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FRAUDULENT PLEDGE OF SECURITIES OF NONPUBLIC CORPORATIONS: THE INADEQUACY OF UCC ARTICLE 8

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This article addresses the ability of the pledgor of stock in a closely held or subsidiary corporation (who can control the corporation's issuance of additional stock) to fraudulently defeat the pledgee's security interest. The gap in the law that permits this result under the present Article 8 remains, according to the authors, under proposed Revised Article 8 (and conforming Article 9 revisions). The authors suggest a practical means of limiting this risk through the use of corporate governance but they recognize that this solution may not be fully effective and that the optimum solution is a revision of Article 9, which protects secured lenders and enhances the collateral value of stock in a closely held or subsidiary corporation.

Perfection of a security interest creates certain rights in the secured party, such as establishing a claim to the debtor's assets as against other creditors or the debtor's trustee in bankruptcy. However, certain purchasers from the debtor may take free of a prior perfected security interest. Thus, a buyer in the ordinary course of business of a debtor's stock in trade takes free of any security interest created by his seller, even if the buyer knows of the existence of a perfected security interest.[1] This rule is based on the policy ground that routine commercial sales by a person in the business of selling goods of that kind would be impeded greatly if buyers could not assume that the sale did not violate the rights of a third party. Similarly, concerns about the liquidity of securities in public markets has led to the principle that a bona fide purchaser

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[1] UCC § 9-307(1).

for value should, in most situations, take free of prior adverse claims, even if there is fraud or theft in the chain of title.[2]

The desire to assure liquidity in the securities markets may, however, create opportunities for fraud as well as result in an innocent party bearing the risk of such fraud. For example, the conflict between successive pledgees of the same security arising out of fraudulent double financing is most likely to occur in the case of closely held corporations, the certificated securities of which can be easily duplicated and delivered physically to effect perfection by possession.[3]

Often, a corporate borrower, or its parent or owner(s), as a guarantor, will pledge all of the shares of a wholly or partially owned subsidiary or other closely held corporation to secure performance by the borrower under a credit agreement or to secure the parent's guaranty. Yet, the security interest created by such pledge, whether perfected under the present Article 8 of the Uniform Commercial Code or, when and if enacted, under the proposed Revised Article 8 (and its conforming amendments to Article 9) (hereinafter, collectively, Revised Article 8),[4] is easily, if fraudulently, susceptible to being defeated, a possibility that is often overlooked.

To a degree, corporate procedures and records can be utilized to protect the security interest and bridge the gaps in the Uniform Commercial Code.[5] It might be preferable, however, if the revision of Article 8 were to focus on this problem by recognizing that perfection solely by possession of stock of a closely held corporation is not the optimal approach.[6]

For example, recently, in the authors' experience, the lender was quite concerned when a corporate-parent guarantor was unable

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[2] See Official Uniform Comment to UCC § 8-311.

[3] A security interest created in this manner is described as a "pledge."

[4] All references to Revised Article 8 refer to the 1994 Official Text with Comments.

[5] Traditionally, due diligence on the part of the lender and opinions of counsel have been relied on to minimize the risk of prior fraud and to buttress the bona fide status of the pledgee.

[6] Perfection in respect of partnership interests usually is accomplished by filing a financing statement; a partnership interest is a general intangible unless it is dealt in or traded on a securities exchange or in securities markets, or the issuer has expressly "opted in," in which event it would be a "security" subject to Article 8. See Revised UCC § 8-103(c). It would appear that such filing would usually also be efficacious in respect of an interest in a limited liability company or a limited liability partnership. All of such interests are in the category of general intangibles. See, e.g., In re Hartman, 102 BR 90 (Bankr. ND Tex. 1989) (holding under Texas law that partnership interest is general intangible).

to locate a stock certificate representing one-third of the shares of the borrower-subsidiary. The shares were intended to be pledged by the guarantor to the lender. The guarantor requested that a new certificate representing the missing shares be issued and undertook to indemnify and hold the borrower-issuer harmless should another party show up with the lost certificate.[7] Without the borrower's or guarantor's fraud or negligence,[8] a holder of the "lost" securities could have no real hope of prevailing in a claim against the issuer, guarantor, or lender, because under Article 8 the new holder of the lost certificate could not become a bona fide purchaser without the indorsement of the registered owner[9] unless the issuer issued a new certificate in the holder's name.[10] However, such fraud or negligence should not entirely displace the lender's rights in the stock constituting its collateral, but should only dilute the collateral to the extent of the pro rata percentage of ownership represented by the fraudulently issued certificates.[11]

Similarly, fraudulently issued securities acquired by a bona fide purchaser (BFP)[12] subsequent to the time when the lender perfected its security interest would dilute the lender's collateral[13]

[7] See UCC § 8-40 5(2). Of course, if the guarantor's principal asset is its interest in the subsidiary, or the guarantor is otherwise not creditworthy, such indemnity may be of little or no value, and the issuer may require an indemnity bond from a creditworthy surety. Even if the guarantor is independently creditworthy, its indemnity is of no added value to the lender, which in any event is entitled to look to the credit of the guarantor.

[8] If the guarantor entrusted the certificates to an employee or other agent who under the laws of agency had the power to indorse such certificates for transfer, the guarantor may be precluded from asserting that the indorsement was invalid. See UCC § 8-311; Revised UCC § 8-107 (which more clearly explains UCC § 8-308—Effect of Unauthorized Indorsement or Instruction).

[9] UCC § 8-311(a); Revised UCC § 8-308.

[10] In the case of publicly traded stock, the transfer agent will generally require a guaranty of any indorsement from a commercial bank or a brokerage firm that is a member of the New York Stock Exchange and corporate resolutions if the transferor is a corporation. *See* Rule 209 of the General Rules of the New York Stock Exchange, Inc. (CCH) (1995) (except where securities are delivered pursuant to the rules of a qualified agency or are in the name of a participant in a signature guarantee program, a signature must be guaranteed by a member).

[11] See UCC § 8-405(3).

[12] A "bona fide purchaser" must take for value in good faith and without notice of any adverse claim. UCC § 8-302(1).

[13] The pledgee in Simcox v. San Juan Shipyard, Inc., 754 F2d 430 (1st Cir. 1985), was fortunate that the court found that purchasers of fraudulently issued shares of a closely held corporation issued subsequently to the pledge were not BFPs and thus had no rights in such shares nor any claim against the corporation. Id. at 443–446. This decision, though determined under the laws of Puerto Rico, is relevant to a UCC analysis because the commercial law of Puerto Rico is based on the Delaware UCC. Id. at 443–446. If the purchaser in Simcox had been a BFP, clearly, the pledgee's collateral would have been devalued by almost two-thirds. See id. at 441, 443–444; see also McDonnell v. Tabah, 297 F2d 731 (2d Cir. 1961) (affirming judgment cancelling 200,000 shares of fraudulently issued stock, where purchaser found not be BFP).

and, depending on the number of fraudulent shares issued, could have the effect of substantially diminishing the value of the secured lender's lien.[14]

Perfection of Security Interests in Securities

The perfection of security interests in securities is controlled for the most part by Article 8 of the Uniform Commercial Code, as adopted (with certain nonuniform provisions) in the various states, and to a lesser extent by Article 9.[15] Section 8-313 provides the exclusive means of transfer of a security or a limited interest (including a security interest) in a "security."

The operative subsection for a pledge of closely held stock is Section 8-313(1)(a) of the UCC, which provides that a transfer of a security interest occurs "when he [the secured party] or a person designated by him acquires possession of a certificated security"[16]—here, certificates representing the outstanding stock of the borrower, its subsidiary, or other closely held corporation (hereinafter, such certificates sometimes are referred to as "Pledged Securities"). In the usual case the lender or an agent for the lender acquires possession of the certificates[17] together with undated stock powers

[14] See UCC § 8-405; cf. UCC § 8-313(2). For example, assume that guarantor pledges all of the stock of borrower, which at that time are represented by 100 shares, to Lender A. Assume also that guarantor then has borrower fraudulently issue 100,000 additional shares of stock, which guarantor pledges to Lender B. In this manner, regardless of whether the issuance of the additional shares would result in overissue, Lender A's collateral would be worth 0. percent of its original value. A more equitable result would be for the two innocent pledgees to share the aggregate collateral in the proportion of the secured indebtedness held by each of them.

[15] See UCC §§ 8-302, 8-304, 8-306, 8-308, 8-311, 8-313(1)(g), 8-315, 8-320. The exception to this general rule concerns book-entry obligations of the U.S. Treasury, U.S. agencies, and instrumentalities thereof (Governmental Securities) recorded on the books of a Federal Reserve Bank branch. Federal book-entry regulations govern the effectiveness of transfers between Federal Reserve Bank members of Governmental Securities. In all other instances, federal regulations direct that "applicable" law shall govern the effectiveness of transfers, including pledges, of interests in such obligations. See Subpart O (36 CFR § 306.118); 24 CFR §§ 41 et seq.; 1 CFR § 462. Presumably, the "applicable" law would be the Uniform Commercial Code. In re Red Lion, 49 BR 163, 186–88 (Bankr. SDNY 1985).

[16] Though UCC § 8-313(1)(i) would in most cases also be applicable, that subsection may afford the lender little comfort as a security interest so obtained would lapse within twenty-one days unless perfected under some other subsection of Section 8-313 and, in any event, subsection 8-313(1)(i) does not afford the lender BFP status.

[17] Stock of a closely held corporation is, in the United States, invariably certificated. An uncertificated security must be distinguished from an unissued security. The latter is a general intangible that must be perfected under UCC Article 9. Heinicke Instruments Co. v. Republic Corp., 543 F2d 700, 702 (9th Cir. 1976) (holding interest in corporation to be general intangible until securities are issued); Money Store Inv. Corp. v. Liscinski (In Re Wholesale Warehouse, Inc.), 141 BR 59, 62–63 (Bankr. DNJ 1992) (holding interest in cooperative association where certificates never issued to be a general intangible); see also UCC § 9-106.

endorsed in blank, with signature guaranteed. Moreover, the lender would presumably take its security interest (1) in "good faith";[18] (2) without "notice" of any adverse claim;[19] and (3) with a given "value."[20] As a result, the lender would be a BFP under Article 8.[21]

Section 8-302 provides that a BFP acquires its interest free of any adverse claim to the security.[22] The definition of "adverse claim" apprehends a broad range of claims that may be either legal or equitable.[23] "Adverse claim" includes the claim that a third party is owner of the security. Whether the issuer fraudulently issued the security to facilitate a double financing or the BFP's transferor acquired the security by means of *theft* or *fraud* does not impair the bona fide purchaser protection afforded by Article 8.[24] Achieving BFP status affords protection from all *prior* claims (other than certain tax claims[25] and state-by-state exceptions),[26] but it most

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[18] UCC § 1-201(19).

[19] UCC §§ 1-201(25), 1-201(26), 1-201(27), 8-304.

[20] UCC § 1-102(44).

[21] UCC § 8-302(1)(a).

[22] A BFP of a security takes "priority over an earlier security interest even though perfected." UCC § 9-309. Moreover, a prior filing under Article 9 covering "securities" does not constitute notice of a security interest to a purchaser who is otherwise a BFP or a protected purchaser under Revised Article 8. UCC § 9-309 (unchanged under Revised Article 8).

[23] UCC § 8-302 (Official Comment 4).

[24] See UCC § 8-302(3); First Nat'l Bank v. United States, 625 F. Supp. 926 (ND Ill. 1986); Hawkland, Alderman & Schneider, UCC Series § 8-302:01 (Art. 8) (Clark, Boardman & Callaghan 1988 & Supp. 1993).

[25] Tax liens, however, are not governed by the UCC and, therefore, are not encompassed in the category of adverse claims, though the federal framework does have a similar feel. With regard to federal tax liens, IRC § 6323(b)(1) provides that a filed tax lien shall not be valid as against a purchaser of securities or a pledgee of securities without actual notice or knowledge of such lien at the time the interest was acquired. IRC § 6323(h)(1) (defining "security interest"); IRC § 6323(i)(1) (defining "actual knowledge or notice").

[26] For example, Section 324 of the General Corporation Law of the State of Delaware (the GCL) provides that the shares of stock of any person in a Delaware corporation may be attached and sold for a debt or other demands. Because the attachment provisions of Section 324 of the GCL supersede the attachment provisions of Article 8 of the Delaware UCC, see 6 Del. C. § 8-317(1) and 8 Del. C. § 201, there could be an attachment of the shares of pledged stock under Section 324 of the GCL that takes precedence over the pledge of pledged stock if the shares of the pledged stock are registered in the name of the pledgor and only endorsed in blank to the pledgee and not registered on the books of the issuer of the pledged stock in the name of the secured party or its agent. Further, Section 169 of the GCL provides that the situs of the ownership of stock of a Delaware corporation is regarded as the State of Delaware, regardless of the actual situs of the certificates. The scope of Section 169, however, is limited by Shaffer v. Heitner, 433 US 186, 207, 217–219, 97 S. Ct. 2569, 2581, 2587 (1977) (holding jurisdiction based solely on Section 324 to be unconstitutional). In any event, most institutional pledgees prefer not to become, or have their nominees become, stockholders of record for fear of being deemed in control of the issuer or otherwise becoming subject to liability (see, e.g.,

definitely does not protect against the claims of *subsequent* BFPs.[27]

Although Terminology Will Change Under Proposed Revised Article 8, Many Outcomes Will Remain the Same

Under proposed Revised Article 8, the rules governing the perfection of security interests in securities (and securities entitlement)[28] are set forth in Section 9-115(4) of the Revised UCC. Although filing of a financing statement would be, under the revised UCC provisions, a permissible method of perfection in most cases,[29] this would not assure a secured party of priority against prior or subsequent claims of a "purchaser." A prior or subsequent purchaser could have or gain "control" of the security, and, as provided in Section 9-115(5) of the Revised UCC, a "security interest of a secured party who has control over an investment property has priority over a security interest of a secured party who does not have control over the investment property."[30] Therefore, consistent with the present regime, the preferred method of perfection of a security interest in a certificated security, which is not recorded on the books of a financial intermediary, is by possession—which gives the possessor control—of the security; this is accom-

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Sections 628 and 629, NY Bus. Corp. Law) or becoming embroiled in environmental problems of the borrower.

[27] See generally Jeanne L. Schroeder & David Gray Carlson, "Security Interests Under Article 8 of the Uniform Commercial Code," 12 Cardozo L. Rev. 557, 637–648 (1990).

[28] "Securities entitlement" is a new concept under the Revised Article 8 and means, in shorthand, the rights and interests of a person having an account with a financial intermediary against such financial intermediary in respect of interests in securities and other investment property recorded on the books of such financial intermediary. Revised UCC § 8-102(15).

[29] Exceptions to this general rule concern debtors that are brokers, securities intermediaries, and commodity intermediaries. Revised UCC § 9-115(4).

[30] Revised UCC § 8-106 provides:

> (a) A purchaser obtains "control" of a certificated security in bearer form if the certificated security is delivered to the purchaser.
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> (b) A purchaser obtains "control" of a certificated security in registered form if the certificated security is delivered to the purchaser, and:
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> (1) the certificate is indorsed to the purchaser or in blank by an effective indorsement; or
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> (2) the certificate is registered in the name of the purchaser, upon original issue or registration of transfer by the issuer.

"Control" is a new concept under Revised Article 8, and, in the context discussed here, "control" and "possession" are one and the same.

"Purchaser" includes a pledgee. UCC §§ 1-201(32), 1-201(33).

plished by "delivery" of the security,[31] as opposed to by "transfer" under present Article 8.[32] Of course, in the usual case, the stock of a subsidiary or other closely held corporation is not recorded on the books of a financial intermediary (e.g., a broker holding stock in street name), although that could be the case if a portion of the outstanding shares is publicly traded.

Robert Maxwell's Fraud Illustrates the Risks

Although decided in a context different from that of the pledge of securities of a closely held corporation, *Macmillan, Inc. v. Bishopsgate Investment Trust*[33] illustrates the risks involved in pledges created by the power of the pledgor to cause additional securities to be issued. In *Bishopsgate*, an English court, reaching its decision under the New York version of Article 8,[34] held that a bank lender-pledgee was a BFP of its security interest in fraudulently reissued and transferred shares of a publicly traded company and, thus, took free of the claims to the shares by the "true owner."

Facts in Bishopsgate

Briefly, the facts concerning *Bishopsgate* are as follows:[35] The late Robert Maxwell was an officer of, and controlled, Maxwell Communications Corp. (MaxCorp), a public corporation, which owned all of the common stock of Macmillan, Inc. (Macmillan). Macmillan, in turn, owned 56 percent of the common stock of

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[31] Revised UCC § 8-301.

[32] UCC § 8-313(1)(a). There are significant changes in the BFP provisions under the Revised Article 8: first, the term "bona fide purchaser" is changed to "protected purchaser"; second, the "good faith" requirement is eliminated, the concept being subsumed under the lack of notice requirement; and, third, the purchaser must obtain "control."

[33] Joseph H. Levie, " 'Macmillan': English Court Rules on New York UCC," NYLJ, Jan. 13, 1994, at 5 (providing a concise review of a more than 600-page opinion). Also relied upon are portions of the transcript of the opinion of Justice Millet in Macmillan, Inc. v. Bishopsgate Inv. Trust, Chancery Div. (Dec. 10, 1993) (on file with the authors) (hereinafter Transcript). Large portions of the opinion are unavailable for review because of ongoing cases.

[34] Transcript, supra note 33, at 477–551. The court determined that the application of English law in international pledge transactions depends on "lex loci actus, that is, the law of the place where the transaction took place on which the later assignee relies for priority over the claim of the original owner," id. at 497–498, and lex situs, the law of the locations where the goods are situated, id. at 501, which the court determined in this case were one and the same. Because the security interests were either initially perfected in New York or, in respect of the pledgees that received physical delivery in England, later registered at DTC in their names, New York law was held applicable to all of the transfers.

[35] Transcript, supra note 33, at 1–17.

Berlitz International, Inc. (Berlitz), a company listed on the New York Stock Exchange. The series of transactions that led to conflicting claims to the Berlitz stock were initiated by Robert Maxwell.

First, as an officer of Macmillan, Maxwell, supposedly on its behalf, directed the Berlitz transfer agent to transfer the Berlitz shares registered in the name of Macmillan to Bishopsgate Investment Trust (the Trust) and to reissue the shares in the name of the Trust. Next, he had the Berlitz shares, registered in the name of the Trust, delivered to Morgan Stanley with instructions to deposit them in The Depositary Trust Co. (DTC) in New York City in the name of Morgan Stanley as nominee, subject to instructions of London & Bishopsgate International Investment Management Ltd., a private Maxwell affiliate. The transfers were without consideration and were clearly in breach of Maxwell's fiduciary duty to MaxCorp and Macmillan as a director or officer of these entities.[36] Last, Maxwell caused the pledge of the reissued Berlitz shares to secure obligations of other Maxwell-owned private companies. The pledges were effectuated by two different methods—either shares were transferred to the pledgee on the books of DTC or shares were reissued in certificated form and were indorsed in blank and delivered, in a manner that seemed valid on its face, to bank lender pledgees in London (who then had such shares registered in their names through DTC),[37] in each case as collateral for credit extended to other Maxwell interests.

Notice on the Part of the Pledgees

As a result of Maxwell's fraud, the court had to determine which party or parties had priority to the Berlitz stock, the purchasers of the security interests in stock (i.e., the pledgees) or Macmillan, the owner of the stock prior to its conversion. Unquestionably, the stock had been converted by Robert Maxwell; only if there was a basis under the New York UCC for the "true owner's" rights to be cut off could the pledgees prevail. The court found such a basis under Section 8-302(1)(a), because the pledgees were BFPs who

[36] It should be noted that Maxwell did not purport to act on behalf of Berlitz and there was no overissue of Berlitz shares.

[37] Transcript, supra note 33, at 512.

took free of any adverse claim, including a claim that another is the rightful owner.[38]

Although not discussed, the pledgees apparently satisfied the "good faith" and "for value" requirements of Section 8-302. The issue before the court in determining whether the pledgees were BFPs was whether the pledgees had "notice" of an adverse claim or defense. The court determined that they did not.

Under New York's nonuniform provision, in order for a purchaser to have "notice" of an adverse claim or defense, "the purchaser must have knowledge of the claim or defense or knowledge of such facts that his action in taking the security amounts to bad faith."[39] The court found that case law and the Uniform Official Comment make clear that this is a subjective standard of knowledge.[40] Macmillan did not allege that the pledgees had actual knowledge but claimed that the pledgees had constructive knowledge based on all the documents in their possession, which should have alerted them to Macmillan's ownership. The court disagreed.

Unauthorized Indorsement or Unauthorized Delivery

Next, Macmillan argued that because Maxwell converted the Berlitz stock when he indorsed and delivered the stock to the Trust, the indorsement was unauthorized. The argument continued that, inasmuch as a purchaser taking by way of an unauthorized indorsement cannot take priority over the true owner unless he has caused a new certificate to be issued in his name,[41] and because no new certificates had been issued in the name of either pledgee, Macmillan's claim was superior to the pledgees' claims.[42] However, the court distinguished between the making of the indorsement, which was within Maxwell's power as an officer of Macmillan, and the delivery of the securities, which was not. Because the indorsement, being within Maxwell's power, was held to be valid, the pledgees were BFPs, who took their interests free of Macmillan's claim.[43]

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[38] Transcript, supra note 33, at 554–559. The pledgees were able to achieve BFP status because they acquired their security interest under UCC § 8-313(1)(a) in the case of physically delivered certificates and Section 8-313(1)(g) in the case of transfers on the books of DTC.

[39] UCC § 8-304(4).

[40] Transcript, supra note 33, at 596–603.

[41] UCC § 8-405(3).

[42] See UCC §§ 8-302(1)(a), 8-311(a).

[43] Transcript, supra note 33, at 558–567. In more precise terms, Section 8-308(1) provides that an "indorsement . . . is made when an appropriate person signs on" the security. An "appropriate

In addition, the court rejected Macmillan's assertion that, so long as the transferee had not received certificates reissued in its own name, any prior unauthorized indorsement would abrogate the pledgees' claims to BFP status.[44] The court stated, in dicta, that even if the indorsement had been unauthorized, upon the *first* reissuance (in the name of the Trust) prior invalid endorsements may not be relied on by the true owner to defeat a subsequent BFP.[45] There is simply no requirement that each subsequent purchaser have the shares reissued in its own name in order to acquire the protection of this rule.

A Proposed Practical Solution

In *Bishopsgate*, Maxwell, unilaterally, as an officer of Macmillan, had the power, albeit fraudulently, to endorse its securities, but did not have any power to issue additional Berlitz stock.[46] In the garden variety parent-subsidiary relationship, both entities may have common directors and officers or the directors and officers of the subsidiary realistically may not be exercising independent judgment. While *Bishopsgate* did not involve a fraudulent issuance but rather a fraudulent transfer of securities in the context of a closely held corporation, the pledgee by analogy is vulnerable to such issuance. The reasoning of *Bishopsgate* as to the authority of an officer, as agent for a corporation, similarly applies to a wrongful act by an officer of an issuer acting in concert with its directors who could have authorized the issuance.[47] As a result, at first blush, after

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person" includes an authorized agent of a corporation. UCC § 8-308(8)(f). Because Maxwell, as an officer, was an authorized agent of Macmillan, he was an appropriate person and the court held that his indorsement was therefore valid, regardless of the fact that his actions in delivering the security were illegal. See also Revised UCC § 8-107(c) (as to effectiveness of indorsements).

The holding in Bishopsgate, if decided under Revised Article 8, apparently would remain the same. In fact, Example 5 presented in Official Comment 3 to Revised UCC § 8-502 sets forth a scenario strikingly similar to Bishopsgate.

[44] See UCC § 8-311(a).

[45] Transcript, supra note 33, at 567–569.

[46] Interestingly, an initial pledgee of the Berlitz shares, being viewed as in a position analogous to that of Macmillan, could have been better protected than Macmillan, the "true" owner of the Berlitz stock. Such pledgee could have prevented Maxwell's fraud in respect of its prior security interest under both the present and Revised Article 8. Certain Berlitz shares were recorded on the books of DTC, a financial intermediary, and could have been delivered to a different financial intermediary to effect the pledge. If such were the case, the initial secured lender could have achieved BFP status under Section 8-313(1)(d)(i) (or "protected purchaser" status under Revised §§ 9-115(5)(a), 8-303, and 8-106) by having the financial intermediary act as agent or custodian for the pledgee, thus destroying Maxwell's ability to transfer those shares without the pledgee's consent.

[47] See Simcox, 754 F2d at 441–443.

Bishopsgate, it appears impossible to fully protect the pledge that is first in time against a subsequent fraudulent issuance and pledge of equivalent or dilutive stock. However, steps can be taken to minimize the risk.

Not confronting the legal issue of authority directly, lenders, at times, have resorted to taking possession of stock books of the issuer of Pledged Securities. However, this is of little preventive value because new stock books can be printed or obtained by a dishonest borrower. Similarly, lenders have taken grants of security interests in stock books; surely, the grant would not protect against fraud.[48]

In the guarantor-corporate parent or controlling shareholder (the Controlling Pledgor) context, where the Controlling Pledgor first pledged the Pledged Securities to a lender and then fraudulently had additional shares issued and transferred to a BFP (either by outright sale or by grant of another security interest), attention should be turned to the fraudulent issuance of the shares, as opposed to the later transfer, which, although presumably in violaiton of the first lender's credit and security agreements, could nevertheless be effective under either version of the UCC. There are two operative factors involved in controlling the effective (from the wrongdoer's perspective) fraudulent issuance of securities: first, limiting the authority of the issuer or its corporate agent to issue and deliver certificated securities without lender consent, and, second, creating a framework in which prospective transferees of securities issued without such consent will likely acquire actual knowledge of the resrictions on issuance.

Concerning the issuance of securities, present Section 8-205 of the UCC provides:

> An unauthorized signature placed on a certificated security prior to or in the course of issue . . . is ineffective except that the signature is effective in favor of a purchaser for value . . . , if . . . such purchaser is without notice of lack of authority *and if signing has been done by*

[48] Some measure of protection may be obtained by lenders requiring that pledged shares constitute all the authorized capital stock of the issuer. Unless the issuer's certificate of incorporation was later amended to authorize more shares, an overissuance would constitute a violation of a "constitutional" provision making the certificated security invalid in the hands of the initial BFP, but nevertheless valid with respect to any subsequent BFP. See Section 8-202(2)(a). Moreover, as per the court's dicta in Bishopsgate, a pledgee would gain maximum protection against any unauthorized signature by having the stock certificate reissued in its name or in the name of its nominee, but such reissuance in its name would not accord protection to a prior pledgee whose lien is diluted by a subsequent BFP.

> (a) an authenticating trustee, registrar, transfer agent or other person entrusted by the issuer with the signing of the security or similar securities . . . or the immediate preparation for signing of any of them; or
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> (b) an employee of the issuer or of any of the foregoing entrusted with responsible handling of the security. . . .

(emphasis added).[49] Official Comment 3 to this Section helps delineate the scope of the liability of the issuer by stating that an "issuer cannot be held liable for the honesty of employees not entrusted, directly or indirectly, with the signing, preparation, or responsible handling of similar securities . . . and whose possible commission of forgery it has no reason to anticipate." Therefore, to better protect the first lender's security interest, the authority to issue further shares (without such lender's consent) should be appropriately circumscribed.[50]

In contrast with Section 8-205, Section 8-202(2)(a) provides that a certificated security in the hands of a purchaser for value "even though issued with a defect going to its validity is valid with respect to such purchaser if he is without notice of the particular defect."[51] The limited case law supports the proposition that the invalidity of a security (including in the case of overissuance) is normally not available to the issuer as a defense.[52] As a result, it

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[49] Revised UCC § 8-205 (to the same effect as the present UCC § 8-205); see Green v. Caribou Oil Mining Co., 179 Cal. 787, 789, 178 P. 950, 951 (Cal. 1919) (holding corporation bound by pledge of stock fraudulently issued by its officer intrusted to issue stock).

[50] See UCC § 8-202(3) ("Except as otherwise provided [in the case of certain unauthorized signatures], lack of genuineness of a certificated security . . . is a complete defense even against a purchaser for value without notice."); Revised UCC § 8-202(c) (to the same effect as the present UCC § 8-202(3)); see also New Jersey Bank, NA v. Bradford Sec. Operations, Inc., 690 F2d 339, 343–344 (3d Cir. 1982) ("[T]he issuer or agent bears risk of loss only when employees within its control are responsible for the unauthorized signature.").

[51] Likewise, Revised UCC § 8-202(b)(1) provides:

> A security . . . , even though issued with a defect going to its validity, is valid in the hands of a purchaser for value without notice of the particular defect. . . ."

But cf. supra note 48.

[52] See Bonini v. Family Theater Corp., 327 Pa. 273, 194 A. 498 (1937) (holding that purchasers of unauthorized stock "were not compelled to inquire into the validity of the stock represented by the certificates transferred to them, when the same were on their face in proper form with all the indicia of duly authorized issuance"); see also UCC § 8-202 (Official Comment 2); Revised UCC § 8-202 (Official Comment 1); cf. First Nat'l Bank v. Alaska Airmotive, Inc. 119 F2d 267, 269 (9th Cir. 1941) (though decided before the adoption of the UCC, but under a similar statutory construct in respect of the issuance and pledge of securities, holding that shares of a closely held corporation issued in violation of its constitutional documents could not be rescinded because they were transferred by pledge to the bank "for value in good faith without notice of any facts making the transfer wrongful"). But cf. Dempsey-Tegeler & Co. v. Otis Oil & Gas Corp., 293 F. Supp. 1381, 1387 (D.

probably would likewise be unavailable to a secured lender defrauded by the improper issuance of a security.

Still, corporate governance can be utilized to make it more difficult for new securities to be duly issued without lender consent and in a manner calculated to give prospective purchasers and pledgees notice of the need for such consent. Remember, Maxwell had the corporate authority, and, as a result, the power to cause the transfer of the shares of Berlitz to a BFP. The same principle applies to the issuance of shares. The Controlling Pledgor or his designee may have the corporate authority to cause the fraudulent issuance of shares, which even a vigilant shareholder or prospective shareholder or pledgee may be unable to detect.

Issuance of shares, as distinguished from a transfer of already-issued shares, would usually require board of directors' approval. Further, where the issuance would exceed the corporation's authorized shares shareholder approval would be necessary to amend its certificate of incorporation. In the context of a closely held corporation, the distinction between officers and directors may well not be meaningful, because the same persons are likely to occupy both positions. Therefore, to better protect the secured lender, the certificate of incorporation of the issuer could be amended to provide that (1) the signature of a specific, independent third party approved by the lender be required on all new certificates representing shares in the underlying entity to be issued and (2) any future amendment to the certificate of incorporation require the unanimous consent of the shareholders of the issuer's stock.[53] To close the circle, the lender would have to obtain the right to vote in respect of any amendment to the certificate of incorporation, either by the registration of a share in its name or through a voting agreement or irrevocable proxy.[54] In that way no employee or officer of the borrower would have the legal authority to issue (or have issued) new share certificates of stock without lender consent, presumably

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Col. 1968) (stating that a residual troublesome question remains, namely whether the purchaser of shares fraudulently executed by facsimile signature is charged with notice of the Colorado UCC provision requiring certificates issued with facsimile signatures of the president and the secretary be countersigned by a transfer agent).

[53] The by-laws could also be amended, but this would have less effect because by-laws do not have to be filed with any public official such as the secretary of state.

[54] Where an issuer agrees to these measures, it should require an agreement with the lender as to cases where lender must consent.

even if the certificate of incorporation was amended fraudulently or in violation of a lender-imposed covenant, to eliminate shareholder consent.[55]

Any prospective purchaser or pledgee of shares in a closely held company or subsidiary presumably would (or certainly should) request a certified copy of the issuer's certificate of incorporation, which is a public record. He would also request a long-form certificate of good standing listing all charter papers on file, including amendments, as part of its due diligence and thereby would receive notice of the lack of authority of any agent of the issuer to unilaterally authorize the issuance of any securities.[56] The implication of *Bishopsgate* is that without such authority, putatively issued shares would be invalid and that any transferee with notice of the defective issuance of such shares would not be a BFP.

If taken, the steps outlined previously would eliminate the legal authority of the issuer to issue or reissue shares without a lender's prior consent (and would place most prudent prospective transferees on notice of the need for such consent). Further, given the implementation of the outlined proposal, under the general law of agency, corporate employees and agents might not even be found to have apparent authority to sign a security certificate.[57] Nevertheless, if a prospective transferee of securities issued by such employees or agents was in fact unaware of the situation, Section 8-202 of the UCC would appear to make such securities valid in most cases in

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[55] Cf. Concrete Constr. Sys., Inc. v. Jensen, 410 NYS2d 460, 461–462 (App. Div. 4d 1978) (holding, where shares of corporation not properly issued, the holder of such shares was not entitled to commence dissolution proceeding); Tabulating Card Co. v. Leidesdorf, 223 NYS2d 652, 655–656 (Sup. Ct. 1961) (holding approval of issuance of stock by required director who was invalidly elected to be void).

[56] The lender also could insist that the pledge be disclosed in pledgor's financial statements and that a reference to a negative pledge covenant be included in any financing statement filed in connection with the financing.

[57] Neither the present UCC § 8-205 nor the Revised UCC § 8-205, which are nearly identical, directly references the laws of agency concerning the effects of unauthorized signatures in the issuance of securiies. Concerning the transfer of securities, the Revised Article 8, however, does state that an indorsement is effective if it is "made by a person who has the power under the law of agency to transfer the security . . . on behalf of the appropriate person." Revised UCC § 8-107(b)(2).

In addition, some courts have placed a duty of inquiry on third parties dealing with agents to determine the scope of putative agents' authority. Ford v. Unity Hosp., 346 NYS2d 238, 244, 299 N.E.2d 659 (1973) ("When a party deals with an agent he does so at his own peril and must make the necessary effort to discover the actual scope of authority."); Sponge Rubber Prods. Co. v. Purofied Down Prods. Corp., 119 NYS2d 783 (App. Div. 1953), aff'd, 306 NY 776, 118 NE2d 479 (1954). But see Herbert Constr., 931 F.2d at 995–996.

the hands of a purchaser for value.[58]

A Proposed Legislative Solution

A far more efficient and effective solution to the possible fraudulent issuance of shares of closely held corporations would be to provide, in Revised Article 8, that filing a financing statement with respect to shares of a closely held corporation—where market liquidity is not a serious concern—together with possession of certificates representing such shares creates a security interest not subject to being primed or diluted by a subsequent fraudulent issue of securities of the closely held corporation.[59] This would create a different rule from that applicable to the stock of non-closely held corporations; however, that different rule is justified (as some courts, which have held that shares of stock in closely held corporations are not even Article 8 securities, have recognized).

Such courts, although by far a minority, appear disconcerted by the perception that the nature of a shareholder's interest in a

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[58] See supra note 52. In analyzing whether a president has the power to bind a corporation with regard to an act that was not authorized by the board of directors, courts have invoked an implied authority rule in order to find the corporation liable to third parties. The idea behind the implied authority rule being not that the agent/president derives his authority from the conduct of the corporation (other than his appointment as president), but rather that his authority is derived from the expectation that presidents of corporations generally have such authority. See Scientific Holdings Co., Ltd. v. Plessey Inc., 510 F2d 14, 24 (2d Cir. 1974). For example, in New York, the rule is usually considered to contain an "ordinary business" limitation, in other words, the president's implied power to bind the corporation will extend to transactions in the ordinary course of the corporation. Id.

[59] An additional benefit of a filing would be to perfect in respect of proceeds of stock collateral. Perfection under Article 8 does not necessarily assure to the lender the fruits of its collateral. Under Article 8, the familiar Article 9 concept of "proceeds" has no application to nonliquidating dividends unless such "proceeds" were to be reduced to possession or fall within the ambit of collateral covered in the hands of the recipient Controlling Pledgor as after-acquired property under a security agreement executed by such Controlling Pledgor as debtor in favor of the lender. This might work if the subsidiary pays a dividend in kind, but is less likely to be effective for cash dividends. The latter would soon lose their identity and become unidentifiable in the hand of the parent stockholder. See UCC § 9-306.

The matter is further complicated in the case of a stock split or stock dividend upon stock held as collateral by the lender. Typically, the lender, for various reasons, will not have had the stock re-registered in its own name or that of its nominee. Under normal corporate principles, a dividend is paid to the stockholder of record on the record date. To afford a measure of protection to the lender, the security agreement will usually provide that such dividend, if received by the Controlling Pledgor, may in the case of an ordinary dividend (absent default), be retained, but in the case of a liquidating dividend or one paid in property or in stock of the payor, will be held in trust by the Controlling Pledgor and promptly turned over to the lender to be added to collateral in the lender's possession. See FDIC v. W. Hugh Meyer & Assocs., Inc., 864 F2d 371, 375–376 (5th Cir.), reh'g denied, 871 F2d 121 (5th Cir. 1989).

closely held corporation is different from that of a shareholder in a publicly traded corporation.[60] In fact, without Official Comment 2 to Section 8-102 of the UCC, which states that "stock of closely-held corporations, although they are not actually traded upon securities exchanges, is intended to be included within the definitions of both certificated and uncertificated securities," the minority view likely would have won more adherents. Clearly, the majority view means that the shares of all corporations are Article 8 "securities," and, indeed, that is precisely one part of the Revised Article 8 definition: "A share or similar equity interest issued by a corporation, . . . is a security, whether or not the particular issue is dealt in or traded on securities exhanges or markets."[61]

Yet merely because shares in closely held corporations are, and should be considered, "securities" does not mean that certain rules pertaining to such shares cannot or should not be different. Revised Article 8 speaks of "control" of a security, but if the pledgor still has the power, although in violation of covenants or even fraudulently, to issue additional securities, the concept of control is seriously undermined as a practical matter.

The main purpose of the secured party gaining control of securities is to prevent the debtor from defrauding creditors. A scheme under which the debtor is not totally divested of practical control is needlessly defective.[62] Market liquidity simply is not

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[60] Although the great weight of authority favors the position that shares of stock in all (or all types of closely held corporations are "securities" (e.g., Associates Fin. Servs. Co. v. Sevy, 776 P2d 650, 9 UCC Rep. Serv. 29 (Callaghan) 222 (Utah Ct. App. 1989); Bretz v. Portland Gen. Elec. Co., 882 F2d 411 (9th Cir. 1989)), this conclusion is not universally accepted. See Kottis v. Cerilli, 18 UCC Rep. Serv. 2d (Callaghan) 701, 705 (RI 1992), appeal dismissed, 627 A2d 329 (RI 1993); Blasingame v. American Materials, Inc., 35 UCC Rep. Serv. (Callaghan) 1610, 1614 (Tenn. 1983) (holding stock of closely held corporation not Article 8 "security"); Rhode Island Hosp. v. Collins, 21 UCC Rep. Serv. (Callaghan) 619, 621 (RI 1977) (holding same based on fact that there is not reasonable expectation of dividends); see also Levey v. Burke, Wilson & McIlvaine (In re Bragiel), 151 BR 186, 188–189 (Bankr. ND Ill. 1993) (holding shares in professional corporation not "of a type" and, therefore, not "securities").

Therefore, in jurisdictions where there is any doubt on this point, caution would suggest that along with acquiring possession of Pledged Securities to perfect under Article 8 (as a "security") and Article 9 (as an "instrument"), a financing statement should be filed covering the borrower's interest in its subsidiary or the guarantor's interest in the borrower as a "general intangible." Another reason for filing is that the owner of Pledged Securities may have other rights related to its ownership of the Pledged Securities that are not embodied in them but are rather contained in a shareholders' agreement, voting trust, or other contractual arrangement.

[61] Revised UCC § 8-103(a).

[62] See Robert A. Zadek, "The Uniform Commercial Code's Misplaced Emphasis on Possession," 28 Loy. LAL Rev. 391, 396–398 (1994).

implicated in the sale or pledge of securities of a subsidiary or other closely held corporation any more than it would be in the pledge of an interest in functionally equivalent economic units, such as partnerships or limited liability companies. Market liquidity and the avoidance of market disruption appear to be the primary reasons why financing statements under Revised Article 8 are deemed ineffective as against subsequent purchasers (including pledgees).[63]

To the contrary, a purchaser or pledgee of an interest in a closely held corporation—if at all prudent or competent—would investigate the issuer and should want a system whereby most prior adverse claims could be ascertained and subsequent claimants would be cut off. It is submitted that a system of public filing of financing statements in respect of pledged stock of closely held corporations would be efficacious in minimizing the problems herein discussed and should have the concomitant effect of enhancing the collateral value of stock of closely held corporations.

Two key elements of this proposal that must be addressed are the definition of a "closely held corporation" and the priorities rules concerning conflicting security interests in the same collateral comprised of pledged securities. In this context, "same" does not mean the same shares but rather the pledge of shares having the effect of diluting the first pledgee's percentage interest in the issuer's outstanding shares. The definition of a closely held corporation should be specific in order not to risk disruption in the securities markets. For example, part of the Internal Revenue Code Subchapter S definition of a small business corporation, which requires a small business corporation to have no more than thirty-five shareholders of record,[64] could be adopted as the UCC definition of a "closely held corporation." Admittedly, a bright-line definition may leave gaps: for example, an 80 percent subsidiary with 20 percent publicly traded stock would not under the proposed definition be a closely

[63] As stated in Official Comment 5 to Revised UCC § 9-115:

> [I]n order to avoid disruption of existing practices in this business it is necessary to give perfection by filing a different and more limited effect for securities than some other forms of collateral.

[64] Section 1361(a) of the Internal Revenue Code of 1986, as amended. A "shareholder" would be defined to include any natural or artificial person. Beneficial ownership should probably not be considered as it is difficult to ascertain from an examination of stock records. Further for our purposes, any fraudulent or negligent issuance of Pledged Securities that would cause the number of shareholders to exceed thirty-five should not change the characterization of the issuer as a closely held corporation.