). So regarded, the issuer does not "transfer" the security in any meaningful sense. What he does is to record a transfer, completed or projected as the case may be. Hence "transfer on the books" has nothing more to do with this transfer than recording a deed has to do with the validity of the conveyance between the parties.

Accordingly, the Code has adopted language that accurately reflects what is going on. When the seller, an "appropriate person," indorses and delivers the stock certificate, he "transfers" it; when the certificate is presented and a new one issued in another name, the issuer or transfer agent "registers transfer."

2. *The Legal Rules.*—What are the issuer's duties and liabilities in connection with "registration of transfer?" Earlier we dis-

²³¹ This was clearly recognized by *Scottish Bank v. Atkinson*, 245 N.C. 563, 96 S.E.2d 837 (1957).

²³² N.C. GEN. STAT. § 55-77 (1965); the same is true under the Code G.S. § 25-8-207.

²³³ N.C. GEN. STAT. § 55-59 (1965).

tinguished transfers vitiated by an unauthorized indorsement and those impaired only by some defect in authority to deliver. For the issuer (or transfer agent) the problem is the scope of its duty to pursue adverse claims to a security presented for registration. The issuer had no duty of inquiry under early American decisions,²³⁴ which followed English cases,²³⁵ now codified into positive law.²³⁶ The issuer did remain liable for registering transfer when an indorsement was forged or otherwise unauthorized, but not when transfer was wrongful only because of some breach of trust or like duty.

An 1848 leading case²³⁷ decisively altered American law by broadly declaring that a corporation is

the custodian of the shares of stock, and clothed with power sufficient to protect the rights of everyone interested, from unauthorized transfers; it is a trust placed in the hands of the corporation for the protection of individual interests, and like every other trustee, it is bound to execute the trust with proper diligence and care, and is responsible for any injury sustained by its negligence or misconduct.²³⁸

The case held a corporation liable for breach of this trust in registering transfer of securities contrary to the provisions of a probated will when it had constructive notice of the will's terms. North Carolina decisions²³⁹ adhered to this doctrine, which supplanted the older view, so that the corporation was obligated at its peril to judge the rightfulness of any particular transfer by a fiduciary or other.²⁴⁰

Over the years North Carolina gradually eased the case-law rule, one of the most undesirable side-effects of which was to compel the issuer to overprotect itself by obtaining such extensive documentation of security transfers that serious delay and expense would result, at least for fiduciary security transfers.²⁴¹ The Uniform

²³⁴ *Bank of Virginia v. Craig*, 6 Leigh (50 Va.) 399 (1835).

²³⁵ *Hartga v. Bank of England*, 3 Ves. Jur. 56, 30 Eng. Rep. 891 (Ch. 1796).

²³⁶ Companies Act, 1948, 11 & 12 Geo. 6, c. 38, § 117.

²³⁷ *Lowry v. Commercial & Farmers' Bank*, 15 Fed. Cas. 1040 (No. 8581) (C.C.D. Md. 1848), was a decision by Chief Justice Taney on circuit.

²³⁸ *Id.* at 1047.

²³⁹ *King v. Richardson*, 136 F.2d 849 (4th Cir.), *cert. denied*, 320 U.S. 777 (1943); *Baker v. Atlantic Coastline R.R.*, 173 N.C. 365, 92 S.E. 170 (1917); *Wooten v. Wilmington & W.R.R.*, 128 N.C. 119, 38 S.E. 298 (1901); *Cox v. First Nat'l Bank*, 119 N.C. 302, 26 S.E. 22 (1896).

²⁴⁰ In particular, see *Baker v. Atlantic Coastline R.R.*, *supra* note 239, stating rules governing particular classes of fiduciaries.

²⁴¹ Some of the difficulties encountered by issuers and transfer agents

Fiduciaries Act relieved issuers and transfer agents of any duty to "inquire whether the fiduciary is committing a breach of his obligation . . . or to see to the performance of the fiduciary obligation" and exacted liability only if the issuer registered transfer with "actual knowledge" of the breach or otherwise in bad faith.²⁴² The Simplification Act carried this further and expressly relieved issuers and transfer agents of a general duty to inquire into the fiduciary relationship,²⁴³ authorized issuers to assume without inquiry the rightfulness of each transfer,²⁴⁴ negated constructive notice from publicly recorded documents,²⁴⁵ specified the limited documentation needed to register a fiduciary security transfer,²⁴⁶ and exonerated the issuer from liability for acts conforming to the statutory standards.²⁴⁷

The Code simply applies these Simplification Act standards to every registration of transfer. Issuers continue absolutely liable for registering transfer on unauthorized (including forged) indorsements but are given full relief from any consequences of registering a merely wrongful transfer, if they have no duty of inquiry or discharge such strictly limited duty as they may have. Before analyzing the issuer's *duty* to register transfer²⁴⁸ and its possible *liabilities* for registering²⁴⁹ or not registering transfer,²⁵⁰ we first note the issuer's obligation to investigate the rightfulness of transfer²⁵¹ and its privilege of demanding "assurances" that indorsements are effective.²⁵² The strictly limited duty to inquire is the chief survival of the common-law rules, while "assurances" concerning the indorsements protect the issuer in the only area of absolute liability—forged indorsements.

are recounted in Conrad, *New Deal for Fiduciaries Security Transfers*, 56 MICH. L. REV. 843 (1958).

²⁴² N.C. GEN. STAT. § 32-4 (1950). This was construed in *Carolina Tel. & Tel. Co. v. Johnson*, 168 F.2d 489 (4th Cir. 1948), to relieve the issuer in that case from liability for registering a stock transfer by a guardian who failed to account for the sale proceeds.

²⁴³ N.C. GEN. STAT. § 32-15 (Supp. 1965).

²⁴⁴ N.C. GEN. STAT. § 32-16(1), (2) (Supp. 1965).

²⁴⁵ N.C. GEN. STAT. § 32-16(3) (Supp. 1965).

²⁴⁶ N.C. GEN. STAT. §§ 32-17, -18 (Supp. 1965).

²⁴⁷ N.C. GEN. STAT. § 32-19 (Supp. 1965).

²⁴⁸ G.S. § 25-8-401(1).

²⁴⁹ G.S. § 25-8-404.

²⁵⁰ G.S. § 25-8-401(2).

²⁵¹ G.S. § 25-8-403.

²⁵² G.S. § 25-8-402.

B. Issuer's Responsibility: Duty to Inquire

Although the Code continues some issuer liability for registering "merely" wrongful transfers,²⁵³ it is no longer absolute as under the case law's trustee theory but turns upon extremely limited duty to investigate rightfulness. This duty of care is discharged by observing procedures that the issuer need follow only if it receives formal notice as to a specified adverse claim concerning a particular security. It is assumed that all indorsements are effective.

1. *Stop Transfer Orders.*—Code section 8-403 approves the so-called "stop transfer notice" which is lodged with an issuer or transfer agent to block registering a security transfer and may be used for many purposes, including protection of adverse claims.²⁵⁴ This partly duplicates existing provisions of the Simplification Act.²⁵⁵ The stop order to be effective, *i.e.*, to evoke the issuer's duty to inquire, must be written, must be received in time to provide a reasonable opportunity to act on it before registering transfer, and must identify the security, the registered owner, the claimant, and provide the claimant's address.²⁵⁶ This all means that the order is ineffective if (1) it is telephoned to the issuer or otherwise given orally, (2) is delayed in the mails, although the claimant is not at fault, or is never received, or (3) is otherwise deficient. These requirements are reasonable since a stop transfer order can only be effectively honored if it is a form readily keyed to the issuer's or transfer agent's records or automated equipment.

Hence, upon due receipt of the order in proper form, the issuer is liable if it registers transfer without reference to the order. The issuer also bears the risk, once the order is "received," of filing it

²⁵³ That is if the issuer demands and obtains certain excess documentation. G.S. § 25-8-402(4).

²⁵⁴ Such notices are also used to block registration of transfer of securities issued under some exemption from federal and state securities regulation statutes, *e.g.*, a "privately placed" issue. *Welland Inv. Corp. v. First Nat'l Bank*, 81 N.J. Super. 180, 195 A.2d 210 (1963), recognized such a restriction as an adverse claim which could be cut off only in the hands of a bona fide purchaser without notice of the restriction and held that when the bona fide-purchaser status of the presenter was uncertain the transfer agent could refuse registration. See also discussion in text accompanying notes 125-38 *supra*.

²⁵⁵ N.C. GEN. STAT. § 32-18 (Supp. 1965); see also the Uniform Gifts to Minors Acts, N.C. GEN. STAT. § 33-73 (Supp. 1965).

²⁵⁶ G.S. § 25-8-403 (1)(a). It is not necessary to furnish the certificate number.

or otherwise using the information.²⁵⁷ Thus, if the Code requirements are met, the issuer cannot plead lack of actual knowledge.

Once the duty of inquiry arises, how is it discharged? In general by "any reasonable means."²⁵⁸ However, transfer agents will usually follow a Code-approved routine, which presumably is a complete defense to any contention that the transfer agent did not discharge its duty to inquire. Under this procedure, the transfer agent notifies the adverse claimant that the security has been presented for registration, which will occur unless "within thirty days from the date of mailing the notification" (1) a court of competent jurisdiction issues a restraining order or like process, or (2) the issuer or transfer agent receives indemnity sufficient to protect it from loss resulting from the issuer's honoring the adverse claim.²⁵⁹ Thus, the issuer may safely register transfer if no restraining order or bond is forthcoming within thirty days. The Code leaves some uncertainties in this procedure. Does a court of "competent jurisdiction" refer to any court that might have power to issue such an order, or does it imply also that venue must be proper and process served on the issuer? In short, must a North Carolina claimant secure a New York state or federal court order to restrain Guaranty Trust Company from registering transfer of certain shares? Also who would be the necessary parties: certainly the issuer, but what about the person presenting the security to be registered? Seemingly, the presenter would not be bound unless it too is a party, although perhaps the proceeding would be one quasi in rem if the certificate is in the court's territorial jurisdiction as it would be if the transfer agent has possession of it and suit is brought in that locality. The purpose of the proceeding is, of course, to obtain a final determination of the conflicting claims to the security.

As an alternative to securing a court order, the claimant may post bond the amount of which must be "sufficient in the issuer's judgment to protect" it from loss suffered "by complying with the adverse claim."²⁶⁰ Furnishing bond contemplates a refusal to register transfer, which will usually mean that the presenter will sue

²⁵⁷ See G.S. § 25-1-201(26) for a definition of when "a person 'receives' a notice or notification. . . ." See G.S. § 25-1-201(27) for the Code rules concerning circulation of notice, or notification in a "organization," which is defined in G.S. § 25-1-201(28).

²⁵⁸ G.S. § 25-8-403(2).

²⁵⁹ *Ibid.*

²⁶⁰ G.S. § 25-8-403(2)(b).

the issuer (or transfer agent). Although the issuer determines the amount of the bond, it presumably would not act in "good faith" by demanding an exorbitant indemnity arrangement.

The Code does not specify the duration of the stop order, in contrast to the six-month period for a stop payment on a check,²⁶¹ nor are the time and circumstances when a notice loses effect determined by the Code.²⁶² Although arguably check stop payment rules might serve as an analogy,²⁶³ it would appear that the absence of any specified time period implies indefinite effectiveness of a stop transfer order. The analogy to checks is inapposite, since checks, as demand instruments, may soon become stale,²⁶⁴ while investment securities continue in effect indefinitely (most stock, redeemable shares aside) or for long periods (bonds and debentures). This argues against any arbitrary cut-off time since lost, stolen or destroyed securities may turn up years later. Nor is it a burdensome operation to key a stop order into the issuer's records or equipment and keep it in effect.

2. *Inquiry Duty From Documents.*—An issuer may also be charged with notice of adverse claims if it demands documentation beyond what the Code prescribes. This is supposed to deter issuers from following their old practices of dragging in every conceivable document, court order, instrument, opinion of counsel, etc., particularly for fiduciary security transfers. This is constructive, not actual, notice "of all matters contained [in the documents] affecting the transfer."²⁶⁵ Such a duty of inquiry may be discharged like any other duty—by notifying the claimant who must procure a restraining order or give an indemnity bond,²⁶⁶ although the issuer may have trouble locating and communicating with one or more possible claimants. The prudent issuer will not seek documents other than those the Code requires or for any purpose other than the Code specifies—that is, to determine whether a necessary indorsement is genuine and effective.²⁶⁷ Unsolicited documents should be returned

²⁶¹ G.S. § 25-4-403(2); the order may be renewed.

²⁶² G.S. § 25-1-201(25).

²⁶³ This is suggested by Israels, *How to Handle Transfers of Stock, Bonds and Other Investment Securities*, 19 BUS. LAW. 90, 106 n.19 (1963).

²⁶⁴ See G.S. § 25-3-503(2).

²⁶⁵ G.S. § 25-8-402(4).

²⁶⁶ G.S. § 25-8-403.

²⁶⁷ G.S. §§ 25-8-402(3)(b), -402(4).

at once without examination; the issuer incurs no liability by so doing, but may get into trouble by inspecting or keeping them.

3. *Indorsement Guarantee*.—Before registering transfer, an issuer may demand a signature guarantee, which sufficiently guards against its absolute liability for registering transfer on a forged signature. It may *not* demand an indorsement guarantee, which not only warrants the genuineness of the signature and the appropriateness of the signer, but also the rightfulness of the transfer "in all respects."²⁶⁸ However, a presenter may "voluntarily" give the issuer an indorsement guarantee as an inducement to register transfer,²⁶⁹ although any guarantor should think carefully and charge sufficiently if he gives such a sweeping assurance. If the issuer then ignores known adverse claims, it would be liable, but the indorsement guarantor must answer. Thus, the guarantee functions like the indemnity bond just considered, although here it is procured by the presenter rather than by the adverse claimant.²⁷⁰ However, if the issuer were to refuse to hold up registration absent an indorsement guarantee, it would probably be liable to the presenter.²⁷¹

In conclusion, the issuer need not inquire unless it (1) has received a stop transfer notice, or (2) has demanded and received excess documentation, but any such duty may be discharged through any reasonable means, including notice to the adverse claimant who must get a restraining order or give bond, or by an indorsement guarantee "voluntarily" furnished by the presenter.

C. Issuer's Protection: Signature Guarantee

Since the issuer remains absolutely liable for registering transfer on an unauthorized indorsement, it has rights to protection congruent with the scope of its liability. Denied this "assurance," an issuer may refuse to register transfer without liability to the presenter.²⁷² As stated by the Code, "the issuer may require . . . assurance that each necessary indorsement . . . is genuine and effective. . . ."²⁷³

²⁶⁸ G.S. § 25-8-312(2).

²⁶⁹ G.S. § 25-8-312, comment 3. One suspects that giving an indorsement guarantee would be "voluntary" in the sense that Chinese "volunteers" participated in the Korean War.

²⁷⁰ Thus, in some respects it resembles an indemnity to induce honor of a draft drawn under a letter of credit. See G.S. § 25-5-113.

²⁷¹ See G.S. § 25-8-401(2).

²⁷² *Ibid.*

²⁷³ G.S. § 25-8-402(1).

1. *Signature Guarantee*.—In all cases the issuer may demand a guarantee that at the time of signing (1) “the signature was genuine,” *i.e.*, the person who indorsed the certificate “Henry James” was really Henry James, (2) “the signer was an appropriate person to indorse,” *i.e.*, the Henry James who indorsed was the Henry James named in the certificate, and (3) “the signer had legal capacity to sign,” *i.e.*, the Henry James who signed was not a minor, insane, etc., at the time.²⁷⁴ The issuer may insist upon a guarantor “reasonably believed by the issuer to be responsible.”²⁷⁵ Thus, Chase Manhattan Bank as transfer agent would hardly reject a signature guaranteed by Manufacturers Hanover but if it was guaranteed by a North Carolina bank, Chase Manhattan might accept it or it might also require a second signature guarantee.²⁷⁶ Standards of responsibility need only be “not manifestly unreasonable.”²⁷⁷

2. *Other Assurances*.—Besides assurance that the indorsement is genuine—given by the signature guarantee—the issuer may require confirmation that the indorsement is “effective,”²⁷⁸ typically when securities carry an agent or fiduciary indorsement.

(a) The signature guarantee itself confirms effectiveness of the agent's or fiduciary's indorsement, since it warrants that the indorser was an “appropriate person,” which may include fiduciaries of various sorts and “authorized agent[s].”²⁷⁹ This is illustrated by *Jennie Clarkson Home for Children v. Missouri, K. & T. Ry.*,²⁸⁰ in which Lessels, the treasurer of the Jennie Clarkson home, a charitable corporation, asked a New York Stock Exchange member (Gibson) to sell railroad bonds registered in the charity's name. Lessels learned that the bonds could be sold only if the issuer put

²⁷⁴ G.S. § 25-8-312(1)(a)-(c). This codifies the antecedent law as stated in *Jennie Clarkson Home for Children v. Missouri, K. & T. Ry.*, 182 N.Y. 47, 74 N.E. 571 (1905). See also Simplification Act, N.C. GEN. STAT. § 32-20(a) (Supp. 1965).

²⁷⁵ G.S. § 25-8-402(2).

²⁷⁶ See NEW YORK STOCK EXCH. Rule 209 requiring signature guarantee by a “member or member organization” of the Exchange or “by a commercial bank or trust company organized under” federal or New York law “and having its principal office in the vicinity of the Exchange.” The latter phrase is interpreted by the Exchange to mean the Borough of Manhattan, south of Fulton Street. 2 CCH N.Y. STOCK EXCH. GUIDE ¶ 2209 (1962).

²⁷⁷ G.S. § 25-8-402(2).

²⁷⁸ G.S. § 25-8-402(1) (preamble).

²⁷⁹ G.S. § 25-8-308(3)(b)-(g).

²⁸⁰ 182 N.Y. 47, 74 N.E. 571 (1905).

them into bearer form, for which the issuer required an authenticated resolution of the charity's board of directors. Lessels forged a resolution and a power of attorney to sell the bonds. The latter included a signature guarantee which Gibson signed in good faith. The railroad then issued bearer bonds that were sold, Lessels receiving the proceeds which he converted to his own use. Neither the railroad nor Gibson knew of the forgeries. Since the railroad was absolutely liable for registering transfer, it had a right over against Gibson, who was held not only to have "guaranteed the genuineness of the signature of Lessels, who wrote the name of the corporation over his own name as attorney," but also "that Lessels had authority to sign the name of the corporation."²⁸¹ Indeed, "the purpose of the rule [is] to cast upon the broker, who witnesses the signature, the duty of ascertaining whether the person signing the name of the corporation had authority to so do, and making the witness a guarantor that it is the signature of the corporation in whose name the stock stands."²⁸² The Code result is identical: Lessels would not have been an "appropriate person" to indorse, and the signature guarantor would have been liable to the railroad.

Since one guaranteeing an agent's or a fiduciary's signature warrants authority to indorse, the guarantor may, and usually will, seek pertinent documentation, *e.g.*, board resolutions, court orders, controlling instruments, etc.²⁸³ If the signature guarantor knows the signor and the circumstances of the transaction or has confidence in the signor, it assumes little risk, but it should still insist on proper papers, which will, incidentally, accompany the security on its journey to the transfer agent.

(b) Aside from the signature guarantee warranting the agent's or fiduciary's authority to indorse, the issuer or transfer agent may itself demand "appropriate assurance of [an agent's] authority to sign," "appropriate evidence of appointment or incumbency" of a fiduciary, and so on.²⁸⁴ Often documents accompanying the signature guarantee will suffice, but if not the issuer may demand the needed documents *but only for the purpose of assuring itself of the signer's authority to indorse, and not to check on rightfulness of*

²⁸¹ *Id.* at 64, 74 N.E. at 576.

²⁸² *Id.* at 65, 74 N.E. at 576.

²⁸³ The Code says nothing about the kind of documents a signature guarantor may demand, since there is no duty of any sort to give a guarantee.

²⁸⁴ G.S. § 25-8-402(1)(b)-(e).

transfer.²⁸⁵ In harmony with the Simplification Act, the Code elaborates the "appropriate evidence of appointment or incumbency" of a fiduciary.²⁸⁶ For a court-appointed or qualified fiduciary, this means an official certificate dated not more than sixty days from the date the security is presented for registration. For other fiduciaries, it means a copy of the document (such as the trust instrument or a certificate by a responsible person for other evidence) showing the fiduciary's appointment or incumbency. Possession of these documents does not of itself put the issuer on notice as to any facts relating to rightfulness of the transfer if it has sought these documents solely to check out appointment or incumbency or authority to indorse. However, the issuer should promptly return any requested documents, since this would tend to show its strictly limited purpose in obtaining them. Thus, the Code, like the Simplification Act, overturns much case law imputing notice to the issuer of adverse claims and wrongful transfers.²⁸⁷ Now, the issuer can avoid getting "notice" and, in fact, the Code intends that it should avoid it and not bear the burdens which issuers carried under the old case law.

3. *"Further Reasonable Assurances."*—Occasionally, an issuer, moved by excess caution, seeks assurances beyond a signature guarantee and authentication of an agent's or a fiduciary's authority to indorse. If it does so to determine rightfulness of transfer, it is automatically charged with "notice of all matters contained therein affecting the transfer."²⁸⁸ Hence, a degree of ignorance is the better part of prudence. This is especially true since the issuer cannot demand as of right any guarantee or indemnity against this type

²⁸⁵ This is particularly true as to fiduciary security transfers. G.S. § 25-8-402(3)(b), (4).

²⁸⁶ Compare N.C. GEN. STAT. § 32-17 (Supp. 1965) with G.S. § 25-8-402(3).

²⁸⁷ This includes constructive notice from a probated will, *Lowry v. Commercial & Farmers' Bank*, 15 Fed. Cas. 1040 (No. 8581) (C.C.D. Md. 1848), or from a relevant document furnished for some other purpose. Cf. *Browning v. Fidelity Trust Co.*, 250 Fed. 321 (3d Cir.), *cert. denied*, 248 U.S. 564 (1918) (notice to commercial department of a bank held also notice to trust department); *Hazzard v. Chase Nat'l Bank*, 159 Misc. 57, 287 N.Y. Supp. 541, 559 (Sup. Ct. 1936) (similar case), or because the transfer books disclosed the existence of a trust, *Magwood v. Railroad Bank*, 5 S.C. 379, 390-92 (1874), or because an employee's personal knowledge of an adverse claim or wrongful transfer was imputed to the issuer under ordinary rules of notice through an agent.

²⁸⁸ G.S. § 25-8-402(4); the Simplification Act had no corresponding sanction.

of liability; and unless it has a full indorsement guarantee, it should not venture into these dangerous waters.

D. Issuer's Duties and Liabilities

Having examined the issuer's right to assurances that indorsements are "genuine and effective" and its limited duty to inquire into merely wrongful transfers, the issuer's duties and liabilities, both to the "true owner" (adverse claimant) and the presenter (purchaser) fall into place. Two sections set forth the issuer's duty to register transfer²⁸⁹ and its liability and non-liability for improper registration of transfer.²⁹⁰

1. *Duty to Register—Section 8-401.*—Although the Simplification Act solved many problems concerning fiduciary security transfers and relieved issuers of the weightiest risks, no pre-Code statute had generalized the duty to register transfers.²⁹¹ The Code's mandate should accelerate transfer registrations by specifying the circumstances creating the duty to register transfer, making the duty specifically enforceable,²⁹² and declaring a statutory liability for loss due to an issuer's "unreasonable delay in registration or from failure or refusal to register the transfer."²⁹³

The duty to register transfer arises if five conditions are met. Three have been considered: (1) an "appropriate person" has indorsed the security,²⁹⁴ (2) the issuer is assured that these indorsements are "genuine and effective,"²⁹⁵ and (3) "the issuer has no duty to inquire into adverse claims or has discharged any such duty."²⁹⁶ The fourth condition—compliance with any applicable law²⁹⁷—needs no special comment. Before considering the important fifth condition—that "the transfer is in fact rightful or is to a bona fide purchaser"²⁹⁸—it should be noted that the issuer may

²⁸⁹ G.S. § 25-8-401.

²⁹⁰ G.S. § 25-8-404.

²⁹¹ The Simplification Act exonerated issuers dealing with fiduciary security transfers but nowhere declared a *duty* to register transfer.

²⁹² The Code does not in terms authorize injunctive relief, but prior law had recognized a remedy to compel registration. See, e.g., *Sheppard v. Rockingham Power Co.*, 150 N.C. 776, 781, 64 S.E. 894, 896 (1909) ("A *mandamus* or mandatory injunction lies to compel a corporation to transfer stock. . ."). Damages are also available according to G.S. § 25-8-401, comment 3. Compare *State ex rel. Townsend v. McIver*, 2 S.C. 25, 49 (1870), recognizing mandatory relief because of the inadequacy of damages.

²⁹³ G.S. § 25-8-401(2).

²⁹⁴ G.S. § 25-8-401(1)(a).

²⁹⁵ G.S. § 25-8-401(1)(b).

²⁹⁶ G.S. § 25-8-401(1)(c).

²⁹⁷ G.S. § 25-8-401(1)(d).

²⁹⁸ G.S. § 25-8-401(1)(e).

waive one or more of these conditions.²⁹⁹ Thus, an issuer might register despite noncompliance with some tax requirement, or it might, however unlikely, waive its right to "reasonable assurance" that indorsements are "genuine and effective."

The fifth condition states alternatives: (1) either the transfer is "in fact rightful," *e.g.*, the fiduciary is authorized to indorse and his transfer complies with the trust or court order, as the case may be, or (2) the transfer is to a bona fide purchaser, which imposes a duty to register although the transfer is not "in fact rightful" if the presenter is a bona fide purchaser—a reading in accord with other Code provisions³⁰⁰ and with existing law.³⁰¹ This fifth condition impliedly negates any duty unless the transfer is "in fact rightful" or is to a bona fide purchaser, although all other conditions are satisfied. Suppose that an issuer has no duty to investigate adverse claims since it had no stop transfer order on its books and had not demanded excessive documentation giving it constructive notice of a transfer in breach of trust. Moreover, the issuer has no knowledge one way or another whether the presenter is a bona fide purchaser. All it has is a certificate duly indorsed by the appropriate person with a signature guarantee by a reputable institution and a trust instrument showing the trustee's incumbency. Clearly the issuer must register transfer and should not poke around for evidence as to the presenter's bona fide-purchaser status or the rightfulness of transfer. But suppose, however, that in examining the trust instrument to ascertain the trustee's incumbency it discovers that the transfer is in fact in breach of trust, *e.g.*, the instrument forbids the trustee to transfer a security to himself while the security presented for transfer is by the trustee to himself. The Code surely contemplates that the issuer need not participate in perfecting this wrongful transaction, and that it incurs no liability for refusing to do so. To take a variant situation, suppose that the trust instrument, inspected solely to determine the trustee's incumbency, clearly states that no security transfer may be made without court approval of which there is no evidence. The issuer does not know whether the presenter is or is not a bona fide purchaser.

²⁹⁹ G.S. § 25-8-401, comment 3.

³⁰⁰ See G.S. §§ 25-8-315(1), -404(1).

³⁰¹ *Green v. Forsyth Furniture Lines, Inc.*, 198 N.C. 104, 107, 150 S.E. 713, 715 (1929).

Again, it would appear that the issuer is privileged to refuse registration.

The more difficult problem is whether the issuer is privileged to register transfer if it accidentally discovers that the transfer is not rightful or the presenter is not a bona fide purchaser. It is assumed that the issuer had no duty to investigate adverse claims since none of the statutorily prescribed events triggered such a duty, and it is known that no general duty to inquire into adverse claims exists under the Code. The relevant question, then, is whether the issuer acts in "good faith" in registering transfer under such circumstances. I suggest that, as a general rule, the issuer acts in "good faith"—that is, it is "honesty in fact in the . . . transaction"³⁰²—in this situation. The Code's unmistakable purpose is to confine narrowly inquiries as to rightfulness of transfers in order to facilitate security transfers and minimize the burdens of processing transfers. It is inconsistent with this intent if, under the guise of acting in "good faith," the issuer must run down every bit of information incidentally or accidentally acquired or try to determine whether, if the transfer is wrongful, the presenter is a bona fide purchaser. These investigations into possibly complicated and difficult factual matters would thwart the statutory purpose of simplifying registrations, and would invite back all of the old difficulties of policing the rightfulness of the transfer. "Good faith" should be invoked only in the most unusual and extreme circumstances. The "good faith" test is, of course, primarily subjective—did this issuer act honestly?—but there is also an objective component in terms of what other persons skilled in the field would regard as honest and decent conduct under the circumstances.^{302a}

2. *Liability for Registration—Section 8-404.*—Having examined the issuer's duties, privileges, and liabilities to the presenter, we consider its position vis-à-vis the "true owner," when it registers a security into some other person's name.

(a) Non-Liability: Only two conditions need be satisfied for the issuer to avoid liability to "the owner or any other person suffering loss as a result of the registration of a transfer of a security": (1)

³⁰² G.S. § 25-1-201(19).

^{302a} Since this article was written, an important and relevant decision by a federal district court dealing with duty to register transfer under the Code was reported. *Kanton v. United States Plastics, Inc.*, 248 F. Supp. 353 (D.N.J. 1965).

the security carries the "necessary indorsements,"³⁰³ i.e., they are by an "appropriate person" and they are not "unauthorized," and (2) the issuer has no duty to investigate adverse claims or has discharged any such duty.³⁰⁴ Thus, it follows that the issuer is not liable for registering a merely wrongful transfer.

(b) Liability: Outside this shelter, the general rule is issuer liability to the true owner.³⁰⁵ Thus, the issuer would be liable if it registered transfer absent the necessary indorsements, or if the indorsements were forged, or if it ignored its duty of inquiry.³⁰⁶ So, too, the issuer is liable if it registers transfer when the true owner has given due notice of loss, theft, or apparent destruction.³⁰⁷ Given the issuer's liability, its duty is to deliver a like security to the true owner, but if overissue would result, the issuer must purchase a security on the market or, if unable to do this, pay the true owner.³⁰⁸

E. Lost, Stolen and Destroyed Securities

Lost, stolen and destroyed securities raise special problems, since if the owner has procured a replacement certificate and the original later turns up, there will be one set of creditor or equity rights now evidenced by two certificates each of which may be entitled to registration. Obviously the issuer does not want to recognize both, or, if it must, it seeks indemnity.

1. *Rights of the Owner of the Original Certificate.*—Like the Uniform Stock Transfer Act, the Code gives the owner a right to a replacement certificate if he asks for it before the issuer receives notice that a bona fide purchaser holds the original, files with the issuer a sufficient indemnity bond, and complies with any other reasonable requirement imposed by the issuer.³⁰⁹ Thus the Code abandons the Stock Transfer Act's clumsy and little-used requirement of a court order for a new certificate³¹⁰ in favor of the alternative procedure, recognized by many corporation statutes and by

³⁰³ G.S. § 25-8-404(1)(a).

³⁰⁴ G.S. § 25-8-404(1)(b).

³⁰⁵ G.S. § 25-8-404(2).

³⁰⁶ G.S. § 25-8-404(2)(a) referring to G.S. § 25-8-404(1).

³⁰⁷ G.S. § 25-8-404(2)(b). See G.S. § 25-8-405 (lost, stolen or destroyed securities).

³⁰⁸ G.S. §§ 25-8-404(2)(c), -104.

³⁰⁹ G.S. § 25-8-405(2).

³¹⁰ N.C. GEN. STAT. § 55-91 (1965).

North Carolina³¹¹ and widely used in business absent statute, of voluntarily issuing a replacement certificate with or without posting bond.³¹² The Code goes beyond the North Carolina corporation law provision in making this procedure a legally enforceable duty of the issuer. Thus the true owner must act promptly upon the discovery of the loss.

One or two problems should be noted here. First, it is not clear whether a notice of the lost security must comply with the specific requirements as to a "stop transfer" notice.³¹³ Although arguably any reasonable form of notice is sufficient, it is advisable for the owner to conform his notice to the specific provisions governing stop transfers. Secondly, the "sufficiency" of an indemnity bond is a vexing question, since the original security may turn up years later worth many times its original value. One would suppose that a bond fixed at 2500 times the present market value of the lost security would be manifestly unreasonable, but in one case the unit value had increased from 5 dollars to 12,800 dollars per share.³¹⁴ Thirdly, "other reasonable requirements"³¹⁵ should present no problem where manifestly related to the issuer's duty, *e.g.*, an affidavit as to the circumstances of the loss.

2. *Loss of True Owner's Rights*—If the owner fails seasonably to notify the issuer of the loss, a bona fide purchaser of the original certificate prevails.³¹⁶ This is easy enough to understand if, for example, the owner had indorsed the security in blank and it was lost or stolen; the only vice is wrongful transfer. But the owner also loses even though the original certificate carries a forged indorsement, for the owner's failure to notify the issuer "within a reasonable time after he has notice" of the loss precludes the owner from asserting his claim.³¹⁷ By negative implication, if the owner does act seasonably he retains his rights to protest an unauthorized

³¹¹ N.C. GEN. STAT. § 55-57(e) (1965).

³¹² G.S. § 25-8-405(2) (b) imposes a duty to issue a replacement certificate if a sufficient bond is forthcoming, but the issuer could waive the bond if it saw fit without violating Code standards.

³¹³ G.S. § 25-8-403(1) (a).

³¹⁴ *Davis v. Fraser*, 307 N.Y. 433, 121 N.E.2d 406 (1954) (unit value of lost shares had increased from \$5 in 1898 to \$12,800 in 1952). Probably, it would be unreasonable to ask for so large a bond because of the improbability of so great an increase in value coupled with a security lost for so long a time.

³¹⁵ G.S. § 25-8-405(2) (c).

³¹⁶ G.S. § 25-8-405(2) (a).

³¹⁷ G.S. § 25-8-405(1).

indorsement,³¹⁸ although presumably he must still defer to the bona fide purchaser in respect of claims growing out of a merely wrongful transfer.

3. *Bona Fide Purchasers of Original and Replacement Securities*.—Unlike the counterpart provision in the Stock Transfer Act,³¹⁹ the original security supposedly lost remains viable, and if it passes into the hands of a bona fide purchaser, it may have to be registered even though the replacement certificate issued to the owner has also been registered.³²⁰ Honoring the original certificate which turns up in bona fide-purchaser hands is a logical consequence of the Code's rigidly applying the concept that the certificate is the thing, rather than the underlying intangible rights, and if the original certificate is still kicking around, when everyone supposes it to be a small pile of ashes, a bona fide purchaser should be fully protected since, by hypothesis, he has no notice of the loss. The problem is more complex if both the original and the replacement certificates are in bona fide purchasers' hands. Several simple illustrations show the Code rules in operation:³²¹

Example 1: *A* loses his bond, and *T* Corporation issues a replacement bond which is registered in *A*'s name. The original bond turns up and is purchased by *B*, a bona fide purchaser. The consequences are that

(1) *T* Corporation must register *B*'s bond.³²²

(2) *T* Corporation may either reclaim the replacement bond from *A* or recover on the indemnity bond *A* gave when it applied for the replacement bond. Hence, only one registered security will be outstanding, *viz.*, the original security now in *B*'s hands. *B* is favored because free negotiability dictates maximum protection to bona fide purchasers such as *B*, and after all *A* was probably best positioned to avoid the loss that caused all the trouble in the first place.

Example 2: As in Example (1), *A* gets a replacement bond which *A* sells to *C*, a bona fide purchaser, who is entitled to have transfer to him registered with *T* Corporation. Thereafter, the

³¹⁸ *Ibid.*

³¹⁹ Under N.C. GEN. STAT. § 55-91 (1965) the original security is ineffective except so far as it represents an action for damages when held by a bona fide purchaser without notice.

³²⁰ G.S. § 25-8-405(3).

³²¹ Except as otherwise noted, G.S. § 25-8-405(3) applies to all of the following examples.

³²² Unless overissue would result in which case G.S. § 25-8-104 governs.

original bond is found and transferred to *B*, also a bona fide purchaser, and also entitled to registration into his name. From this it follows that

(1) *T* Corporation may not reclaim the replacement bond now held by *C* and registered in *C*'s name (since this would impair negotiability); but

(2) *T* Corporation may recover on *A*'s indemnity bond.

Example 3: As in Example (1), *A* gets a replacement bond. The original bond is found and sold to *B*, a bona fide purchaser, who is entitled to and gets the bond registered into his (*B*'s) name. Thereafter, *A* sells his replacement bond to *C*, also a bona fide purchaser and also entitled to registration into his (*C*'s) name.

The consequences here are the same as in Example 2.

V. CONCLUSION

The Code completes the evolution of investment securities into fully negotiable instruments controlled by uniform rules applicable to creditor and equity securities, thereby ending the old law's segregation of shares and bonds between two different statutes (not always consistent and badly outdated) and also modifying the unsatisfactory case law concerning the issuer's heavy liabilities on registering transfer of securities. A major criticism is Article 8's deference to prior law in reaffirming the traditional absolute liability of the issuer, who is otherwise almost solely a registrar under the Code, for honoring forged indorsements—an apparent device to escape the too radical innovation of excusing the issuer except for its own lack of care. However, even this criticism is muted since, arguably, the issuer is a convenient focus for liability to the true owner wronged by transfer on his forged indorsement, and since also the issuer's risk can be shifted (1) to the responsible institution guaranteeing the transferor's signature, and (2) by insuring the guarantor or issuer or both. Accordingly, the Code approach has both the strengths and the weaknesses of a pragmatic rather than an doctrinaire solution to the problem. On a while, despite some minor anomalies, the Code fairly and rationally balances all interests in the issue, ownership, and transfer of securities; its enactment in North Carolina significantly updates this area of the law.

APPENDIX A

RIGHTS, DUTIES AND LIABILITIES: INDORSEMENT
'UNAUTHORIZED'

1. *Issuer's Liability*.—Issuer remains absolutely liable for registering transfer on unauthorized indorsement, G.S. §§ 25-8-311(b), -404(2). And as to the true owner, issuer must:
 - a. Furnish a new security, G.S. § 25-8-404(2); or
 - b. Meet the requirements of G.S. § 25-8-104 if issuing a new security would result in overissue; but
 - c. Ordinarily has no liability to pay damages, see G.S. § 25-8-404, comment 2, except in certain overissue cases, G.S. § 25-8-104(1)(b).
2. *Issuer's Rights*.—Although absolutely liable for registering transfer on unauthorized indorsement, issuer has a right to:
 - a. Recover from the one making the unauthorized indorsement;
 - b. Recover from the signature guarantor, G.S. § 25-8-312(1), (3);
 - c. Recover from person presenting security for registration of transfer, G.S. § 25-8-306(1) (first sentence), *except* that a purchaser for value without notice of adverse claims who receives new security on registration of transfer warrants only no knowledge of unauthorized indorsement. G.S. § 25-8-306(1) (second sentence).
3. *Issuer's Duty*.—No duty to register transfer on unauthorized indorsement. G.S. § 25-8-401(1)(a) (by implication).
4. *True Owner's Rights*.—True owner of a security transferred on unauthorized indorsement may "reclaim or obtain possession of the security or a new security," G.S. § 25-8-315(2), or in certain circumstances secure damages for conversion, G.S. § 25-8-315, comment 2, from:
 - a. A bona fide purchaser (and non-bona fide purchaser); but not from
 - b. A "purchaser for value and without notice of adverse claims who has in good faith received a new, reissued or reregistered security on registration of transfer," G.S. § 25-8-311(a); nor from
 - c. An agent, bailee, or broker on theories of "innocent conversion," G.S. § 25-8-318.

5. *Purchaser's Rights*.—No purchaser, including a bona fide purchaser, G.S. § 25-8-302, is entitled to the security as against the true owner, G.S. §§ 25-8-311(a), -315(2); but a "purchaser for value and without notice of adverse claims who has in good faith received a new, reissued or reregistered security on registration of transfer" prevails over the true owner, G.S. § 25-8-311(a).

APPENDIX B

RIGHTS, DUTIES, AND LIABILITIES: TRANSFER WRONGFUL BUT INDORSEMENT NOT 'UNAUTHORIZED'

1. *Issuer's Liability to True Owner*.—Issuer not liable to true owner for registering transfer even though transfer is wrongful, if
 - a. Security bore necessary indorsements, G.S. § 25-8-404(1)(a), and
 - b. Issuer had no duty to investigate adverse claims or discharged such duty, G.S. § 25-8-404(b). Duty of inquiry into rightfulness of transfer arises only if
 - A. Stop transfer notice received, G.S. § 25-8-403(1)(a), or
 - B. Issuer is charged with notice of adverse claims from controlling instruments, G.S. §§ 25-8-403(1)(b), -402(4).
2. *Issuer's Duty to Purchaser*.—Issuer must register transfer if transfer is in fact rightful or if presenter is a bona fide purchaser, G.S. § 25-8-401(1)(e).
 - a. Failure or delay in carrying out duty to register transfer makes issuer liable, G.S. § 25-8-401(2).
 - b. Issuer's performance of duty to register transfer precludes liability to true owner, G.S. § 25-8-404(1).
3. *Issuer's Rights on Registering Transfer*.—Before registering transfer, issuer may demand full compliance with G.S. § 25-8-401(1), and assurances that indorsements are effective, G.S. § 25-8-402, including
 - a. Signature guarantee, G.S. §§ 25-8-402(1)(a), -312(1); but
 - b. Issuer may not demand guarantee that transfer is rightful as condition of registering transfer, G.S. § 25-8-312(2), since issuer is ordinarily no longer liable for merely wrongful transfers, G.S. § 25-8-404(1).
4. *True Owner's Rights*.—True owner of security wrongfully transferred may:

- a. Reclaim possession of the security so transferred, *e.g.*, against any purchaser except a bona fide purchaser, G.S. § 25-8-315(1); or
 - b. Obtain possession of a new security from issuer, G.S. §§ 25-8-315(1), -404(2); or
 - c. Have damages against anyone except a bona fide purchaser, G.S. § 25-8-315(1); and
 - d. Assert any other rights against person wrongfully transferring the security; *but* has no rights against agents, bailees, brokers, etc., for "innocent conversion," G.S. § 25-8-318.
5. *Purchaser's Rights.*—Bona fide purchaser is
- a. Entitled to the security, G.S. § 25-8-301(1), (2);
 - b. Entitled to registration of transfer by issuer, G.S. § 25-8-401(1)(e);
 - c. Not liable to the true owner, G.S. § 25-8-315(1); and
 - d. Not liable to issuer on presenter's warranty, G.S. § 25-8-306(1), since he is "entitled to the registration" of the security as bona fide purchaser, G.S. § 25-8-401(1)(e).