RECONSIDERATION OF SHARE CERTIFICATE NEGOTIABILITY

The Uniform Stock Transfer Act makes share certificates negotiable to the extent that bona fide and value-giving certificate purchasers are insured of title if all necessary indorsements are regular and to the extent that both good faith and value are defined very broadly. The purpose of this note is to ex-

1 Uniform Stock Transfer Act, §§ 1, 4–8, 22. The act as drafted by Professor Williston was approved by the Conference of Commissioners on Uniform State Laws in 1909. The act applies only to stock in corporations organized within states that have adopted the act or a similar law, only to transfers within such states, and only to certificates issued after the adoption, Uniform Stock Transfer Act, §§ 22–3; Hunt v. Drug, Inc., 35 Del. 332, 156 Atl. 384 (1931). Voting trust certificates and share certificate receipts are not subject to the act, for these instruments are evidence only of stock certificates and not of corporate shares, Union Trust Co. of Rochester v. Oberg, 214 N.Y. 517, 108 N.E. 809 (1915); Hearne v. Gillette, 151 La. 79, 91 So. 634 (1922); Comm'r of Banks v. Chase Securities Corp., 10 N.E. (2d) 472, 485 (Mass., 1937).

The act also makes share certificates negotiable to the extent that bona fide and value-giving certificate purchasers are insured of freedom from corporate liens not stated on the instruments and freedom from claims of prior owners' creditors, Uniform Stock Transfer Act, §§ 13–15. These topics will not be discussed in this note because they are collateral to the
amine the negotiability provisions of the act, to analyze the asserted justifications for these rules, and to suggest changes that may be advisable under modern practices in share certificate transactions.

I. NEGOTIABILITY OF SHARE CERTIFICATES UNDER THE UNIFORM STOCK TRANSFER ACT

The act defines good faith as simply honesty in fact. If this means that the recipient of a certificate must have a "clear conscience," then good faith refers to a state of mind and the test of bonafides is completely subjective. A state of mind, however, can be demonstrated only through external manifestations, and the standard of good faith depends upon the types of words and conduct which are considered as indicating dishonesty. Conceivably uncautious or careless business conduct could be considered as evidence of bad faith, for one who acts without due caution may be attempting to avoid actual notice of a defect. Were customary commercial patterns of carefulness used as standards of measuring conduct, bona fides would mean "businesslike action" or commercial honesty. The Transfer Act, however, apparently intended a liberal test of good faith, for it provides that negligent conduct is not indicative of dishonesty. Where there is no actual notice, bad faith can be demonstrated only by proving knowledge that should put one on suspicion or by proving that the instrument was obtained "out of the ordinary course of business." Since

main problem of negotiability. Neither does the note consider whether assignment of a certificate terminates any right the corporation may have to refuse recognition to shares represented by the certificate, for the Transfer Act, except for the provision that a corporation is protected in paying dividends to the registered owner, ignores the problem, Uniform Stock Transfer Act, § 3. More specifically, the act does not provide whether a corporation may assert the defense of an infirmity arising when a certificate is issued against future purchasers of the instrument, nor whether the defense of consent by a predecessor in title may be asserted to bar a shareholder's derivative suit. For a discussion of some of these problems, see a doctor's thesis by William Starr, The Corporate Share Certificate and the Share: A Process of Merger (1935).

The act has been adopted by the following twenty-eight states: Alabama (1931), Arkansas (1923), California (1931), Colorado (1927), Connecticut (1917), Georgia (1939), Idaho (1927), Illinois (1917), Indiana (1923), Louisiana (1920), Maryland (1919), Massachusetts (1920), Michigan (1913), Minnesota (1933), New Hampshire (1937), New Jersey (1916), New York (1913), Ohio (1911), Oregon (1935), Pennsylvania (1911), Rhode Island (1912), South Dakota (1921), Tennessee (1925), Utah (1927), Virginia (1924), Washington (1939), West Virginia (1931), Wisconsin (1913).

2 Uniform Stock Transfer Act, § 22.

3 Concerning good faith in acquiring a share certificate, see De Boer v. Anthony, 15 N.E. (2d) 260 (Mass. 1938); Edgerly v. First Nat'l Bank of Boston, 292 Mass. 82, 197 N.E. 518 (1935); Muffat v. Detroit-Macomb Land Co., 252 Mich. 692, 234 N.W. 148 (1931); Hazard v. Powell, 230 Ohio App. 71, 154 N.E. 357 (1926); Crosby v. Simpson, 234 Mass. 568, 125 N.E. 616 (1920); 1 Meyer, The Law of Stock Brokers and Stock Exchanges 348 (1931). An interesting case is presented when a broker sells a correctly indorsed certificate against which a "stop transfer" order exists. If the broker furnishes his customer with other shares, the broker is deemed a bona fide purchaser of the shares represented by the challenged certificate: stock exchange rules may require the purchase of the replacement shares (see note 70 infra), and so
departure from customary commercial standards of care is often the only dereliction that can be established, proof of bad faith in such cases is difficult under the Transfer Act. To this extent the good faith provision of the act does not materially limit the negotiability of share certificates.\textsuperscript{4}

The Transfer Act adopts the Negotiable Instruments Law definition of value as “an antecedent or pre-existing obligation” or “any consideration sufficient to support a simple contract”; the Transfer Act, however, goes further and expressly provides that security for an antecedent obligation constitutes value.\textsuperscript{5} This broad definition would seem to indicate that even one purchasing for a “pepper-corn” is protected. An unusually low price, however, should be evidence of bad faith. The value and good faith requirements must, therefore, be construed together, and since both value and good faith are defined so broadly, these requirements cannot be said materially to restrict negotiability.\textsuperscript{6}

The Transfer Act provides that share title may be transferred only by delivery of the share certificate indorsed either in blank or specially by the person appearing thereon as shareowner, or accompanied by a separate document of assignment similarly signed.\textsuperscript{7} Delivery “is effectual . . . . though made it can be said the broker acquires the original shares in the ordinary course of business, United States Gypsum Co. v. Faroll, 296 Ill. App. 47, 15 N.E. (2d) 888 (1938). The Illinois court relied on Gruntal v. Nat'l Surety Co., 254 N.Y. 468, 173 N.E. 682 (1930) (dealing with bonds), which, says Steffen, “by sheer force of assertion, gave the broker the immunities of a purchaser in good faith, although obviously he was in no real sense a purchaser,” Steffen, A Proposed Uniform Act Making Investment Instruments Negotiable, 34 Col. L. Rev. 632, 653 (1934).

\textsuperscript{4} Cf. the good faith test in Gill v. Cubit, 3 Bar. & Cr. 466 (K.B. 1824) with that in Goodman v. Harvey, 4 A. & E. 870 (K.B. 1836); see Relation between Bad Faith and Notice under the N.I.L., 81 U. of Pa. L. Rev. 617 (1933). The Transfer Act does not expressly provide who has the burden of proving good faith, but presumably under Section 18 the common law governs, and one purchasing after a theft must establish his good faith, Bank of the United States v. Cooper-Bessemer Corp., 146 Misc. 20, 261 N.Y. Supp. 687 (1932).

\textsuperscript{5} Negotiable Instruments Law, § 25; Uniform Stock Transfer Act, § 22.

\textsuperscript{6} See McAllister v. McAllister Coal Co., 120 N.J. Eq. 394, 184 Atl. 716 (1936); Adams v. Silver Shield Min. & Mill. Co., 82 Utah 586, 21 P.(2d) 886 (1933) (holding that acquisition of a share certificate through a property settlement contemporaneous with a divorce does not make one a holder for value).

\textsuperscript{7} Uniform Stock Transfer Act, § 1. This note will for convenience use the term “indorse” to include signing a separate document assignment. The usual “separate document” is a power of attorney to “sell, assign, or transfer,” but no particular form is necessary, Holmes v. Holmes, 182 Wis. 163, 196 N.W. 248 (1923). For cases discussing indorsements, see Crosby v. Simpson, 234 Mass. 568, 125 N.E. 616 (1920); Moulin v. Ideal Savings & Homestead Ass'n, 178 So. 521 (La. App. 1938); Clark v. Western Feeding Co., 10 Cal. App. (2d) 727, 52 P. (2d) 991 (1936). The title transfer requirements of the Transfer Act are usually held not to govern an attempted share transfer unless a third party's rights intervene, In re Cornell's Estate, 282 Pa. 555, 128 Atl. 503 (1923); In re Estates of Antkowski, 286 Ill. App. 184, 3 N.E. (2d) 132 (1936). But see Parker v. Colonial Bldg.-Loan Ass'n, 111 N.J. Eq. 49, 161 Atl. 353 (1932). Between immediate parties to a transfer, title passes at the time intended; since a third party's rights may prevent this title transfer, it is often said “equitable title” passes when intended, while “legal title” passes upon compliance with the act's transfer provisions, Stuart v. Sargent, 283 Mass.
by one having no right of possession and having no authority from the owner of the certificate or from the person purporting to transfer title.8 In other words, possession of a regularly indorsed instrument gives rise to a presumption of ownership or power to pass title. Although the act does not specifically state that a thief may transfer title by delivering a correctly indorsed certificate, nevertheless, the Uniform Commissioners intended that the act should give "full negotiability to certificates of stock,"9 and it is now well settled that even a thief may pass good title.10 But whenever the indorsement is special, only a a delivery to the named indorsee is an effective delivery.11

A forged indorsement on a certificate cannot deprive a shareowner of his rights; a genuine indorsement is thus a form required for negotiability. Even if the owner indorses in blank, an erasure and subsequent duplication of the signature results in protection being denied to one purchasing after the alteration; it is said the purchaser relies upon a forgery rather than upon the owner's indorsement.12 There is nothing in the nature of things, however, which prevents legislating that delivery of a falsely indorsed or an unindorsed share certificate passes good title. Share certificates would then be treated like bearer

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9 The Commissioners' notes to Section 5 of the Uniform Stock Transfer Act.

10 Turnbull v. Longacre Bank, 249 N.Y. 159, 163 N.E. 135 (1928), noted in 38 Yale L. J. 390 (1929); Peckinpaugh v. H. W. Noble & Co., 238 Mich. 464, 213 N.W. 859 (1927). But see dissent in Jackson v. Peerless Portland Cement Co., 238 Mich. 476, 213 N.W. 863 (1927), maintaining that the Transfer Act does not apply to shares taken feloniously; see also 27 Mich. L. Rev. 93 (1928). In explaining why a thief should be able to pass good title, it is said that a correctly indorsed certificate appears the same to a purchaser whether it has been stolen, lost, or entrusted to a wrongdoer, Seymour, The Proposed Uniform Stock Transfer Act, 9 Cal. L. Rev. 186, 194 (1921).

11 See Uniform Stock Transfer Act, § 21, providing that after a special indorsement, the special indorsee appears by the certificate to be the shareowner, and his indorsement is necessary again to transfer share title. But cf. Parker v. Roberts, 243 Mass. 174, 137 N.E. 295 (1923), noted in 23 Col. L. Rev. 488 (1923), for the analogous situation in the case of a promissory note.

12 Nat'l Surety Co. v. Indemnity Ins. Co. of N.A., 237 App. Div. 485, 261 N.Y. Supp. 605 (1933). The purchaser is not protected even if a special indorsee's name is erased, leaving what appears to be a blank indorsement, Place v. Chaffee, 251 Mass. 508, 146 N.E. 722 (1925). Where the erasure is skilful, the rule seems hard on purchasers, insofar as the Transfer Act permits reliance on the owner's blank indorsement. An explanation of the result may be a desire to promote examination for erasures; a suggested preventative is to print certificates on paper that exposes erasure.
bonds, and would in effect be more negotiable. Greater care would be required to safeguard stock ownership, but there is no reason to believe that stock would become a less desirable form of investment. Eliminating the indorsement requirement, however, is said to be impractical because stock certificates are almost always registered and the registry is highly convenient for determining who can vote and receive dividends. But turning share certificates into bearer instruments would not impede maintaining the registry: instead of substituting registrations upon receipt of correctly indorsed certificates, as is the practice today, corporations could enter transfers upon receiving unindorsed certificates. The only practical difference to corporations would be that theft of share certificates might increase, and the corporations would become involved in more litigation concerning conflicting claims to stock shares.

II. EXPLORING THE JUSTIFICATIONS FOR THE NEGOTIABILITY CONFERRED UPON SHARE CERTIFICATES BY THE TRANSFER ACT

At the time the Transfer Act was drafted, and even today, the first argument in support of share certificate negotiability is that “it is in accordance with mercantile custom.” This however is a loose manner of speaking, for negotiability is not a matter of business practice but a legal principle for deciding conflicting claims of ownership. What the mercantile custom proposition probably means is that businessmen consider certificates to be readily transferable and consider possession of a correctly indorsed instrument as giving the possessor a right or power to transfer the obligation represented. The custom argument rests upon the assumption that the standard commercial patterns of conduct do not require an honest person to look behind a correctly indorsed share certificate; the law should not distort these accepted business patterns except in the interests of society as a whole. It is to be doubted, however, whether the assumption has any basis in fact. Cautious brokerage practices would indicate that even stock brokers do not act as if they considered share certificates to be negotiable. Only a few of the Chicago brokers interviewed during this study realized that certificates in corporations organized in states having the Transfer Act are more negotiable than certificates in other corporations.

33 Share certificates would become more negotiable in the sense that one of the forms now required for negotiability and for transfer—a correct indorsement—would be unnecessary, and even unindorsed (or falsely indorsed) certificates would then be negotiable.

34 But see Coats v. Guaranty Bank & Trust Co., 170 La. 871, 875, 129 So. 513, 514 (1930) stating that if a regular indorsement were not required to transfer title, stock would become “less valuable as an article of commerce.” The court, however, gives no reasons to support its belief.

35 See Uniform Stock Transfer Act, § 3.

36 See pp. 510–11 infra.

37 The Commissioners’ note to Section 5 of the Uniform Stock Transfer Act.
All of the brokers interviewed asserted that they did not treat the two types of certificates differently.\

Whenever the “mercantile custom” argument is raised, it is usually supplemented by the contention that the “interested” commercial society desires negotiability of share certificates. But who are the members of this “interested” group? If everyone having dealings in share certificates desired negotiability, then obviously there would be no reason for deciding share controversies according to any other principle unless vague notions of public policy intervened. But we should regard with suspicion any statement that all interested persons have expressed a desire that share certificates be made negotiable. The large mass of stockowners are practically voiceless; in this respect they resemble the great bulk of “consumers” in our economy. It is much more probable, therefore, that the phrase “interested community” refers only to those members of that community who are sufficiently organized to express themselves. In this smaller group are the bankers and stockbrokers and their insurers. The brokers buy and sell stock, sometimes acting as vendors or purchasers, but usually as agents. The bankers and the brokers advance money on stock collateral. Naturally it is to the advantage of both for the law to say that if they honestly accept a regularly indorsed instrument, no prior owner can claim the shares represented thereby. And of course it is to

Of twenty-four brokers interviewed in the Chicago area, only five knew there was a legal distinction as to negotiability between shares in corporations organized in states having the Transfer Act and shares in corporations organized in other states, see note 1 supra. Two out of the five had studied law.

It was decided by the Conference of Commissioners on Uniform State Laws that “full negotiability ought to be given to these instruments of commerce if the Conference were to act in response to the business sentiment of the country . . . .” Proceedings of the Conference of Commissioners on Uniform State Laws, 101 (1919).

An example may be taken from the development of the negotiability of bills and notes. Early merchant court cases involved only merchant traders, who as a class desired negotiability, Holdsworth, The Origins and Early History of Negotiable Instruments, 31 L. Q. Rev. 12, 173, 376 (1915). Later in the common law courts, non-merchants were allowed to declare on the custom of merchants by employing the fiction that one who used a commercial instrument must be a merchant, see Claxton v. Swift, 2 Show. 494 (K. B. 1686). But when non-merchants became concerned with these instruments, negotiability should not have been justified by saying “all the merchants desire it.”

Even though brokers and bankers may not fully realize how they benefit from negotiability, nevertheless their lawyers are aware of the advantages. The lawyers often advise the brokerage group as to what legislation should be favored, etc. We might well ask whether the negotiability provided for in the Transfer Act was not a direct result of the climate of opinion prevailing at the time the act was drafted, which could be characterized as one favorable to finance capitalism.

Conservative brokers sometimes say that they do not care what rule is adopted concerning negotiability, for the Transfer Act’s lenient rule benefits only the careless and “shady houses.” These utterances, however, must not be taken too seriously, for in speaking “off the record,” the same brokers admit that every once in awhile someone “puts something over” on them.
the advantage of the insurance companies to be relieved from liability under the same circumstances. But is it also to the advantage of that large interested class which may be termed "the investors"? Certainly the inability of investors to reclaim their stock when the indorsed representative certificates are in the hands of bona fide purchasers, does not of itself work to the investors' advantage. This is especially true insofar as stock certificates (to repeat the stereotyped phrase) "may be examined only at long intervals," and investors, especially in rural areas, do not adequately safeguard their certificates and are rather susceptible to being defrauded into intrusting their stock to swindlers. The interests of brokers and bankers, therefore, must be weighed against the interests of investors. Negotiability should be adopted only if it also benefits investors or the economic society as a whole.

To demonstrate that share certificate negotiability is beneficial to investors, it is argued that negotiability protects purchasers' expectations, that investors must be purchasers at one time or another, that the investing and purchasing classes roughly coincide, and that negotiability protects the entire purchasing class at the expense of individuals in the class. It is contended, therefore, that the individuals who are hurt by negotiability have no cause to complain: They benefit by the rule in their capacity as purchasers, and as owners they could have easily protected their share rights by refraining from indorsing, by not having trusted a dishonest person, or by more adequately safeguarding their instruments. In addition, it is said that purchasers (or pledgees), under any other rule, would have the onerous burden of inquiring from the registered owner whether the person in possession of the certificate has the right to transfer title to the shares represented. This argument would perhaps justify share certificate negotiability were it not for one thing: share certificates rarely pass from hand to hand as does money, but in more than ninety-nine per cent of all stock transfers, a broker is employed to buy or sell the shares. Once

23 The insurance companies often carry on the litigation arising out of their customers' transactions.

24 Many brokerage firms are "investors." But for purposes of simplicity this note assumes that the "investor class" is limited to persons outside the brokerage system.

25 MacChesney, Uniform State Laws 55 (1926). Previously, MacChesney says: "While it is true that in certain financial centers like New York City and possibly Chicago also, it is probable that a considerable percentage of certificates of stock are used as collateral, in the aggregate, in my judgment, they form only a small proportion of the total stock investments which are affected by such a provision. . . . ." See also, Seymour, The Proposed Uniform Stock Transfer Act, 9 Cal. L. Rev. 186, 187 (1921), citing MacChesney.


27 For a similar argument in the case of bonds, see Steffen, A Proposed Uniform Act Making Investment Instruments Negotiable, 34 Col. L. Rev. 632, 654 (1934).

28 No adequate statistics are available to determine what proportion of share transfers are outside the brokerage system, but transfer agents and brokers all agree that the percentage is
the professional broker enters upon the scene, the picture changes. The pur-
chaser can secure protection by requiring his broker to certify that all necessary
indorsements are regular and that the shares acquired are not subject to adverse
claims. With brokers making the actual purchases, the purchaser and inves-
tor classes no longer coincide. Furthermore, the broker as a purchaser is in a
position to inquire whether the registered owner has authorized the transfer. And in addition, the broker is also in a position to insure against losses
which may be assessed against him for making an unauthorized transfer.
Under these conditions would it be right to justify share certificate negotiability
by arguments which ignore the brokerage system—the outstanding feature of
stock transfers?

One argument for negotiability of share certificates remains to be investi-
gated. Corporate stock shares are a capital-raising device which operates
through shares being considered as investments. Corporate assets and earning
power underlie share value, but desirability as an investment rests also upon
custodial convenience and marketability. It is said that negotiability enhances
salability because purchasers will be more willing to buy if they are assured of
freedom from the claims of prior owners. Increased salability of share certifi-
cates means that stock shares would be more liquid and hence more desirable
investments. Obviously this result would benefit the investor class, and per-
haps the entire free enterprise economy. But the existence of a brokerage
system makes the argument fallacious. In general, neither one who purchases
through or from a broker nor one who sells to or through a broker will be

extremely small. At the present time, approximately three million shares are transferred
through brokers daily, so that about thirty thousand shares would have to be transferred out-
side the system in order for these latter transfers to constitute one per cent of all transfers.

Notes 88 and 89 and related texts, infra.

Although brokers usually purchase as agents for investors, nevertheless the agency rela-
tionship is peculiar, so that we reasonably can make a dichotomy between "brokers" on one
side and "investors" on the other. See note 89 and text, infra.

Notes 56 and 57 and related texts, infra.

Of the Chicago brokers interviewed, all the large firms and several small houses carried
insurance, note 60 infra.

"The purpose of . . . [the Uniform Stock Transfer Act] . . . is to enable those dealing
with certificates of stock . . . to rely upon them as reliable evidence of title. This facilitates
business by making the circulation and transfer of property as easy, safe, and certain as possi-
ble, and protecting purchasers and lenders acting in reliance upon these documents which are
the customary indicia of title. The security of a large amount of stock transfer, credit, and
banking business rests upon such evidence of title," Ballantine, Private Corporations 473
(1927). "An effective functioning of the markets for the trading of stock requires a fluid, un-
hampered transfer of shares of stock merely by delivery of the certificate," The Uniform Stock
Transfer Act, 32 Col. L. Rev. 894 (1932). See also Berle and Pederson, Liquid Claims and Na-
tional Wealth (1934), advancing the theory that negotiability aids liquidity and so benefits the
economy.
significantly affected by whether or not share certificates are negotiable. Transactions outside the brokerage system are so insignificant that it is folly to contend that they materially affect the salability or liquidity of shares.

The negotiability conferred upon share certificates by the Uniform Stock Transfer Act remains unjustified. The mere fact that negotiability is a simple principle, perhaps a rule of thumb, does not adequately recommend its adoption for deciding cases; simplicity only too often results from blindly accepting unexplored principles. The remainder of this note will attempt to explore principles which should underlie rules for deciding conflicting claims to stock ownership.

III. CONSIDERATION OF PRINCIPLES TO SUPPLANT NEGOTIABILITY

Since the stock-brokerage system (including the banks) plays such an important role in stock transactions, any rules for determining controversies arising out of stock transfers must reflect the system's operation. But there are still a few transfers completely outside brokerage circles, and principles that work justice within the system may not do so in other controversies. Two sets of principles may therefore be needed inasmuch as the two types of transactions are fundamentally different.

A. TRANSACTIONS WITHIN THE STOCK-BROKERAGE SYSTEM

The stock-brokerage system consists of individuals, partnerships and corporations, labelled brokers, licensed by states to engage in the business of buying and selling securities. In addition, banks that perform investment services for their customers and that advance money on stock collateral are an integral part of the system. Brokers usually buy or sell securities for others on a commission basis, and when they act for themselves, disclosure of that fact might be necessary. The brokers are located chiefly in the large financial centers, especially in cities having stock exchanges; the larger firms are usually

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34 One who purchases from a broker need not be materially affected by negotiability, for he can procure the broker's guarantee, see note 89 and text, infra. A registered owner who sells through a broker will not be concerned with the negotiability of his certificate. Only where the registered owner appoints a new agent to deal with the broker or where one other than the registered owner represents himself to the broker as shareowner does negotiability substantially affect the transaction. The broker's caution may slow down the sale. P. 512 infra.

35 Brokers and bankers often cooperate in engineering stock transactions. Brokers consider banks as part of the general stock-investment scheme, for banks not only loan money on stock collateral, but often purchase securities for their customers, guarantee indorsements, and furnish information concerning strangers. Before the National Banking Act of 1935 many national banks conducted extensive brokerage businesses.


members of the exchanges. Only members can sell on an exchange, but non-members often have agreements with members by which they trade on the exchange through the members. Securities not listed on an exchange are sold “over the counter.” All exchange and most over the counter sales consist of a purchase by one broker from another broker: the buyer’s broker purchases from the seller’s broker, and the selling broker must always guarantee all indorsements to the buying broker.

Towns, small cities, and rural areas usually are not directly served by the brokerage system; the volume of trade does not warrant permanent brokerage establishments, and “traveling salesmen” brokers are rare. Large investors in these areas often establish accounts with brokerage firms in larger cities. The remainder of the populace is only indirectly served by the brokerage system through the local banker, who often acts as an investor’s agent in dealing with city brokers. But on the whole, the great bulk of the populace in the smaller communities shows little interest in stock as a form of investment.

With this system as a base, how should a redrafted Transfer Act adjust rights between a shareowner who has been wrongfully separated from his certificate, a broker who sells the certificate at the request of some third person (who has since disappeared), other brokers who receive the certificate by way of purchase or pledge, and a private investor who purchases the shares represented by the instrument? On the one hand, if justice permits, the rules of law which form the answer to this question should neither require brokers to adopt costly new practices nor unduly slow up brokerage transactions; brokers often operate on a small profit margin and speed of brokerage transactions

The value of securities sold over the counter in the United States is approximated at twice the value of securities sold through the exchanges. A relatively small amount of listed securities are sold over the counter.

Brokers are furnished with a constant stream of information as to shares offered and desired. A broker can locate with amazing rapidity a share offered for sale. In one transaction witnessed, a Chicago broker located a certificate in a small New Jersey corporation within five minutes after the customer requested a purchase. The selling broker was in New York.

During the boom years of the twenties, brokers operated in towns that are now without direct brokerage service. The “traveling salesman” broker has been more prevalent in the Middle West than elsewhere. Sometimes large brokerage firms have “customer men” who travel through the countryside.

One Chicago firm stated they had “regular” customers as far north as Green Bay, Wis., a distance of 211 miles.

The local banker sometimes opposes rather than aids brokerage interests. The country banker, according to brokers, often discourages his customers from purchasing stock and attempts to sell them local real estate mortgages. Just how widespread this practice is has never been determined, but many of the smaller brokers feel that it materially decreases stock purchases.

This statement becomes less true as a speculative spirit surges through the country. Another qualification may be needed when a local community becomes enthused about a neighborhood development that is financed by a stock issue.
underlies the liquidity of corporate shares, making them a desirable form of investment. On the other hand, practices which have already been adopted by many brokers without proving too costly or burdensome and which prevent injury to investors should be encouraged. The law, therefore, should hold brokers to standards of conduct set by careful members of their own group. Twenty-four brokers in Chicago, ranging from the largest to one of the smallest, were questioned as to their practices. The information obtained constitutes the foundation for the remainder of the note.

I. ENTRANCE OF A CERTIFICATE INTO THE BROKERAGE SYSTEM

The first phase of an ordinary brokerage transaction is a broker taking a stock certificate from a non-broker either to sell on the market or to purchase for himself. Controversy between the broker and the registered owner of the certificate arises either if the owner's indorsement was forged, or if one without authority presented the correctly indorsed certificate to the broker. There are three alternative rules for resolving the controversy: (1) the broker is immune if he acted honestly; (2) the registered owner may sue the broker for his stock or the value thereof; or (3) the comparative diligence of the broker and owner is weighed, and the loss is either borne by the less careful party or is split if both are equally careless. The Transfer Act adopts the first rule if the

Brokers' profits at the time of this writing are meager. Chicago brokers are all complaining, apparently with some justification, that the present inactive market has pushed them to the wall. One reason for this is that many of the organizations are geared to function most efficiently in a market such as existed in 1929. See 33 Time 61 (Feb. 12, 1940).

It is fully recognized that the method of investigation employed to gain information for this note is far from scientific. In a sense, the procedure followed resembles the discredited and abandoned anthropologists' device of questioning the wise men and elders of the tribe. The resemblance is all the more close in that brokers consider themselves as a "fraternity," and though frequently reluctant to answer specific questions, they, just as the tribal elders and wise men, often delight in recounting interesting experiences. In order to overcome the difficulties of obtaining accurate information, several brokers were contacted through an intermediary who possessed their confidence. But despite this precaution, the author willingly admits that his limited efforts do not furnish a satisfactory basis (such as that provided by the Underhill Moore studies) for determining the best solutions to the problems involved. The purpose of this note, however, is not to solve these problems, but only to raise them. It is hoped that others will confirm the findings of the author, for it may well be that brokerage practices are not uniform throughout the country or that the author was misinformed.

The first phase of a stock transaction may be a pledge of a certificate to a bank. The bank should be treated as a broker who takes stock to sell, for the problems confronting the bank and broker are the same, and they have identical facilities for protecting themselves.

Henceforth only "typical" brokerage transactions will be discussed. Many variations exist, but the same principles can be applied in adjudicating controversies arising therefrom. Special situations deserving attention will be discussed in footnotes.

Rule (1) makes share certificates negotiable; rule (2) makes certificates non-negotiable; rule (3) does not make certificates negotiable, but accomplishes a similar result in some cases by way of estoppel doctrines, Harvey, Victims of Fraud (1932) (who says we should call this a "relative diligence" principle, rather than an estoppel principle, for the meaning of estoppel has been overly narrowed by judicial precedents).
certificate is genuinely indorsed and the second rule if the indorsement is forged. But is this result sound in the light of cautious brokerage practices?

Brokers say that taking a stock certificate resembles cashing a check: there is danger of the indorsement being forged only if the presenter is not well known. Just as bankers will not cash checks for a stranger, brokers should protect against a forgery by demanding sufficient identification from a stranger who requests share certificates to be sold. The minimum identification that brokers claim to require from strangers varies. Some admit being satisfied with lodge cards, a driver's license and/or a mention of an established customer's name. Others, more cautious, require a written or personal introduction from a regular customer or another broker. Still other brokers assert they refuse to deal with a stranger unless his signature is guaranteed by a bank. The degree of care exercised, however, may depend upon the value of the stock involved and the profit which the broker stands to make. Furthermore, brokers often acquire great confidence in their powers of discernment; as one broker said: "Regulations are regulations and rules are rules, but judgment and experience are most important. Each case must be treated separately. After all these years I can almost feel whether I am in the presence of an honest person or a crook." But since brokers do have expedient devices for detecting forgers

Curiously enough, about one-half of the brokers interviewed mentioned the check analogy.

The bank guarantee of a signature is a peculiar device. Banks apparently will guarantee the signatures of their customers, but not of strangers. Most banks will guarantee a stranger's signature if the stranger procures a customer of the bank to guarantee it first. There is doubt as to whether a bank is legally bound on its guaranty, Christy, The Transfer of Stock § 44 (2d ed. 1940); but brokers often consider banks to be at least morally bound. One broker said that sometimes he is not even satisfied with a bank guaranty and requires in addition the registered owner's signature card from a bank—so as to be able to compare signatures himself.

Surprisingly enough, most brokers say that they do not worry much about one who presents a large block of a well-known (listed?) stock for sale. A person owning such a certificate will be well known in the business community and can identify himself easily. Furthermore, he will be acquainted with commercial practices and will not leave his certificate unguarded; if the instrument is missing, he will immediately have all brokers notified via the ticker (if the shares are listed). Certificates representing a small number of shares cause brokers the most trouble.

Many brokers apparently share this view, although they do not always admit it. One transaction witnessed at a reputable firm is interesting. A young lady asked the broker to sell one share of American Telephone & Telegraph Company. The broker had never seen her before, but merely asked her (1) name, (2) address, and (3) occupation. Upon being informed she was a telephone operator, the broker took the instrument for sale, gave a receipt, and agreed to mail a check in three days. When asked how he knew the lady was the registered owner, the broker replied that "telephone operators often receive shares as bonuses," that "she was just like all the rest of the telephone operators," and that "had she been attempting to sell someone else's certificate, she would have been so nervous her teeth would have chattered!" But the broker was not relying solely upon his ability to size up strangers, for he agreed to make the check payable to the registered owner of the certificate, see the text of note 57, infra.
and since many brokers at least claim to employ these devices today, the law wisely adopts a prophylactic rule according to which brokers who accept falsely indorsed certificates are penalized irrespective of the registered owner's reckless conduct. This rule may make brokers skillful in detecting forgeries, for the analogous Price v. Neal rule has encouraged bank tellers to develop great skill in scrutinizing signatures. Moreover, identification precautions should be considered as part of the brokerage business, which is in a position to insure against losses arising through forgeries.

There is little disagreement with the rule imposing liability where the broker takes a falsely indorsed certificate, probably because commercial society considers a genuine indorsement to be a form necessary for transfer. But possibly because there is some magic in a genuine indorsement, no one inquires whether the broker's facilities for protecting himself are so different that his rights should be changed when there is a correct indorsement but no authority to transfer title. When a shareowner has indorsed his certificate and another presents it to a broker, the broker's problem is to ascertain whether the presenter has authority to transfer share title. In defense of the Transfer Act rule that an honest broker is protected if the owner's indorsement is genuine, it is said:

any rule of law . . . . that places upon the bona fide purchaser of a stock certificate the hazard of determining at his peril, whether or not the owner thereof freely, voluntarily, and without fraud or misrepresentation, indorses the same for the purpose of making a transfer thereof, would subject brokers to so great a liability as to make the risks of the business greater than a cautious man would assume.

But this is not true! Brokers have two simple devices which they can and often do use whenever an indorsed certificate is presented by one other than the registered owner. The presenter may be required to procure on the broker's standardized form blank a waiver signed by the registered owner and perhaps notarized. More cautious brokers claim that in addition they require the registered owner's signature to be guaranteed by a bank or the owner's signature to be on file for comparison. If the presenter says he is selling for the registered owner, and if the broker does not wish to contact the owner to verify the presenter's story, the broker can issue a check payable to the registered owner.

The registered owner may sue the broker for converting the falsely indorsed instrument; if the broker still has the certificate, the owner may recover it. Note 68 infra.


Requiring a signed waiver does not afford complete protection to investors, who may be duped into signing a waiver or who may leave signed waivers with their certificates. But both of these happenings are unlikely, and furthermore, a broker may well be suspicious of a stranger who already has a waiver from the registered owner. Perhaps the broker should require the customer to have the registered owner sign the broker's own waiver blank.
The presenter must then either procure the indorsement of the owner, in which event a fraud will be detected, or forge the indorsement, in which case the bank must either detect the forgery or re-credit the broker's account. How can these practices be called too burdensome on brokers?

If a broker not employing the foregoing protective devices takes a correctly indorsed instrument from a thief, finder, or one without selling authority, why should not the broker bear the loss despite the registered owner's carelessness? Knowing that indorsed instruments are sometimes lost or misappropriated, brokers should be on guard when one other than the registered owner offers certificates for sale. The brokerage business is in many ways a public service, and part of that service certainly should include adopting simple devices which would protect the property interests of investors. Furthermore, the individual stockholder is rarely in a position to insure against loss, theft, or misappropriation of his certificates, whereas brokers can carry insurance against selling stock without the shareowner's consent. As a matter of record, many large brokers and a few small ones carry such insurance and usually do not feel that the premiums are too high. The usual provision in these policies relieving the insurance company of liability if the broker fails to exercise "reasonable care" tends to promote cautious brokerage practices.

Not only is the Transfer Act rule protecting the subjectively honest broker unnecessary but it may have deleterious effects. A substantial evil in our society is the professional "fence"—the person or organization specializing in the purchase of stolen items. Theoretically the fence should be eliminated through enforcement of the criminal law, but actually the fence has managed to operate with many articles despite threatened criminal penalties. Property law must take the fence into consideration. Not much traffic in stolen share certificates

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57 Many stock transactions are carried on by an owner's authorized agent. Where there has been a course of dealings through a certain agent, the broker should be able to trade with the agent without contacting the registered owner each time. Normal agency principles should govern rights in this situation, and the owner should be required to notify the broker when the agency is terminated.

58 If the registered owner is another broker, perhaps we should adopt a comparative diligence test in adjudicating the controversy. For even though the broker taking the instrument for sale is in a position to verify his customer's authority, it seems unfair to place the loss on him if the other broker was even more careless in losing the instrument. Therefore, the general principles advocated in this note perhaps should be restricted to where the registered owner is outside the brokerage system.

59 Even if all brokers adopted the protective devices, investors would not be completely protected. One who wrongfully acquires a correctly indorsed instrument could have the corporation issue a new certificate in his name and then sell the new instrument through a broker. Perhaps we should prevent this occurrence by requiring that a licensed broker or a bank or trust company must certify that the registered owner has authorized the transfer. Note 81 and text, infra.

60 No premium figures could be obtained, but several brokers suggested that in computing premiums insurance companies considered the size of the brokerage firm and the firm's carefulness.
has been uncovered, probably because registration of share certificates increases the fence's inability to dispose of the shares; the absence of registration expedites traffic in stolen bearer bonds. Nevertheless, brokerage circles have at times been troubled by "shady houses" which close their eyes in purchasing stolen certificates. A pretense of honesty is rather simple, so that the Transfer Act provision is a boon to the very institutions that we should exterminate.

A second evil which the Transfer Act fosters is the professional swindler who procures indorsed certificates through misrepresenting that he is the issuing company's agent for exchanging certificates, attempts to sell the shares, and to pocket the proceeds. Today the swindler often tries selling to or through brokers, who are protected by the act as long as they appear to be "honest." Holding brokers to a more stringent standard of conduct would terminate one of the swindler's chief outlets. Perhaps, however, the swindler might be driven to selling only directly to the public, and this must be considered in discussing transactions outside the brokerage system.

Besides being unjustified and perhaps having deleterious effects, the Transfer Act's negotiability and good faith provisions require of brokers a lower standard of conduct than they have set for themselves. Most brokers do much more than merely act "honestly," even when they know the law will protect them. The reasons for this are far from altruistic. Brokerage houses like to be considered as "substantial" or "conservative" firms, and so they often attempt to impress new customers with extremely cautious business methods. Furthermore, litigation is costly, furnishes bad publicity, reveals agency secrets, and sometimes necessitates political intrigues; consequently brokers usually attempt to stay out of the courts. The broker's attitude is not changed by carrying insurance, since increased litigation may mean higher premiums in future years. Finally, among honest brokers it is a matter of pride to frustrate a crook and avoid being fooled by a "slicker." In the light of these considerations it is dubious whether the Transfer Act provision protecting "honest" brokers will encourage less cautious brokerage practices among reputable firms which today in no way differentiate between stock certificates that are governed by the

61 Brokers seem reluctant to admit that there are such things as "shady houses." But after extensive questioning, quite a few brokers said they "sort of recall" firms that "may have been involved in suspicious purchases and sales."

62 The best evidence that swindlers operate in this manner is that many brokers have foiled attempts of swindlers to unload securities. One broker mentioned that he had uncovered a pair of swindlers who had defrauded a large number of shareholders in Iowa and who were attempting to sell the securities in Chicago. Even though the swindlers had obtained signature guarantees by a large national bank, the broker was suspicious because the swindlers had certificates of many different registered owners.

63 A broker usually makes only a small profit from a single deal and, therefore, must rely on volume in his transactions. The broker, consequently, attempts to gain his customer's confidence, and one way of doing this is by a display of conservatism. But carelessness in the form of a "favor" may also accomplish the desired result.

64 One broker summarized this attitude by saying: "Rather lose a sale than win a lawsuit."
act and those that are not. But is it wise policy to have legal standards below those which the "profession" sets for itself? The competition in laxity among less responsible brokers must inevitably lead to a lowering of the standards by some members of the profession to that sanctioned by the law.

On the other hand, requiring brokers to adopt cautious business methods would slow up brokerage transactions only to an imperceptible extent. If it is true that most brokers exercise greater caution than is demanded by law, brokerage practices will not be affected if the law requires that greater caution. Aside from this, very few share transfers are materially impeded by the protective devices. Seldom is a certificate brought to a broker by one other than the registered owner or the owner's regular agent. But even when another does present the instrument, the registered owner usually can be contacted promptly. Only in the exceptional case where the registered owner cannot be reached and the presenter is unwilling to take a check made out jointly to himself and the registered owner will there be a delay until the corporation transfers the shares to the presenter. But even this exceptional delay should not be cause for concern. If the situation arises at all, it probably will be in connection with less active stocks, for such shares are more likely to be transferred between private individuals (i.e., from the registered owner to the presenter). Speed of disposal is usually unimportant if the stock is inactive. Moreover, the presenter deserves no sympathy, for he probably acted in an unbusinesslike manner in not having had the shares transferred into his name at the time of acquisition.

2. MOVEMENT OF A CERTIFICATE THROUGH THE BROKERAGE SYSTEM

The second phase of an ordinary brokerage transaction is sale of stock by a broker to another broker who purchases for a customer. The typical situation causing controversy is where the selling broker forwards a falsely indorsed certificate or a genuinely indorsed certificate which was presented to him by one having no authority to transfer title. We saw in the previous discussion that the registered owner should be able to recover damages from the selling broker. But what are the registered owner's rights against the purchasing broker in case the selling broker is insolvent? These rights may depend upon whether the selling broker forwards to the buying broker (1) the registered owner's certificate, or (2) a certificate in the name of a broker. We shall con-
sider the governing precedents and determine whether they are justified under modern brokerage practices.

Under the Transfer Act an honest purchasing broker is completely protected if he acquires a correctly indorsed certificate. If he obtains a falsely indorsed instrument, however, the registered owner thereof may sue in conversion or for return of the certificate.\(^6\) The argument made in support of this distinction is that the purchasing broker should be able to rely on a correct indorsement and should not be required to inquire whether the registered owner authorized the sale of his shares. But the argument rests on a faulty assumption. The purchasing broker never relies on the regularity of the registered owner's indorsement, for he does not know the owner's signature and is in no position to verify its authenticity. Rather than relying on the owner's indorsement, the purchasing broker relies on the selling broker's guaranty that all necessary indorsements are regular. Both the Transfer Act and brokerage custom provide for this seller's warranty which places the primary pecuniary loss on the person—usually a broker—who receives the instrument from the forger.\(^6\) But since the purchasing broker has no better facilities to confirm the registered owner's authorization to transfer the shares than to verify the owner's indorsement, a similar rule should be adopted in the two situations. The purchasing broker should rely on the selling broker using due caution in taking the certificate for sale, and if the selling broker failed to confirm his customer's authority to sell, the purchasing broker should be liable to the owner and should have his recourse against the selling broker. Under this rule, purchasing brokers would require selling brokers to guarantee against adverse claims of the registered owner, as well as to certify all indorsements as genuine. In other words, selling brokers would be required, as under stock exchange rules, to make "good de-

\(^6\) Angus v. Cincinnati Morris Plan Bank, 56 Ohio App. 444, 10 N.E. (2d) 1019 (1938); Pierpoint v. Hoyt, 260 N.Y. 26, 182 N.E. 235 (1932). Conversion, however, has been attacked as being an inappropriate remedy, 82 U. of Pa. L. Rev. 174 (1933). It is said that since a certificate merely evidences a share, and since the registered owner cannot lose his share through losing an unindorsed certificate, a purchaser of the falsely indorsed instrument does not disturb the owner's share title, Pierpoint v. Farnum, 234 App. Div. 205, 254 N.Y. Supp. 758 (1931), rev'd Pierpoint v. Hoyt, 260 N.Y. 26, 182 N.E. 235 (1932) over a vigorous dissent by Justice Lehman; Steffen, A Proposed Uniform Act Making Investment Instruments Negotiable, 34 Col. L. Rev. 652, 653 (1934). As a substitute for conversion it is urged that the owner should merely recover his certificate plus damages for loss of title evidence. It seems, however, that a conversion action usually accomplishes an equivalent result: conversion would be brought only if the value of the owner's share has declined; the damages for loss of title evidence would normally equal this decline, for without a certificate the owner could not sell his share at the higher price; therefore, title evidence damages plus retention of his share will net the owner a total value equal to that recoverable in conversion.

\(^6\) Uniform Stock Transfer Act, § 11. But does the selling broker make the Transfer Act warranty on his own behalf or on behalf of the person for whom he is selling the certificate?
livery”—i.e., delivery of unquestioned certificates. The result would not be harsh, for as in the forged indorsement situation, the buying broker must take care to trade with financially responsible brokers. The result, furthermore, would again shift the ultimate pecuniary loss to the party best able to avoid it—the broker who originally takes the instrument for sale.

Brokers treat all shares alike, and in selling a customer's share, the broker may for convenience deliver someone else's certificate to the buying broker. This is ordinarily done when there is need for an immediate delivery and the selling broker has or can borrow a certificate in the buying broker's city. Usually in these cases the certificate delivered is in a broker's name and is referred to as a "street certificate." The purchasing broker under these circumstances is not considered as buying the share of the selling broker's customer, but rather as taking a "street share." Consequently, if an owner's share is received by the selling broker from a forger or from one having no authority to sell, and a street certificate is then forwarded by the selling broker, the purchasing broker is immune from claims of the wronged owner.

The New York Stock Exchange, for example, has the following rules governing reclamations of securities:

RULE F.P. 116. "Definition. The term 'reclamation' as used in these rules means a claim for the right to return, or to demand the return of, a security previously accepted."

RULE F.P. 112. "Manner of Settlement. When a security is returned or reclaimed, the party who delivered it shall immediately give the party presenting it either the security in proper form for delivery in exchange for the security originally delivered or the current money value thereof. In the latter case, unless otherwise agreed, the party to whom the security is returned shall be deemed to be failing to deliver the security until such time as a proper delivery is made."

RULE F.P. 113. "Minor Irregularities. Reclamation for an irregularity which affects only the currency of the security in the market shall be made within ten days from the day of original delivery."

RULE F.P. 117. "Lost and Stolen Securities—Imperfect Title. Reclamation by reason of the fact that title to a security is called in question, or a security is reported to have been lost or stolen, may be made without limit of time, and such security may be returned to the party who introduced it into the market."

RULE F.P. 119. "Special Circumstances. The Committee may make special rulings in circumstances not specifically referred to in these rules. The Committee may also make special rulings in particular cases, in spite of any general rule herein contained, if, in the opinion of the Committee, there are equitable considerations therefor," excerpts from Rules Adopted by the Committee on Floor Procedure Pertaining to the Settlement of Exchange Contracts, New York Stock Exchange (Adopted May 16, 1938).

It perhaps could be argued that even though the selling broker forwards a borrowed street certificate, the purchasing broker acquires the registered owner's share. But this view would be realistic only if certificates were not closely associated with shares. Today, however, we think of each certificate as representing a specific share.

The selling broker takes the ultimate loss under the Transfer Act if the indorsement of the registered owner's certificate is forged: the corporation will refuse to transfer the certificate, and the broker will become liable on his warranty or guarantee if he sells the instrument. Under the principles advocated in this note, the selling broker should also bear the loss if he takes a correctly indorsed instrument from one without authority to sell it.
The purchasing broker usually transfers the certificate he receives into his customer's name because the customer will not be entitled to receive dividends or vote until registered on the corporate books. By transferring the certificate, the purchasing broker's rights should in no way be improved; if he is liable to the registered owner for merely purchasing the latter's instrument, then clearly he should be liable if in addition he procures a transfer thereof. If the broker procures transfer of a falsely indorsed certificate he will be liable to the corporation on his "implied warranty" that the owner's indorsement is regular. The implied warranty has been attacked as being unrealistic, but it accords with accepted transfer practices.

Corporations and their transfer agents are in a difficult position to verify indorsements; they do not become expert in recognizing signatures since they seldom execute many transfers for a single registered owner (as a bank pays many checks of a depositor). Transfer agents usually overcome their difficulty by requiring a broker, bank, or trust company

73 The former registered owner perhaps might sue to have the new certificate cancelled or transferred to him on a constructive trust theory, 23 Minn. L. Rev. 484, 500 (1939).

74 The Transfer Act does not provide remedies for corporate refusal to make a transfer. At common law one who purchased a certificate which the corporation refuses to transfer could claim a conversion and recover the share value or compel a transfer in equity, Va. Pub. Service Co. v. Steindler, 166 Va. 686, 187 S.E. 353 (1936); St. Roes v. Levee Steam Cotton Press Co., 127 U.S. 614 (1888). Courts have rejected the contention that under the Transfer Act a corporation must convert the certificate in order to convert the stock, Booth v. Cincinnati Finance Co., 19 Ohio App. 730 (1923).


76 Ames suggested that we should think of the broker as presenting to the corporation a writing purporting to be the registered owner's order on the corporation to substitute the presenter or his nominee as shareholder, Ames, Forged Transfers of Stock: Another View, 77 Harv. L. Rev. 543, 546 (1904); cf. Thorndike, Forged Transfers of Stock and the Sheffield Case, 17 Harv. L. Rev. 373 (1904); see Corporation of Sheffield v. Barclay, [1903] 1 K. B. 1, rev'd 1903 2 K. B. 580 (C.A.); rev'd again, [1905] A. C. 392 (H.L.). The corporation would then be in an analogous situation to a drawee bank; under the Price v. Neal rule, the corporation would have to determine the extent of its duty, and if it acted on a forged signature, it could not recover for its mistake, see Christy, Transfer of Stock § 3 (2d ed. 1940). But even if the broker procuring a transfer does not imply warrant the owner's indorsement, the corporation may obtain recovery through derived rights: If the registered owner can sue the broker for converting his share (see note 68 supra), but instead elects to remain a shareholder, the corporation by recognizing him as such may become subrogated to his conversion action.

77 For the problems confronting a corporation or its transfer agent, see Dewey, The Transfer Agent's Dilemma: Conflicting Claims to Shares of Stock, 52 Harv. L. Rev. 553 (1939).
to "guarantee" the owner's indorsement. Thus aside from any implied warranties, the risk of forgery is expressly placed on the brokerage system; and the ultimate loss is once again shifted to the broker who initially accepted the falsely indorsed instrument.

Under the Transfer Act, a corporation is protected in cancelling a genuinely indorsed certificate. If the registered owner has inserted a "stop transfer" order, the corporation should notify the rival claimants and await an adjudication of their rights before issuing a new certificate. In the absence of a "stop," the corporation need not be concerned with whether the registered owner authorized transfer of the indorsed instrument. But perhaps if we require a selling broker to certify to a buying broker that the registered owner had authorized a transfer (as suggested previously), we should also require a broker seeking a new certificate to guarantee the same to the corporation.

3. EXIT OF A CERTIFICATE FROM THE BROKERAGE SYSTEM

The last phase of a normal brokerage transaction is delivery of a certificate by the purchasing broker to his customer. Controversy involving the customer arises when the share purchased is or was represented by a certificate that had been either falsely indorsed or sold without the registered owner's authority. The rights of the customer may depend upon whether the purchasing broker delivers to the customer (1) a new certificate in the customer's name, (2) the registered owner's instrument, or (3) a street certificate.

As was stated previously, the purchasing broker usually obtains a certificate in his customer's name through procuring a transfer of the registered owner's instrument. Is the customer thereafter fully protected from claims of the corporation even though the registered owner's instrument was falsely indorsed? The general rule is that a corporation may cancel a new certificate issued under these circumstances provided the instrument has not been passed on by the procurer to a bona fide purchaser. But what is the status of the purchasing broker if a new certificate is subsequently issued to the customer? The corporation must continue to recognize the owner of the falsely indorsed and cancelled certificate as a shareholder (unless he chooses to sue in conversion), and since the new certificate becomes binding on the corporation when transferred to a bona fide purchaser (see Rand v. Hercules Powder Co., 129 Misc. 891, 223 N.Y. Supp. 383 (1927)), two shares may be created out of a

78 Christy, Transfer of Stock § 44 (2d ed. 1940). There is some question whether a bank guarantee is ultra vires. See note 50 supra.

79 Casey v. Kastel, 237 N. Y. 305, 142 N. E. 671 (1924). This is true even though a finder or thief requests the transfer.

80 Christy, Transfer of Stock c. 18 (2d ed. 1940).

81 This procedure would invalidate the usual argument that in the absence of a "stop," the corporation has no convenient means of determining whether the registered owner has consented to the transfer.

82 The selling broker may sell directly to an investor. In that event, the selling broker is a purchasing broker as far as the buyer-investor is concerned.

83 Cancellation, which is a form of rescission, rests on mutual mistake, if the forgery was unsuspected, or on fraud, if the procurer knew the signature was false. Brown, Lancaster & Co. v. Howard Fire Ins. Co., 42 Md. 384 (1875); see Simm v. Anglo-American Tel. Co., L.R. 5 Q.B.D. 188 (1879); Hambleton v. Central Ohio R. Co., 44 Md. 551 (1876). Since the corporation must continue to recognize the owner of the falsely indorsed and cancelled certificate as a shareholder (unless he chooses to sue in conversion), and since the new certificate becomes binding on the corporation when transferred to a bona fide purchaser (see Rand v. Hercules Powder Co., 129 Misc. 891, 223 N.Y. Supp. 383 (1927)), two shares may be created out of a
broker's customer? It is unrealistic to call the customer a bona fide purchaser of the new certificate for it is issued directly to him, and although the broker actually procures the transfer, the broker acts only as the customer's agent. But allowing the corporation to cancel the new certificate seems harsh to the customer, who usually does not see the registered owner's certificate. Upon receiving the new instrument, the customer relies on the corporation's implied representation that everything is in order. Furthermore, the controversy is between a corporation and a private investor, and we should limit the corporation to recourse against the guarantor of the registered owner's signature or the broker (or individual) who procured the transfer. This provision would tend to give increased security to stock acquisitions—a desirable result for stock investments generally.

Frequently an investor or speculator desires to remain off of the corporation's books and consequently asks his broker for an indorsed street certificate. The purchasing broker may furnish a street certificate that he already has, borrow one from another broker, or procure one through transferring the registered owner's instrument. Even if the last-mentioned procedure is followed, the broker's customer is immune from the claims of the former registered owner, for the customer is a bona fide purchaser of the new (i.e., street name) certificate. The fact that a broker's customer is protected from the claims of the corporation or of the former registered owner when the customer receives a certificate in a broker's name should be an additional reason for immunizing the customer when he receives a certificate in his own name.

A wronged registered owner's certificate that enters the brokerage system will seldom come into the hands of a broker's customer, but when it does, how should rights be adjusted? On the one hand, the purchasing broker should be


...
liable to his customer for not making "good delivery," for the broker alone can obtain assurances that the purchased instrument effectively passes share title. Unfortunately, the legal precedents indicate that a broker need act only as a reasonable broker and not "as a principal, or a guarantor, or as insurer." But since many brokers today replace controverted instruments as a matter of policy, a similar legal requirement (as a corollary of the principles suggested previously) would not place an unduly heavy burden on brokers. On the other hand, the registered owner of the certificate should be able to sue (as suggested previously) either the purchasing or selling broker. Therefore, only where the purchasing broker and selling broker (who may be one person) are insolvent should any serious problem arise in adjusting rights between the broker's customer and the registered owner. If the owner's certificate was falsely indorsed, the owner undoubtedly should retain his share, for a correct indorsement is a form necessary to transfer a share; the purchaser's recourse must be against the insolvent broker or brokers. However, since the controversy is between two private investors, if the registered owner's certificate was regularly indorsed in blank but transferred without the owner's authorization, the share should be awarded to the more diligent party.

B. TRANSACTIONS OUTSIDE THE BROKERAGE SYSTEM

Stock transfers outside the brokerage system generally fall into two classes: (1) transfer of shares between acquaintances and (2) sale of shares by a stranger. The desirability of negotiability in share transfers between friends cannot easily be determined. The problem of adverse title claims arises only when the transferor gives a certificate in someone else's name. This situation will rarely occur, but should it occur, it can be argued that the transferee relies on his friend rather than on the certificate. The typical transaction outside the brokerage system that raises the negotiability problem is a sale by a non-broker stranger of a third person's certificate. How should the conflicting rights of owner and purchaser be resolved if the indorsement was forged or if the stranger had no authority to pass title? The Transfer Act protects the honest purchaser if the indorsement is regular and protects the owner if the indorsement is forged.


89 All but one of the brokers interviewed said they felt obligated to replace a contested instrument.

90 Notes 58 and 68 and text, supra.

91 See Harvey, Victims of Fraud c. 4 (1932).

92 Another situation in which this remedy might be resorted to is where both the former registered owner and the broker's customer want the shares represented by the certificate, and no other shares can be purchased on the market. If the purchaser and former owner were equally diligent, the shares represented by the contested certificate should be split between the two, and each should have a remedy against the brokers involved for the additional shares.
This result is indefensible. The purchaser does not rely on the registered owner's indorsement when purchasing from a third-party stranger, since the purchaser never knows the registered owner's signature. Furthermore, the registered owner may have been even more careless in suffering a forgery of the undorsed certificate than in becoming separated from the indorsed instrument. Clearly some other standard is necessary.

One suggestion is to deny protection to those purchasing from non-broker strangers. The state licenses security brokers, thereby indicating that it considers stock transactions as dangerous and as needing control; if one wants to purchase from a non-broker, he should do so at his own risk. Moreover, sale of securities in a tavern or kitchen is not the liquidity and salability desired. Too often swindlers dispose of their securities in this manner, and we should hesitate to protect purchasers who even unconsciously aid swindlers. Furthermore, the average person should immediately suspect a non-broker stranger who attempts to sell stock; investigation and identification are dictated by common sense, and a mere "clear conscience" should be insufficient to warrant protection by the law.

The prophylactic rule, however, seems too harsh. After all, the purchaser is only an ordinary individual who is susceptible to being misled. The other claimant of the stock, the registered owner, may also have been misled, or perhaps even careless or negligent. There is no necessity to apply a simple, arbitrary rule to adjust their rights. The conduct of the claimants should be weighed and the stock awarded to the more careful of the two. If both acted with approximately equal care, splitting of the loss between them should be required, because they were, in a sense, both victims of the same wrong.

IV. CONCLUSION

At the time the Uniform Stock Transfer Act (formerly labeled the Transfer of Stock Act) was approved by the Conference of Commissioners on Uniform State Laws, it was said:

The intention of the Conference with regard to the Transfer of Stock Act . . . . has been to make [share certificates] fully negotiable. . . . . These documents of title were already clothed with a quasi-negotiable character by mercantile usage and judicial decision. . . . . The test of the wisdom of [the Commissioners'] action is not to be found in any appeal to a theoretical standard or the authority of tradition, but whether or not they have acted in response to the prevailing sentiment among business interests.93

The Conference's attitude, although perhaps necessary to expedite adoption of the proposed act, reflects an inadequate examination into the nature of negotiability.94

94 MacChesney, for example, thought that share certificates should not be made negotiable, and as an Illinois Commissioner on Uniform Laws voted against the proposed act. Later, however, he said: "Nevertheless, I regard it as so highly necessary that the rule upon such a question should be uniform that now that this act has been recommended by the National Conference and adopted by a large number of the leading States, that I would earnestly recommend that Illinois adopt it also." MacChesney, Uniform State Laws 55 (1916).
“Negotiability” primarily describes a legal adjustment of conflicting assertions to rights represented by a writing:95 the purchaser's expectations as created by the appearance of the paper are protected as if he had actually relied on its contents.96 This protection is extended despite existence of adverse title claims of former owners or of defenses of the maker, which, in the absence of negotiability, could otherwise be asserted.97 The adoption by the law of such an adjustment of rights rests upon an attitude developed in society, and more particularly, commercial society, toward the instruments involved. This attitude is complex but may be characterized basically as follows: Probably because the instrument is frequently transferred in response to business needs, the interested community closely associates the paper with the right represented thereby. The close identity means that psychologically people do not distinguish the chose from the evidence of the chose, and possession of the instrument gives rise to a presumption that the possessor may enforce or transfer the claim represented. This attitude crystallizes in respect to instruments exhibiting certain formalities and those dealing with the paper tend to feel secure without looking behind the writing when the forms are present. In this environmental background the law is called upon to adjudicate conflicting claims in respect to the rights represented by the formalized paper. Because the commercial society regards the paper as highly representative of the underlying claim, the lawmakers suspect there must be a good commercial or business reason for this attitude. If some such reason can be found, the law-makers believe that the

95 Historically, negotiability originally referred only to the assignability of an instrument promising a payment to the bearer thereof or to the nominee of a person named in the writing, see Holdsworth, The Origins and Early History of Negotiable Instruments, 31 L.Q. Rev. 12, 173, 376 (1915); 32 L.Q. Rev. 20 (1916); Ewart, Estoppel by Misrepresentation 384 (1900). Transferees of such paper were later permitted to sue in their own name, and it could then be said that the obligor made an independent promise to each person in the chain of title, see Hussey v. Jacob, 1 Salk. 344 (1696); Holdsworth, ibid., 31 L.Q. Rev. 173, 182-4 (1915); Jenks, On the Early History of Negotiable Instruments, 9 L.Q. Rev. 70 (1893). The adoption of this view meant that the rights of a holder were not subject to the obligor's defenses against predecessors in title. With attention centered on the holder's position, it was also easy to conclude that if the holder's title were in order, his rights should not be affected by adverse title claims of prior owners of the instrument, see Anonymous, 1 Salk. 126 (1698). Negotiability thus took on a new meaning and now referred to freedom of a right from prior infirmities after transfer of an instrument representing the right. When many other types of claims were made assignable, this new meaning became the primary one.

96 “Actual reliance” is used to mean parting with value on the faith of the signature of the person being sued on the instrument, see note 99 supra. In the case of share certificates there is always reliance on the corporation’s implied promise to recognize the shares represented by the certificate.

97 By protecting a purchaser's expectations, negotiability does not lessen the protection afforded property rights. A purchaser's interest in his purchase is as much a property right as is an owner's interest in his possessions; therefore negotiability merely protects the security of acquisition property interests at the expense of ownership property interests. Unfortunately we have been conditioned to think that the purchaser acquires a property interest in his purchase only if he can secure specific enforcement of the purchase contract.
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legal counterpart of the businessman's attitude should be that one who gives value in bona fide reliance on the accepted forms ought to be protected in his expectations. When the law adopts this position with reference to an instrument, we say that instrument is "negotiable." By making the instrument negotiable, the law protects the "dynamic institution of exchange."98

From the foregoing analysis, two propositions can be derived that are of paramount importance in considering the negotiability of share certificates. Firstly, negotiability is a form of estoppel.99 Negotiable instruments contain "ambulatory promises"; the owner of such an instrument who creates an appearance that he has transferred his rights should be estopped to assert title claims against subsequent holders, other than the immediate transferee.100 The rationale of the estoppel analysis is that, measured by the rough standards of the business community, the former owner who is asserting an adverse title claim must have been more careless than the purchaser. The purchaser acquired the instrument in the ordinary course of business, while the former owner either trusted a wrongdoer, lost his instrument, or enabled a thief to obtain the

98 Houston, The Enforcement of Decrees in Equity 129 (1915).
99 Ewart, Estoppel by Misrepresentation c. xxiv (1900).
100 As to terminating the obligor's defenses, Ewart says that one who makes a promise to the bearer of an instrument or to a named party's nominee makes an "ambulatory promise." When a "promisee" in the chain of title attempts to enforce the promise, the obligor is estopped to assert that he received no consideration or that he has a defense against the holder's predecessors in title. Ewart goes on to say that if "negotiability" merely means "transferability," the term should be discarded because it is too confusing. Ibid., at c. xxiv.

The Ewart estoppel analysis may account for instruments being negotiable, but it fails to explain why some instruments containing ambulatory promises are not negotiable. History reveals that certain formalities have always been prerequisite to negotiability, American Nat'l Bank of San Francisco v. Sommerville, 191 Cal. 364, 216 Pac. 376 (1923). Estoppel analysis can explain the need for forms by saying that in the light of commercial practices there can be reasonable reliance only when certain forms are present. But estoppel cannot explain the origin of the particular forms that are required. An examination of institutions must therefore supplement any theory of negotiability.

It should be noticed that the Ewart analysis explains why acting in good faith and parting with value are prerequisites for asserting the negotiable benefits: giving value is often considered the only means to satisfy the estoppel requirement of detrimental reliance, and bad faith bars the privilege of claiming an estoppel. But the analysis must overcome two conceptualistic obstacles to make this explanation satisfactory: (1) Traditional estoppel notions require actual reliance on the representation of the person estopped, Bigelow, The Law of Estoppel c. 18 (1913). In practice, however, a purchaser of a negotiable instrument may have relied solely upon his transferor's indorsement without reference to the principal obligor's undertaking, and yet the law does not consider this as improving the principal obligor's rights. Perhaps traditional estoppel notions of reliance are too narrow. See the risk of reliance analysis in Promissory Obligations Based on Past Benefits or Other Moral Consideration, 7 Univ. Chi. L. Rev. 124 (1939). (2) The estoppel analysis does not explain what is necessary for "good faith." It is very likely that the good faith notion which arose in connection with estoppel differs from that which grew out of the mercantile transactions giving rise to negotiable instruments. But commercial bona fides could be incorporated into that part of estoppel relating to commercial instruments.
instrument in a form effective to transfer title. Applying this rationale to share certificates, the standard of good faith set by the Transfer Act, under which a purchaser may ignore good business practices and still be bona fide, cannot be defended. The Transfer Act completely disregards the existence of an extensive brokerage system, the presence of which means that in most stock transactions, purchasers (i.e., brokers) as a class may be distinguished from investors (i.e., owners) as a class. The professional broker should be held to a different standard of conduct from the private investor. The careful broker claims that he never handles a certificate without verifying the registered owner's authorization. If this is true, the estoppel argument can no longer be made: the purchasing broker must have been careless in taking the instrument for sale; regardless of the registered owner's carelessness, the broker should have detected the absence of the owner's authorization to make a transfer; therefore, as against the broker or anyone claiming through him, the registered owner should not be estopped to assert his adverse title.

Secondly, the mere fact that the commercial community considers certificates as highly representative of the underlying shares and desires the paper to be negotiable is not in itself sufficient reason for the law to immunize a bona fide purchaser of the writing from adverse title claims. The desire must be supported by a genuine commercial or business need for negotiability, which need must sufficiently offset any disadvantages that would result to other interests in the society. A good plea for negotiability can be made along these lines on behalf of the older negotiable instruments. The negotiability of checks, for instance, promotes their function as payment devices insofar as check transactions can be closed within the shortest possible period. The negotiability of bills and notes originally served a similar purpose for it developed at a time when these instruments served as media of payment and transferring funds. Moreover, bills and notes were for short terms and circulated from hand to hand among merchants without the intervention of a professional broker or banker. The negotiable character of the instruments, once established, made them eminently useful as short term credit devices because readily discountable and rediscountable; negotiability aids both completion and discount. And throughout their development, the ownership property interest in these writings was relatively small and could be sacrificed to commercial expediency. But share certificates are usually investments that are retained for long periods of time. The ownership property interest is consequently of great importance. On the other hand, there is no genuine need for the negotiability of share certificates in our present society. This note has suggested that most stock transactions are handled by professional brokers and bankers, who act as though

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101 Some notes are made for long terms, but these are usually held by banks or insurance companies, rather than private individuals. For a discussion on how the law should reconcile business interests with other interests in the society, see Ehrlich, Fundamental Principles of the Sociology of Law (1936).
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certificates were not negotiable. The fluidity of share certificates within the brokerage system depends not upon negotiability, but upon confidence between brokers. It is at the point where a certificate enters brokerage or banking channels that negotiability has its greatest significance. Negotiability at that point serves to protect careless brokers and bankers who introduce certificates into the brokerage system without confirming the registered owner's authorization to transfer the shares. This protection is at the expense of private investors, who as a class, cannot protect themselves with the ease or effectiveness that brokers can.

THE TRUST INDENTURE ACT OF 1939: LIMITATIONS ON THE TRUSTEE'S PRIVILEGE OF LENDING TO THE OBLIGOR

Most trust companies which serve as trustees for indenture security issues are also commercial bankers making short-term loans. It may happen, therefore, that such companies will occupy the dual position of indenture trustee and creditor of the obligor on the indenture securities. As trustee, the trust company's duty to the bondholders requires that it refrain from any action which may diminish the value of the property available to the indenture security holders to satisfy the indenture lien or claim; as a bank creditor, the trust company's duty to its depositors and stockholders compel it, in conformity with sound banking practice, to make itself whole on any outstanding loans to the obligor. Because of the risk that such a trustee-creditor may disregard its fiduciary duties to the investor, the Trust Indenture Act of 1939 requires a qualified indenture to contain certain provisions which protect the indenture security holder against the trustee's improving its position as creditor within four months of default on the indenture obligation.

Prior to the Trust Indenture Act, there were but few suits to compel a corporate trustee to share with investors any preferential payments which were made by the obligor on debts to the trustee and which were received by the

1 For example, see SEC, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, pt. VI, Trustees under Indentures, at 99 (1936). Of 308 corporate trustees, the commission found 240 were also commercial bankers.


3 The commission will refuse to allow a registration statement for the sale of indenture securities to become effective if the indenture does not contain the provisions required by Sections 310 to 318 inclusive, § 305(b)(2). Section references are to the Trust Indenture Act of 1939, which is title III of the Securities Act of 1933.

4 §§ 311, 313(a)(2), (3), 313(b)(2). A "default," except where the trustee acts as trustee for two or more qualified indentures, is defined as "any failure to make payment in full of principal or interest, when and as the same becomes due and payable" by the terms of the indenture, § 311(a).