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# BANK STOCK TRANSFER AGENTS: THE NEED TO SHORE UP DEFENSES

by  
Marc H. Folladori\*

In recent years both independent and bank-affiliated stock transfer agents have come under increasing criticism by those in the securities industry. Some of the complaints have centered around the amount of paperwork required that results in much delay in processing transfers of shares of stock, especially in a heavy volume securities trading market such as that which occurred in 1968-1970. In addition, some authors have expressed the opinion that abuses have grown out of the transfer agent's relatively unregulated status under federal and state laws, and that minimal fiduciary standards have not been observed by transfer agents with respect to their relations with brokers, securities attorneys, and the investing public.<sup>1</sup>

Recent years have also witnessed expansion of the potential liabilities of stock transfer agents. Article 8 of the Uniform Commercial Code<sup>2</sup> makes transfer agents primarily liable for wrongful transfers of securities, or wrongful refusals to transfer, to the owner or the issuer of such securities.<sup>3</sup> Transfer agents have also been subjected to liability for violations of federal securities laws; and now, legislation has been enacted which authorizes direct federal regulation of transfer agents.<sup>4</sup>

This Article will describe the areas of expanding liability and the reasons for this expansion, and emphasize the need for improved controls to assist transfer agents in avoiding liability. Moreover, because of the increased legal problems inherent in an upswing in the volume of securities traded and transferred, stock transfer agents should take heed of this Article as a warning against stubborn adherence to traditional modes of doing business.<sup>5</sup>

## I. THE STOCK TRANSFER AGENT

The Uniform Commercial Code does not expressly define the term "stock transfer agent" or its attendant duties, nor does the Code define an "authen-

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1. Bell & Arky, *Public Investor Protection and the Need for Regulation of Transfer Agents*, 26 BUS. LAW. 1649 (1971); Johnson, *The Registrar and Transfer Agent—Child of the Securities Industry; Neglected or Indulged?*, 1971 UTAH L. REV. 308.

2. The Uniform Commercial Code (UCC) in various amended forms has been adopted by all states except Louisiana. References in this Article shall not be to any particular state's adopted form (except where otherwise indicated) but rather to the sections numbers and official comments promulgated thereunder of the Uniform Commercial Code (1972 version) prepared under the joint sponsorship of the American Law Institute and the National Conference of Commissioners on Uniform State Laws.

3. UNIFORM COMMERCIAL CODE § 8-406, Comment 1; see note 19 *infra* and accompanying text.

4. Pub. L. No. 94-29 was signed by the President on June 5, 1975. See notes 99-117 *infra* and accompanying text.

5. These factors were pointed out as reasons for transfer agents to adopt fully automated and modernized procedures, and to utilize services such as stock clearing systems and depositories, in an address by Lee A. Pickard, Director of the Securities and

ticating trustee" or "registrar." The authenticating trustee, more commonly known as the indenture trustee, has the authority to authenticate and generally to deliver the original issue of debt instruments and to register and authenticate each transfer.<sup>6</sup> The main duty of the registrar is to prevent the issuance of certificates representing an amount of stock greater than the amount created or permitted by the corporate charter (*i.e.*, an "overissue"). Unlike the transfer agent, the registrar is not charged with any duty regarding the propriety of a transfer of stock, except that before any certificate is issued in transfer, a certificate for a like amount of stock must be cancelled.<sup>7</sup> The transfer agent has the duties of recording the transfer of stock on the corporation's books and issuing new certificates to the transferee. Also, the transfer agent may prepare and certify stockholders' lists, pay dividends, assist in stock redemptions, act as warrant or subscription agent, mail stockholders' notices and perform a variety of similar functions.<sup>8</sup> It is particularly advantageous for a corporation whose stock is publicly traded to have an independent stock transfer agent.<sup>9</sup> The high volume in the number of transfers of stock of publicly held issuers gives rise to the need for efficient transfer procedures. The independent stock transfer agent and registrar can perform the necessary tasks more efficiently, in most cases, than can the issuer.

Generally, bank transfer agents are appointed by the issuer corporation through the adoption of appropriate corporate resolutions. These resolutions are usually set forth on a form provided by the bank, and often set out in great detail rights, duties, and obligations between the corporate issuer and the bank transfer agent. The form resolutions are generally sprinkled with indemnity clauses, requiring the issuer to indemnify the transfer agent for losses suffered by it under varying degrees of culpability.<sup>10</sup> Under pre-UCC common law principles, the transfer agent was regarded as a true agent of the issuer, and was, therefore, not liable to the owner of securities for mere nonfeasance regarding its duties, for example, a refusal to register a transfer.<sup>11</sup> The transfer agent could be liable to the issuer under common law

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Exchange Commission (SEC) Division of Market Regulation before the Stock Transfer Association, Inc., on Nov. 14, 1974, at Scottsdale, Ariz., reprinted in full text in [Current Volume] CCH FED. SEC. L. REP. ¶ 80,011 (1974).

6. The authenticating trustee will sign, either manually or by facsimile signature, a legend on the debt instrument certificate, that such certificate represents one of the bonds or debentures described in the indenture. C. ISRAELS & E. GUTTMAN, *MODERN SECURITIES TRANSFERS* § 7.03 (rev. ed. 1971).

7. F. CHRISTY, *TRANSFERS OF STOCK* § 280 (5th ed. 1972).

8. *Id.* § 279.

9. An Indiana statute requires all publicly held corporations, with some exceptions, to have an independent transfer agent. IND. CODE ANN. § 23-2-2-1 (1972). Independent transfer agents and registrars are required for corporations whose stock is listed on the New York Stock Exchange or the American Stock Exchange. *See, e.g.*, 2 CCH NYSE GUIDE ¶ 2496 (1975).

10. UNIFORM COMMERCIAL CODE § 8-406 imposes upon the transfer agent "a duty to the issuer to exercise good faith and due diligence in performing his functions," which duty is refined in *id.*, Comment 3, to "preclude arbitrary, capricious, overcautious and super-technical objections and requirements." According to Comment 3, to insist upon more documents than properly required before registering a transfer where there has been no notice of adverse claims, may give rise to transfer agent liability for wrongful refusal to register a transfer.

11. *Hulse v. Consol. Quicksilver Mining Corp.*, 65 Idaho 768, 154 P.2d 149

principles only for a loss suffered by reason of a wrongful transfer of stock or a wrongful refusal to transfer the stock where reasonable care had not been used in examining the transfer.<sup>12</sup> These theories of liability were developed under common law agency concepts, whereby an agent could not be held liable for acts performed within the scope of its agency agreement.<sup>13</sup> Additionally, in certain instances, the transfer agent could be held responsible for failure to pay stock transfer taxes,<sup>14</sup> and, in a like manner, could be charged with penalties for permitting the transfer of stock without securing any necessary inheritance tax waivers.<sup>15</sup>

Article 8 of the UCC<sup>16</sup> now embodies the legal framework regarding purchases, sales, and transfers of investment securities.<sup>17</sup> The overriding theme of article 8 is that investment securities be treated in the same manner as negotiable instruments under article 3 of the Code, that is, in the absence of certain conditions, they should be freely transferable without restrictions on transfer.<sup>18</sup> The broadened liability of the transfer agent under the Code is embodied in section 8-406, which provides that transfer agents will now be liable *both* to issuers *and* owners for a wrongful refusal to register a transfer, as well as for wrongful registration of a transfer, "in any case within the scope of their [respective] functions where the issuer would itself be liable."<sup>19</sup> Moreover, the transfer agent is placed "under a duty to the issuer to exercise good faith and due diligence in performing his functions."<sup>20</sup> In *Welland Investment Corp. v. First National Bank*<sup>21</sup> the court held that the bank transfer agent was liable for damages under section 8-406 to the owner of securities who had requested registration for wrongful refusal to register transfer.<sup>22</sup> This by-passing of the issuer in favor of the transfer agent as

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(1944); *Lewis v. Hargadine-McKittrick Dry Goods Co.*, 305 Mo. 396, 274 S.W. 1041 (1924); *Nicholson v. Morgan*, 119 Misc. 309, 196 N.Y.S. 147 (N.Y. Mun. Ct. 1922).

12. F. CHRISTY, *supra* note 7, § 281.

13. 2 RESTATEMENT (SECOND) OF AGENCY §§ 376-98 (1958).

14. F. CHRISTY, *supra* note 7, § 389.

15. *Id.* § 147.

16. Article 8 expressly deals with certain subject matter previously governed by the Uniform Stock Transfer Act, the Uniform Negotiable Instruments Law, and other statutes or common law principles. UNIFORM COMMERCIAL CODE § 1-103 provides that, unless displaced by the particular provisions of the UCC, "principles of law and equity . . . shall supplement its provisions." In addition, care must be taken with respect to each transfer of stock to inspect each applicable state's statutes which may govern, in addition to the provisions of art. 8. For instance, in Texas fiduciary security transfers are governed by statutory provisions outside of art. 8 of the Code. *See* TEX. BUS. & COMM. CODE ANN. §§ 33.01-.06 (1968).

17. "Securities" are defined in UNIFORM COMMERCIAL CODE § 8-102(1)(a) as an instrument in bearer or registered form, which is of a type commonly dealt in upon securities exchanges or markets or is commonly recognized in any area in which it is used or dealt in as a medium for investment, and which evidences a share, participation or other interest in property or in an enterprise, or evidences an obligation of the issuer.

18. "[Article 8] may be likened rather to a negotiable instruments law dealing with Securities." UNIFORM COMMERCIAL CODE § 8-101, Comment. *See also id.* § 8-105(1). Note how this theme may conflict in certain instances with federal and state securities laws policy to prevent unregistered distributions of securities to the public. *See* notes 46-47 *infra* and accompanying text.

19. UNIFORM COMMERCIAL CODE § 8-406, Comment 1. Wrongful refusal to transfer renders the transfer agent liable to the owner for a tort action of conversion.

20. *Id.* § 8-406(1)(a).

21. 81 N.J. Super. 180, 195 A.2d 210 (Ch. 1963).

22. The court remarked that the effect of the adoption of § 8-406 was to "abolish the artificial concept . . . to the effect that an agent could not be held personally liable to third parties for acts constituting mere nonfeasance." 195 A.2d at 213.

authorized by section 8-406 may prove to be a most valuable tool for a plaintiff-securities owner who is seeking damages for wrongful refusal to transfer. He may now have the choice of recovering from a sometimes-solvent issuer corporation or from a generally solvent banking institution, or both.

Thus, the provisions of the Code regarding registration of transfer are expressly made applicable to transfer agents, since registration of transfers is a particular function the transfer agent will perform on behalf of the issuer. By virtue of section 8-401, when a security in registered form is presented to the transfer agent with a request to register transfer, the transfer agent is under a duty to register the transfer as requested, if certain conditions are fulfilled. These conditions are (1) the securities must be endorsed by the "appropriate person or persons," (2) reasonable assurance must be given to the transfer agent that those endorsements are "genuine and effective," (3) the transfer agent has no duty to inquire into adverse claims or it has "discharged any such duty," (4) any applicable law relating to the collection of taxes must have been complied with, and (5) the transfer must be "rightful" or to a "bona fide purchaser."<sup>23</sup> Although not required by the Code, the bank transfer agent should require in every case that each endorsement be accompanied by a "guarantee of signature" of the endorsing person from a national bank or a member of the New York Stock Exchange.<sup>24</sup> Where the endorsement is by an agent of the owner, appropriate assurance of authority to sign may be required.<sup>25</sup> Likewise, when the endorsement is by a fiduciary, appropriate evidence of appointment or incumbency (*e.g.*, a certified copy of a probate court's appointment of executor) may be required to assure that the signature is genuine and effective. Under section 8-402(4) the transfer agent may go beyond the normal means of "assurance" of genuine and effective endorsements in its survey of "evidence" surrounding a fiduciary transfer by requesting and obtaining a copy of a "controlling instrument" (*e.g.*, a will, trust, indenture, etc.), but the transfer agent will be charged with notice of *all* matters contained in the controlling instrument affecting the transfer, including in certain cases, the overall propriety of the transfer.

The transfer agent, when presented with a security for registration, shall be under a duty to inquire into "adverse claims"<sup>26</sup> if "a written notification of an adverse claim is received at a time and in a manner which affords the issuer a reasonable opportunity to act on it prior to the issuance of a new,

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23. UNIFORM COMMERCIAL CODE § 8-401(1).

24. *Id.* § 8-402(2) defines a guarantee of signature to be a guarantee signed by or on behalf of a person reasonably believed to be responsible. While such a guarantee is not expressly required in art. 8, it may be required by other law. For instance, under Texas law regarding transfers of stock by a fiduciary, the signature must be guaranteed by a state or national bank, or an unincorporated Texas bank, or by a firm that is a member of the New York Stock Exchange. TEX. BUS. & COMM. CODE ANN. § 33.04 (Supp. 1975).

25. UNIFORM COMMERCIAL CODE § 8-402(1)(b).

26. "'Adverse claim' includes a claim that a transfer was or would be wrongful or that a particular adverse person is the owner of or has an interest in the security." *Id.* § 8-301(1).

reissued or re-registered security . . . .”<sup>27</sup> The written notification must contain the adverse claimant’s name and address, the name of the registered owner of the security, and the particular issue of which the security is a part. The issuer is also charged with notice of an adverse claim from a “controlling instrument” which it has required and received as described in section 8-402(4).<sup>28</sup> This duty to inquire can be discharged by any “reasonable means,” including notifying the adverse claimant by registered or certified mail that the security has been presented for registration and that the transfer will be registered, unless within thirty days from the date of mailing the notification, either (1) an appropriate restraining order or injunction is issued by a court of competent jurisdiction, or (2) an indemnity bond protecting the transfer agent and issuer from losses which they may suffer by complying with the adverse claim is filed with the issuer or transfer agent.<sup>29</sup> The transfer agent will not be liable to the owner of the security or to any other person suffering loss as a result of the registration of the transfer if the security carried the necessary endorsements and the issuer had no duty to inquire into adverse claims or had discharged such duties under section 8-403.<sup>30</sup> The issuer and transfer agent are provided with certain defenses against objecting purchasers of securities under section 8-202 of the Code. However, except for the defense of lack of genuineness of the security,<sup>31</sup> all defenses of the issuer or transfer agent are ineffective against a purchaser for value who has taken without notice of the particular defense.<sup>32</sup> A “bona fide purchaser” of securities is defined in section 8-302 as a “purchaser for value in good faith and without notice of any adverse claim who takes delivery of a security in bearer form or of one in registered form issued to him or endorsed to him or in blank.” Thus, a purchaser without notice of any adverse claim may be one who has no notice of claims that a transfer was or would be wrongful, or that a particular adverse person is the owner of or has an interest in the security.<sup>33</sup>

Under the Code the purchaser acquires rights in the security upon the effective “delivery” of the security.<sup>34</sup> Delivery occurs when (1) the purchaser or one designated by him acquires possession of the security, or (2) his broker acquires possession of a security specially endorsed to or issued in the name of the purchaser, or (3) the broker sends confirmation of the purchase and, by book entry or otherwise, identifies a specific security in his possession as belonging to the purchaser. In addition, appropriate entries on the books of a clearing corporation and acknowledgments by a third person that he is holding an identified security to be delivered to the purchaser constitute “delivery.”<sup>35</sup> Section 8-313(2) states that the purchaser is the “owner” of

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27. *Id.* § 8-403(1)(a).

28. *Id.* § 8-403(1)(b).

29. *Id.* § 8-403(2).

30. *Id.* § 8-404(1).

31. *See id.* §§ 8-208, and 8-202, Comment 3.

32. *Id.* §§ 8-202(3), (4). This section is consistent with the theme of negotiability of securities under art. 8 of the Code.

33. *Id.* § 8-301(1); *see note 26 supra.*

34. UNIFORM COMMERCIAL CODE § 8-301(1).

35. *Id.* § 8-313(1).

securities held for him by his broker; this principle, and those regarding delivery, may be important with respect to liabilities of a transfer agent for wrongful refusal to transfer. In *Tangorra v. Hagan Investing Corp.*<sup>36</sup> the plaintiff purchased 200 shares of stock in Digimetrics, Inc. through the defendant-broker Hagan. Hagan acquired the stock and sent the plaintiff written confirmation of the purchase, with the settlement date listed as December 29, 1969. On December 23, 1969, the plaintiff paid for the stock. On January 5, 1970, Hagan mailed the Digimetrics, Inc. certificate to its co-defendant, the bank transfer agent of Digimetrics, Inc., for reissuance on January 5, 1970. The certificate was finally prepared by the transfer agent on February 2; however, it was not mailed to the plaintiff until February 21, because of the transfer agent's doubts regarding the plaintiff's correct address. The plaintiff complained that the Digimetrics, Inc., stock became worthless on January 30, and sued for damages. However, the plaintiff failed to allege that she had tried to sell her shares of Digimetrics, Inc. stock between the date the broker acquired the stock for her and January 30, 1970. The court granted defendant's motions to dismiss, relying on section 8-313 in holding that when a broker purchases stock on behalf of the purchaser, title to that stock then vests in the purchaser. Thus, on the day that the plaintiff ordered the stock and the defendant-broker purchased it for her, plaintiff became the owner and had the power to sell, even though she had not received delivery of her stock certificate.<sup>37</sup> In the absence of allegations that the plaintiff tried to sell the stock through the defendants, defendants were not subject to liability for plaintiff's loss.

Because of the theme of negotiability of article 8, a great part of the responsibility regarding "lost" stock certificates lies on the transfer agent. Section 8-405(1) provides that where a security has been lost, destroyed, or wrongfully taken and the owner fails to notify the transfer agent of that fact within a reasonable time after he has notice of it, and the transfer agent then registers a transfer of the security before receiving such notification, the owner is precluded from asserting any claims for wrongful registration or for a new security against the transfer agent. Otherwise, the transfer agent must issue a new security to the owner upon timely notification, but only if, before the transfer agent has notice that the security has been obtained by a bona fide purchaser, the owner requests reissuance and files an indemnity bond with the transfer agent and also fulfills other reasonable requirements imposed by the transfer agent.<sup>38</sup> The key question with respect to a duty to reissue a new certificate is whether the owner notifies the transfer agent within a "reasonable time" after the owner has notice of loss or destruction. In *Arizona Public Service Co. v. Gammons*<sup>39</sup> the bank transfer agent for the issuer-defendant received inquiry in July 1969 from a brokerage firm as to whether a stop transfer order had been placed against the plaintiff's stock.

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36. 38 App. Div. 2d 671, 327 N.Y.S.2d 131 (Sup. Ct. 1971).

37. See also *Broderick v. Alexander*, 268 N.Y. 306, 197 N.E. 291 (1935); *Le Marchant v. Moore*, 150 N.Y. 209, 44 N.E. 770 (1896).

38. UNIFORM COMMERCIAL CODE § 8-405(2).

39. 21 Ariz. App. 400, 519 P.2d 1165 (1974).

An officer of the issuer contacted the plaintiff and asked her whether she still had the stock; she replied that it was at her family's home, and the officer suggested she investigate further. When no additional information was received the brokerage firm was told that no stop transfer was outstanding. In February 1970 the plaintiff discovered that she had not received her December 1969 dividend. She then learned that her certificates had been transferred under the endorsement of some unknown person. Plaintiff sued for reissue of the stock to her. The court held that the inquiries made by the issuer's officer in July of 1969 were insufficient to put plaintiff on notice of the disappearance of her stock and that the plaintiff had notified the issuer-transfer agent in a timely manner upon her actual knowledge of disappearance in February of 1970. The plaintiff, therefore, had the right to a new security.<sup>40</sup> The case points out the need for issuers and transfer agents to follow up on any notification that something may be wrong with a thorough investigation of the circumstances so that the owners will be placed on notice and liability avoided.

## II. THE UNIFORM COMMERCIAL CODE AND FEDERAL SECURITIES LAW

Important conceptual differences exist regarding what constitutes "transfer" and "registration" under the Uniform Commercial Code and federal securities laws.<sup>41</sup> Basically, under the UCC "delivery," and therefore transfer, occurs when the certificate is physically delivered to the purchaser or to the broker.<sup>42</sup> However, under federal securities law a "transfer" is not complete until recorded on the transfer books of the issuer corporation.<sup>43</sup> Section 5 of the Securities Act of 1933<sup>44</sup> provides that it shall be unlawful for any person using channels of interstate commerce (1) to sell, or deliver before or after sale, any security unless a registration statement is in effect as to that security, or (2) to offer for sale any security unless a registration statement has been filed. Registration is not necessary if an exemption from registration is available.<sup>45</sup> A widely utilized transactional exemption is section 4(2) of the 1933 Act which exempts transactions not involving any "public offering" (*i.e.*, offers and sales not of such magnitude as to constitute a "distribution" of securities).<sup>46</sup> Section 4(1) exempts transactions by any

40. The court intimated that had the officer asked the plaintiff whether she had placed a stop transfer on the security, rather than merely if she still possessed the stock, this might have been sufficient to put the plaintiff on notice that someone was attempting to have her stock transferred. 519 P.2d at 1167.

41. Weiss, *Investment and Control Securities—Problems of Transfer Agents and Transfer Departments*, 12 N.Y.L.F. 553 (1966).

42. See notes 34-35 *supra* and accompanying text.

43. Weiss, *supra* note 41, at 556.

44. 15 U.S.C. §§ 77a-77aa (1970) (as amended) [hereinafter referred to as the 1933 Act].

45. Section 3 of the 1933 Act, 15 U.S.C. § 77c (1970), exempts certain securities, and § 4 of the 1933 Act, 15 U.S.C. § 77d (1970), exempts certain transactions (although §§ 3(a)(9)-(11), 15 U.S.C. §§ 77c(a)(9)-(11) (1970), are, in reality, transactional exemptions).

46. The legislative history to the 1933 Act bears out the drafters' desire to exempt from the Act's registration provisions sales of stock to stockholders "so small in number that the sale to them does not constitute a public offering." H.R. REP. No. 152, 73d



person other than an issuer, underwriter, or dealer, and section 2(11) of the 1933 Act defines an "underwriter" as a person who has purchased stock with a view to, or offers or sells in connection with, the distribution of any security. Thus, when a purchaser of securities offers or sells such securities soon after their purchase in a manner which may be deemed a distribution to the public, registration is required.<sup>47</sup> Furthermore, persons in a controlling position with respect to the issuer are deemed to stand in the shoes of the issuer for many securities law purposes.<sup>48</sup> There are basically three danger areas for issuers and transfer agents with regard to transfers of the securities: (1) where there is an offering by the issuer itself which seeks to take advantage of the section 4(2) private offering exemption; (2) where the offering is by a person whose position in relation to the issuer may be deemed to be "controlling"; or (3) where the offering is by a person who acquired the securities in a transaction for which the private offering exemption was claimed.

The private offering exemption has given rise to procedures designed to ensure that the offering is made for "investment" purposes and not with a "view to distribution." Two of these procedures are stop transfer instructions placed with the transfer agent, and restrictive legends printed on the face or back of the stock certificates. These instructions and legends generally provide that unless certain conditions are met so that the registration provisions of the 1933 Act are not violated, the shares may not be offered or sold by the holder. While section 4(2) does not expressly require the placing of restrictive legends on the certificate or stop transfer instructions, the SEC indicated in 1971 that the presence or absence of appropriate restrictive legends and/or stop transfer instructions is a factor to be considered in determining whether the circumstances surrounding an alleged private offering are consistent with section 4(2).<sup>49</sup> Rule 146, the recently enacted SEC promulgation concerning compliance with the section 4(2) exemption, provides that the issuer "and any person acting on its behalf" are under a duty to exercise reasonable care to assure that the purchasers are not underwriters within section 2(11), and that "reasonable

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Cong., 1st Sess. 25 (1933). The SEC has regarded a public offering as having the same meaning as a "distribution" of securities, as found in § 2(11) of the 1933 Act, 15 U.S.C. § 77(b)(11) (1970), which section defines an "underwriter." See R. JENNINGS & H. MARSH, JR., *SECURITIES REGULATION* 407 (3d ed. 1972).

In 1974 the SEC adopted rule 146, which sets out guidelines with which an issuer offering or selling securities may comply, in order for the issuer to be assured of a § 4(2) exemption. 17 C.F.R. § 230.146 (1974). A failure to comply with all of the rule 146 guidelines will not absolutely preclude qualification for an exemption under § 4(2). The transfer agent may wish to require opinions of counsel from the issuer's counsel that particular offerings under an alleged rule 146 exemption do in fact comply with all of the rule's requirements.

47. Rule 144, 17 C.F.R. § 230.144 (1972) adopted by the SEC in 1972, provides specific guidelines for an exemption for transactions by persons who may otherwise be deemed underwriters, and who would have been required to register. See notes 80-86 *infra* and accompanying text.

48. The SEC defines "control" and "controlling" in rule 405 under the 1933 Act as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405 (1947).

49. SEC Securities Act Release No. 5121, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,943 (1971).

care" shall include the placing of a legend on the certificate, the issuance of stop transfer instructions to the issuer's transfer agent, and the obtaining of appropriate investment representations from the purchaser.<sup>50</sup>

Section 8-204 of the UCC states that for restrictions on transfers of securities to be effective against a purchaser of the securities, the restrictive legends must be placed "conspicuously" on the face of the certificate, unless the purchaser had actual knowledge of the restrictions.<sup>51</sup> Under the Code, problems may arise if the purchaser's shares are delivered to him without any restrictive legend on the certificate, the shares are part of a purported investment-purpose private offering under section 4(2) of the 1933 Act, and the purchaser desires to sell the shares immediately. Problems may also develop where stop transfer instructions are placed with the transfer agent, but there is no restrictive legend on the stock certificate. When the purchaser presents his shares for registration of the transfer into his name, and the transfer agent, in accordance with stop transfer instructions from the issuer, refuses transfer in order to forestall an unregistered distribution, sections 8-204 and 8-401 nonetheless indicate that the purchaser has a right to the transfer, and the issuer is under a duty to register transfer of the shares since no restrictive legend has been placed on the face of the certificate.<sup>52</sup> Of course, section 8-204 provides that a purchaser with "actual knowledge" of an unnoted restriction has notice of an "adverse claim," and such a restriction on transfer is effective against him.<sup>53</sup> While "actual knowledge" is not defined in article 8 or article 1 of the Code, a sophisticated purchaser who is buying unlegended shares and who is aware that his seller acquired them for investment in a private offering may have a form of actual knowledge of these unnoted restrictions on transfer.<sup>54</sup>

#### A. *Recent Developments in the Conflict Between the Code and the Securities Laws*

Transfer agents have been enjoined by the SEC for participation in certain unregistered distributions of securities.<sup>55</sup> Additionally, there is the possibility

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50. Rule 146(h), 17 C.F.R. § 230.146(h) (1974).

51. This had been the result under some cases decided under art. 8's predecessor, the Uniform Stock Transfer Law. *See, e.g., Prudential Petroleum Corp. v. Rauscher, Pierce & Co.*, 281 S.W.2d 457 (Tex. Civ. App.—Dallas 1955, writ ref'd n.r.e.).

52. Where the securities are tendered for registration to the transfer agent out of the seller's name prior to any "delivery" to the purchaser, the stop-transfer instructions may be effective to prevent transfer, because it is only upon delivery that the purchaser gains certain rights in the security under the Code. UNIFORM COMMERCIAL CODE §§ 8-313, -301(1). *See* *Israels, Stop-Transfer Procedures and the Securities Act of 1933—Addendum to Uniform Commercial Code—Article 8*, 17 RUTGERS L. REV. 158 (1962).

53. UNIFORM COMMERCIAL CODE § 8-204, Comment 1; *see id.* § 8-304 and Comments.

54. *But see* *Edina State Bank v. Mr. Steak, Inc.*, 487 F.2d 640, 644 (10th Cir.), *cert. denied*, 419 U.S. 883 (1974), *discussed in* note 76 *infra*, for a holding contrary to this author's suggestion.

55. In *SEC v. Dumont Corp.*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,424, at 98,009-12 (S.D.N.Y. 1969), the transfer agent was enjoined from violating the fraud provisions of the Securities Exchange Act of 1934 by aiding and abetting a distribution in violation of the registration provisions of the 1933 Act. *See* A. BROMBERG, *SECURITIES LAW: FRAUD—SEC RULE 10b-5*, at 8.5(537) (1975 ed.). In *Dumont* an officer of the transfer agent was alleged by the SEC to have violated the antifraud provisions by aiding the issuer in conducting an unlawful distribution. The officer dis-

of civil liability where a transfer agent participates in, or aids and abets, an unregistered distribution in violation of the 1933 Act.<sup>56</sup> In 1964 a suit was instituted against a bank transfer agent by an individual because the transfer agent countersigned a stock certificate without any inquiry as to whether the stock was registered, and without placing a legend on the certificate regarding its unregistered status. The suit was settled before trial.<sup>57</sup>

In *Travis Investment Co. v. Harwyn Publishing Corp.*<sup>58</sup> the SEC had notified the transfer agent and the issuer (Harwyn) that certain shares of Harwyn stock might be traded in the market by certain persons in a "control" relationship with Harwyn, without registration. Upon presentation by the plaintiff-broker for transfer of some of the subject shares, registration was refused by the transfer agent. The court held, under pre-UCC New York law, that the plaintiff-broker had failed to prove that the refusal to register transfer was wrongful and in violation of any duty owed to the plaintiff. Both Harwyn and its transfer agent were found to have been aware that the proposed transfer might have been "a 'wrongful' transfer under the 1933 Act." The court did not state whether the certificates in question contained restrictive legends.

Questions have arisen in recent years as to whether SEC no-action letters may be sufficient in and of themselves to warrant transfer in a situation where the transfer agent has demanded assurance that the proposed transfer will not violate federal securities laws.<sup>59</sup> Each case apparently turns upon the particular circumstances surrounding the transfer. In *Riskin v. National Computer Analysts, Inc.*<sup>60</sup> the plaintiff sought and obtained an SEC no-action letter stating that the proposed sale of stock would not require

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claimed knowledge of any illegality by claiming reliance upon an opinion from the president of the issuer that there were no securities laws violations. The court nevertheless held the officer liable for his participation in the unregistered distribution, and pointed out that even with the "assurance" of the issuer's president's opinion, the officer still requested an indemnity agreement from the issuer holding him free from any liability in transferring the stock. The officer was also personally enjoined from selling shares of the issuer's stock he owned.

In *SEC v. Les Studs*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,087 (S.D.N.Y. 1971), the SEC, citing "callous disregard of the securities laws," enjoined the issuer's transfer agent (an individual, not a bank) from distributing unregistered stock of the issuer, which was termed as a "gross abuse of his authority as transfer agent to protect the investing public."

56. See, e.g., *SEC v. Dumont Corp.*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,424 (S.D.N.Y. 1969); see note 55 *supra*. The possibility of transfer agent liability for aiding and abetting a violation of § 5 of the 1933 Act, 15 U.S.C. § 77e (1970), was expressed by the SEC as early as 1934. See Weiss, *supra* note 41, at 556 n.7. Section 12(1) of the 1933 Act, 15 U.S.C. § 771 (1970), imposes "absolute" civil liability for a sale of a security in violation of § 5; there is no defense for the wrongdoer except to prove that the sale was not in violation of § 5. The remedies for a purchaser are (a) rescission if he still owns the securities, or (b) damages, if he no longer owns them.

57. *Landeene v. Merchants-Produce Bank*, an unreported action discussed in F. CHRISTY, *supra* note 7, § 281.

58. 288 F. Supp. 519 (S.D.N.Y. 1968).

59. A no-action letter is an advisory ruling from the SEC that the Commission will take no action regarding a proposed transaction upon the facts presented to it in a request letter. It is not, however, legally binding on the SEC, nor does it foreclose the initiation of proceedings to enforce the securities laws. *Federal Crop Ins. Corp. v. Merrill*, 332 U.S. 380 (1947); *Kenler v. Canal Nat'l Bank*, 489 F.2d 482 (1st Cir. 1973); *Doliner v. Eastern Can Co.*, 62 Misc. 2d 555, 309 N.Y.S.2d 249 (Sup. Ct. 1965).

60. 62 Misc. 2d 605, 308 N.Y.S.2d 985 (Sup. Ct. 1970).

registration. Counsel for the issuer nevertheless sought clarification and even rescission of the no-action position from the SEC. The court found that the transfer agent's refusal to register transfer was wrongful. In *Kanton v. United States Plastics, Inc.*<sup>61</sup> the plaintiff obtained both the opinion of counsel and a no-action letter, but transfer was refused. The court held that the refusal was wrongful, finding that three letters sent by the president of the issuer to the transfer agent instructing no transfer of the subject shares did not constitute "notice of adverse claims," since the president made no claim to the plaintiff's stock. In *Doliner v. Eastern Can Co.*<sup>62</sup> the court noted the non-binding effect of the no-action letter and directed transfer of the stock in question. However, in *Kenler v. Canal National Bank*,<sup>63</sup> where a no-action letter had been furnished, but the legend on the stock certificate in question explicitly required an opinion of counsel before any transfer, and such opinion was not furnished as requested, the court held that the proposed transfer would not be "rightful" under UCC section 8-401(1)(e). The First Circuit noted the non-binding effect of the no-action letter and compared the protective safeguards afforded the transfer agent and issuer by an opinion of counsel, that is, a remedy in tort against counsel who negligently renders his opinion.<sup>64</sup> The holding in *Kenler* was not premised on a finding that the transfer would be "wrongful" because of securities laws violations, but rather on the rationale that the person presenting the shares for transfer had not complied with the explicit instructions on the legend of the certificate. Litigation concerning the role of no-action letters in secondary distributions of securities should abate somewhat with the adoption of rule 144 which, in the SEC release announcing its adoption,<sup>65</sup> provides that the SEC staff will not issue any no-action letters relating to resales of securities acquired after April 15, 1972.

A recent case exemplifying the problems under article 8 regarding transfers of restricted securities is *Dean Witter & Co. v. Educational Computer Corp.*<sup>66</sup> A customer delivered for sale a stock certificate to Dean Witter & Co., a broker, who did not know that the certificate had previously been reported as lost. The transfer agent had been notified of the loss of the certificate, and a stop transfer order had been placed against its transfer. The certificate bore a private placement restrictive legend on its back, although the language was somewhat ambiguous and had been inserted in the midst of other language restricting voting rights.<sup>67</sup> The transfer agent refused

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61. 248 F. Supp. 353 (D.N.J. 1965).

62. 62 Misc. 2d 555, 309 N.Y.S.2d 249 (Sup. Ct. 1965). The court remanded on the issue of damages for a determination of whether the initial refusal to transfer was unreasonable.

63. 489 F.2d 482 (1st Cir. 1973).

64. *Id.* at 487.

65. SEC Securities Act Release No. 5223 (Jan. 11, 1972).

66. 369 F. Supp. 757 (E.D. Pa. 1974).

67. The restrictive legend stated: "[T]he within shares were obtained . . . with no present intention of resale and without reliance on any solicitation, advertisements, dealers or agents." *Id.* at 759. The subject share certificate bore the name of a predecessor company of the defendant—Educational Computer Corp. The customer delivered to Dean Witter along with the share certificate, a prospectus covering a public offering of the defendant's stock which commenced one month prior to the customer's attempted sale in question. The prospectus, according to the court, contained language

to register the transfer upon presentation by Dean Witter, who was forced to "cover" the sale by buying up other shares of the defendant corporation's stock in the market at a loss. Dean Witter then sued Educational Computer Corp. to compel transfer of the shares. The court first looked at the transfer agent's duty to register under section 8-401, and determined that there was initially no duty because at that time there was a temporary obligation to inquire into "adverse claims." The fact that a replacement for the lost certificate had been issued was sufficient notice to the transfer agent that there was an "adverse claimant" to the shares.<sup>68</sup> However, the court found that such a temporary obligation to investigate did not justify a continuing refusal to transfer.<sup>69</sup> The court refused to decide whether the transfer of shares carrying a 1933 Act restrictive legend would make the transfer wrongful,<sup>70</sup> but held that the transfer would not be rightful where the stock had previously been transferred pursuant to an affidavit of loss. Thus, in order for Dean Witter to have prevailed it needed to establish that it had a valid claim for registration as a bona fide purchaser under section 8-401(1)(e), and that its rights were to be determined by section 8-301(2) of the Code.<sup>71</sup> Dean Witter was not a bona fide purchaser, according to the court, because it had had notice of an "adverse claim," by virtue of the legend, which stated that the securities were subject to valid restrictions on transfer. Therefore, the transfer would be "wrongful" under section 8-301(1).<sup>72</sup> The restrictions were noted "conspicuously" on the certificate in accordance with section 8-204.

In *Edina State Bank v. Mr. Steak, Inc.*<sup>73</sup> an employee of the defendant issuer obtained stock certificates representing 2,400 shares from Mr. Steak in a private placement, and pledged his shares as security for loans from Edina State Bank. The certificates had been issued without any restrictive legends, and the employee evidently made representations to the bank that there were no restrictions against transfer. When the employee defaulted in repayment of the loans, the bank submitted 1,000 shares of the pledged stock to a broker for sale. The broker requested registration of the 1,000 shares in the bank's name, and the transfer agent, after consultation with the issuer, refused transfer. The issuer had instructed the bank-transfer agent that no transfer could be made of the 1,000 shares without notice to Mr. Steak plus an opinion of counsel that the transfer would not violate the 1933

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indicating clearly that all shares of stock of the defendant issued prior to its public offering had not been registered with the SEC. Dean Witter, however, was found to have used the prospectus only to verify the change of name of the defendant and the exchange ratio for the shares pursuant to an associated recapitalization. *Id.* at 760.

68. *Id.* at 761 n.21.

69. *Accord*, *O'Neil v. Wolcott Mining Co.*, 174 F. 527 (8th Cir. 1909); *Kanton v. United States Plastics, Inc.*, 248 F. Supp. 353 (D.N.J. 1965).

70. 369 F. Supp. at 762 n.22.

71. UNIFORM COMMERCIAL CODE § 8-301(2) provides that a "bona fide purchaser in addition to acquiring the rights of a purchaser also acquires the security free of any adverse claim."

72. "'Adverse claim' includes a claim that a transfer was or would be wrongful . . ." *Id.* § 8-301(1). Comment 4 further defines "adverse claim" as a claim that the subject shares have been or are proposed to be "transferred in breach of trust or a valid restriction on transfer." *Id.* (emphasis added).

73. 487 F.2d 640 (10th Cir.), *cert. denied*, 419 U.S. 883 (1974).

Act. Edina State Bank apparently relied exclusively on the employee's representations that there were no restrictions on transfer; the bank made no inquiry with the SEC or any brokers. Moreover, the trial court found that the bank's president knew that the stock was privately held and had no market, that Mr. Steak was only "going to go public," and that the president did not know whether the employee's shares were to be included in Mr. Steak's registration statement. The sale of shares was forestalled by the refusal to transfer, and the bank repaid the brokerage firm and instituted suit against Mr. Steak and the bank-transfer agent for damages. The trial court held for the defendants on the theory that federal securities laws preempted the state law in question (the Uniform Commercial Code, as adopted), and must prevail to the extent that any conflict existed.<sup>74</sup> The Tenth Circuit reversed, finding for the plaintiff pledgee-bank on the basis that there was no federal preemption and that under the Code, the plaintiff had a right to the transfer.<sup>75</sup> The court determined that although the bank knew that the stock was privately held and had no public market and made no inquiries concerning these facts, the issuer's failure to place restrictive legends conspicuously on the certificate as required by section 8-204 was controlling. Therefore, it was not the plaintiff bank's responsibility to inquire past the face of the certificate.<sup>76</sup> On the issue of federal securities laws preemption, the court stated that since the bank was seeking only damages and was not demanding registration of transfer, and further because the 1933 Act does not expressly require restrictive legends, no question was presented as to violations of the 1933 Act. Thus, the federal and state laws could be read in harmony. Although the defendants claimed that complying with a request for registration might have made them aiders and abettors to a violation of the 1933 Act, the court did not reach the question, holding that the 1933 Act prohibition against unregistered distributions did not defeat the bank's right to damages. The defendants also asserted that there was no duty to register under section 8-401 because the transfer was not "rightful" and because the bank, having notice of adverse claims, was not a bona fide purchaser. The court, however, felt that it was not necessary to determine whether the bank had come within such "general provisions" and that section 8-204 was controlling in any event. Furthermore, the court held that in light of the issuer's failure to comply with section 8-204, the bank's failure to furnish an opinion of counsel to the defendants was neither a good defense nor a mitigating factor on the question of damages. The result in *Mr. Steak* exemplifies the dilemma which confronts a transfer agent when restricted shares without an appropriate legend are presented for registration. The question of whether a transfer which would violate the registration requirements of the 1933 Act can be "rightful" under section 8-401(e) was ripe for decision, and the Tenth Circuit's light treat-

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74. *Id.* at 644.

75. 487 F.2d 640 (10th Cir.), *cert. denied*, 419 U.S. 883 (1974).

76. The court briefly stated that all of these factors did not constitute "actual knowledge" of restrictions on transfer on the part of the bank, thereby rendering any restrictions ineffective under UNIFORM COMMERCIAL CODE § 8-204. "Those who are only on inquiry notice are not denied protection by the Code." 487 F.2d at 644.

ment of the issue was unfortunate.<sup>77</sup> Additionally, the question of whether the bank was a "bona fide purchaser" and could thereby demand registration was left unanswered.

These issues should have been decided by the court because, while section 8-204 sets forth those *against whom* restrictions on transfer are effective, the question of whether there is a *duty* to transfer controls the issue of liability for damages. That is, if there is no duty to transfer, there can be no liability for failure to transfer. Also, federal policies favoring protection of the investing public should override individual demands for registration of transfer. This was noted in *SEC v. Guild Films, Co.*,<sup>78</sup> where the stock in question was issued with investment legends and then pledged as security for a loan. The pledgee presented the share certificates for transfer, but the transfer agent refused. The pledgee then sued in state court to compel transfer, and, in spite of claims that such a transfer would violate section 5 of the 1933 Act, the court ordered transfer. The transfer agent complied with the order and the pledgee then began selling securities in the open market. The SEC successfully enjoined further sales, and on appeal the Second Circuit affirmed, holding that the federal statute prohibiting unregistered distribution of securities controlled.<sup>79</sup> Of course, *Guild Films* dealt with an actual transfer, while *Mr. Steak* concerned a refusal to transfer and claim for damages. Nevertheless, the key question in both cases was whether, at the time of presentment, the transfer agent was under a *duty* to register the transfer. It is submitted that federal policies prohibiting unregistered distributions of securities place upon the transfer agent a duty *not* to register such a transfer.

### B. Transfers Under Rule 144

Rule 144<sup>80</sup> may have the effect of lightening the investigatory load on the transfer agent regarding transfers of restricted securities. The rule provides that sales of a limited amount of restricted securities<sup>81</sup> shall not be considered distributions, nor shall the persons engaged in such sales be regarded as

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77. One of the leading experts in this field had expressed his opinion that a transfer in violation of the 1933 Act is hardly "rightful" under UNIFORM COMMERCIAL CODE § 8-306. Israel, *How To Handle Transfers of Stock, Bonds and Other Investment Securities*, 19 BUS. LAW. 90, 94 (1963).

78. 279 F.2d 485 (2d Cir. 1960). U.S. CONST. art. VI provides that all laws of the United States promulgated in pursuance of the Constitution "shall be the supreme law of the land."

79. 279 F.2d at 489. In *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948), it was held that provisions of state corporation laws in conflict with SEC proxy rules must give way to the superior force of the federal proxy rules. See Weiss, *supra* note 41, at 563-64.

80. Rule 144 applies to transactions in restricted securities acquired after April 15, 1972. The rule defines "restricted securities" as "securities acquired directly or indirectly from the issuer thereof or from an affiliate of such issuer, in a transaction or chain of transactions not involving any public offering." Rule 144(a)(3), 17 C.F.R. § 230.144a(3) (1974).

81. For listed securities, the maximum amount which can be sold within any six-month period is the lesser of (1) 1% of the shares of the class outstanding, or (2) the average weekly reported volume of trading in such securities on all securities exchanges during the four calendar weeks preceding the filing of form 144. For non-listed securities, the amount is 1% of the shares of the class outstanding. Rule 144(e)(1) and (2), 17 C.F.R. §§ 230.144e(1), (2) (1974).

underwriters, if adequate current public information concerning the issuer is available, the securities have been held for at least two years and sold only in brokers' transactions, and notice of the proposed sale is filed with the SEC on a form 144. Hopefully, these definitive guidelines will elucidate the hazy state of the law existing before rule 144 regarding secondary distributions. The SEC has stated that the transfer agent "has no greater responsibility under Rule 144 than under the [prior] system."<sup>82</sup> However, if the transfer agent "knows or has reason to know" that an illegal distribution would occur in connection with transactions before him, he should "take appropriate steps to forestall such a distribution from taking place."<sup>83</sup> One court has held that shareholders holding restricted stock have an "inherent right" to transfer, as long as the transfer is effected within the guidelines of rule 144.<sup>84</sup> It has been suggested that before transfer, a transfer agent obtain an opinion of counsel for the issuer as to the propriety of the transfer under rule 144.<sup>85</sup> The transfer agent should not rely exclusively on form 144, since the rule expressly states that the filing of form 144 shall not preclude the SEC from taking appropriate action regarding the sale.<sup>86</sup>

### III. OTHER SECURITIES LAW PROBLEMS

Traditionally, any liability under the 1933 Act for unregistered distributions would fall on the person who "offered or sold" the unregistered securities,<sup>87</sup> rather than the transfer agent. However, an aider and abettor can be held primarily liable as well, and a transfer agent could be regarded as an "aider and abettor" of an unregistered distribution of securities.<sup>88</sup> Aiding and abetting is a traditional principle of tort law or criminal law under which one who *knowingly* participates in another's tort or crime becomes subject to the same penalties as the principal wrongdoer.<sup>89</sup> Recent cases indicate that this concept may be changing and that mere negligence on the part of a transfer agent, for instance, negligence in not observing a restrictive legend on a stock certificate, may be enough to justify imposition of aider and abettor liability by the SEC.<sup>90</sup> Given the expansive nature of

82. Defrees, Fiske, Voland, Alberts & Hoffman, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,745 (1972).

83. *Id.*

84. Diversified Earth Sciences v. Hallisey, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,055 (S.D.N.Y. 1973).

85. Stock Transfer Association Memorandum—SEC Rule 144, dated March 22, 1972, prepared by the firm of Christy, Frey & Christy.

86. Rule 144(h), 17 C.F.R. § 230.144(h) (1974).

87. 1933 Act § 12(1), 15 U.S.C. § 771(1) (1970).

88. This was the finding in the *Dumont* case. See notes 55-56 *supra* and accompanying text.

89. 2 A. BROMBERG, *supra* note 55, § 8.5(540), at 208.29 (1973 ed.).

90. See, e.g., SEC v. Spectrum Ltd., 489 F.2d 535 (2d Cir. 1973) (attorney's negligence in preparing opinion of counsel justifies injunction from violations of § 5 of the 1933 Act, 15 U.S.C. § 77e (1970) and rule 10b-5 under the Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (1974)); Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (issuer liable as "aider and abettor" of a broker's activities in manipulating the market because of its awareness of the broker's improper actions and its failure to try to stop them). See also Gould v. American Hawaiian S.S. Co., 331 F. Supp. 981 (D. Del. 1971), and Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66 (E.D.N.Y. 1969) (negligence alone may be sufficient



liabilities under the federal securities laws, a private right of action could arise under this standard. Additionally, while SEC enforcement actions may result only in injunctive proceedings, the unfavorable publicity could be disastrous for a bank transfer agent's business.

Liability may also be predicated upon a theory of "market manipulation." An example of this is where instructions are placed with transfer agents to hold up transfers of stock as long as possible. The effect of holding up transfers is basically a constriction of the supply of shares circulating in the securities markets along with the resultant increase in the price of the stock.<sup>91</sup> Manipulation of securities prices and the use of manipulative devices are prohibited under sections 9 and 10 of the Securities Exchange Act of 1934. In *Brennan v. Midwestern United Life Insurance Co.*<sup>92</sup> the Seventh Circuit noted that the slow delivery of securities had a direct influence on an increase in the price of the stock in question. The issuer, acting as its own transfer agent, was held liable for aiding and abetting violations of section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 because the issuer knew of the delayed deliveries of its stock and did nothing to prevent them.

In a recent Colorado case, an issuer was not liable to a stockbroker who had suffered damages by relying on erroneous information contained in a letter from the transfer agent to the issuer.<sup>93</sup> The court stated that the erroneous information relied upon by the broker could not form any basis for liability since the transfer agent's correspondence with the issuer was not of such a nature as to elicit the reasonable reliance of a broker. The court stated that it was not common practice for a broker to accept a letter from the transfer agent to someone else as evidence that the addressee owned certain stock. The court noted that "[t]o find defendant [issuer] liable in this situation would be to make defendant liable to any third party who might read and rely, to his detriment, on the writing of defendant's agent."<sup>94</sup>

In *Affiliated Ute Citizens v. United States* transfer agent liability was found under rule 10b-5 for failure to make proper disclosures where the bank transfer agent had been engaging in activities similar to "market making" in the stock in question.<sup>95</sup> The bank and its employees were actively encouraging a market in the stock by soliciting and accepting standing orders for the stock and accepting deposits as payment for the stock,

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to sustain an action under § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1970) ). A case pending before the United States Supreme Court may answer some of the questions regarding liability under the securities laws for negligence. *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), cert. granted, 95 S. Ct. 137, 43 L. Ed. 2d 773 (Apr. 14, 1975) (No. 74-1042).

The possibilities of transfer agent liability for aiding and abetting under negligence standards was mentioned in Slain, *Spectrum*, 7 REVIEW OF SEC. REG. No. 9, May 10, 1974, at 927.

91. See Johnson, *supra* note 1, at 318.

92. 417 F.2d 147 (7th Cir. 1969), cert. denied, 397 U.S. 989 (1970).

93. *Birkenmayer & Co. v. Homestead Minerals*, 32 Colo. App. 258, 510 P.2d 449 (1973). While the issuer was the only defendant, the author believes that the rationale is equally applicable to transfer agents.

94. 510 P.2d at 452. The court relied upon the reasoning found in *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931).

95. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

as well as performing normal transfer agent functions. The court noted that if the bank had operated merely as a transfer agent it would have had no duty to make disclosures under rule 10b-5 and would have not been held liable thereunder.<sup>96</sup>

Violations of the proxy rules under the 1934 Act are another possible area of transfer agent liability. All persons involved in the preparation of a 1934 Act proxy statement could theoretically be held liable under section 14(a) of the 1934 Act, as well as under rule 10b-5, either as principals or as aiders and abettors of a section 14(a) violation.<sup>97</sup> Transfer agents are often relied upon by those preparing proxy material under section 14 of the 1934 Act for information concerning the shareholdings of certain individuals or entities. A material misrepresentation by the transfer agent could possibly trigger section 14(a) liability; and it has been held that negligence is sufficient to establish such liability.<sup>98</sup> Recently amended rule 14a-3 places the burden of inquiry on the issuer with respect to requesting information from holders of the issuer's securities who may be holding for beneficial owners (*i.e.*, brokers, dealers, banks, voting trustees, or their nominees) to ensure that proxy materials are received by the beneficial owners. With respect to this responsibility, procedures should be worked out between the transfer agent and the issuer to facilitate compliance with these request requirements.

#### IV. SECURITIES ACT AMENDMENTS OF 1975

On June 5, 1975, the Securities Acts Amendments of 1975<sup>99</sup> were signed into law. The amendments carry with them many substantial changes to the existing federal securities regulatory scheme, but the main thrust and intent is the establishment of a national market system for securities. As part of this, the amendments authorize the creation of "a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto,"<sup>100</sup> and to carry this out, the Securities Exchange Act of 1934 was amended by adding section 17A<sup>101</sup> to provide for federal regulation of clearing agencies and transfer agents. Section 17A, citing "[i]nefficient procedures for clearance and settlement" which "impose unnecessary costs on investors,"<sup>102</sup> authorizes federal registration and reporting requirements for clearing agencies and transfer agents which Congress believes will result in "uniform standards and procedures for clearance and settlement," lessen costs, and increase the protection now

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96. *Id.* at 140.

97. R. JENNINGS & H. MARSH, *supra* note 46, at 1358.

98. *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66 (E.D.N.Y. 1969), *modified and aff'd*, 478 F.2d 1281 (2d Cir. 1973). *See also* *Gould v. American Hawaiian S.S. Co.*, 331 F. Supp. 981 (D. Del. 1971).

99. Pub. L. No. 94-29 (June 5, 1975).

100. *Id.* § 2. While other federal securities laws were amended by the 1975 amendments (including portions of the Securities Act of 1933 and the Investment Company and Investment Advisors Act of 1940), the bulk of its provisions concern the Securities Exchange Act of 1934.

101. Pub. L. No. 94-29, § 15 (June 5, 1975). All references hereinafter are to section numbers of the Securities Exchange Act of 1934 (1934 Act).

102. 1934 Act § 17A(a)(1)(B).

afforded investors.<sup>103</sup> Section 17A(c), which specifically sets forth the procedures for transfer agent regulation, becomes effective 180 days from the date of enactment of the 1975 amendments.

An initial interpretive problem is whether a transfer agent would meet the definition of a "clearing agency" under the 1975 amendments and thereby be subject to the regulatory provisions applicable to clearing agencies. The term "clearing agency" is broadly defined to include "any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities," and would seem to include a transfer agent by its very terms.<sup>104</sup> However, many transfer agents will be able to rely on two exemptions from the definition of a clearing agency, and the applicable registration provisions. Section 3(a)(23)(B)(iii) of the 1934 Act exempts from the definition of clearing agency:

[A]ny bank, broker, dealer, building and loan, savings and loan . . . if such bank [etc.] . . . would be deemed to be a clearing agency solely by reason of functions performed by such institution as part of customary banking . . . activities, or solely by reason of acting on behalf of a clearing agency or a participant therein in connection with the furnishing by the clearing agency of services to its participants or the use of services of the clearing agency by its participants.<sup>105</sup>

The amendments, however, reserve to the SEC the rule-making power over banks who may fit within the broader definition of clearing agency, so that prompt clearance and settlement procedures may be assured, and evasion of the 1934 Act prevented. The second exemption is found in section 3(a)(25)(E), which includes within the definition of "transfer agent" a person who engages, on behalf of an issuer of securities, in transferring record ownership of the securities by bookkeeping entries without the physical issuance of securities certificates. The legislative intent, made clear by the Senate Committee Report, is that transfer agents, including those which offer transfer agent depository services or TAD systems, and which would, therefore, seem to come even more literally under the definition of clearing agency, should be regulated as transfer agents and not as clearing agencies.<sup>106</sup> While these two exemptions may appear by their terms to exempt transfer agents from clearing agency regulation, exemption is not automatic and it is therefore recommended that transfer agents carefully inspect all of their functions to see whether they fall under the definition of a clearing agency.

Section 3(a)(25) of the 1934 Act under the 1975 amendments defines a transfer agent as a person who engages, on behalf of an issuer, or on behalf of itself as an issuer, in (1) countersigning the issuer's securities on their

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103. *Id.* § 17A(a)(1)(D).

104. *Id.* § 3(a)(23)(A). The Act expressly acknowledges the possibility of a transfer agent having to register as a clearing agency, and vice-versa. *See id.* § 17A(b)(1).

105. The term "participant" with respect to a clearing agency, is defined in *id.* § 3(a)(24) as to include "any person who uses a clearing agency to clear or settle securities transactions or to transfer, pledge, lend, or hypothecate securities."

106. REPORT OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, S. REP. NO. 94-75, 94th Cong., 1st Sess. 57 (1975).

issuance, (2) performing the functions of a registrar, (3) registering transfer of the securities, (4) exchanging or converting the securities, or (5) transferring record ownership in securities by bookkeeping methods (referred to in the preceding paragraph).<sup>107</sup> Unless registered under the Act, transfer agents are now prohibited from using the mails or instrumentalities of interstate commerce to perform any of the functions set forth in section 3(a)(25) with respect to any security registered under section 12 of the 1934 Act, or which would be required to be registered except for the exemptions from registration found in sections 12(g)(2)(B) or (G) of the 1934 Act (pertaining to investment company and insurance company securities).<sup>108</sup> Registration is effectuated by the transfer agent's filing an application for registration with the "appropriate regulatory agency," *i.e.*, the Comptroller of the Currency in the case of a national bank or its subsidiary, and the Federal Deposit Insurance Corporation (FDIC) in the case of a bank (or its subsidiary) insured by the FDIC. In the case of a state member bank of the Federal Reserve System, its subsidiary, a bank holding company, or a subsidiary of a bank holding company which is a bank other than a national bank or an FDIC-insured bank, registration is with the Board of Governors of the Federal Reserve System. In the case of any other transfer agent, the appropriate regulatory agency is the SEC.<sup>109</sup> The appropriate regulatory agency is empowered to promulgate exemptions with respect to any transfer agent from the registration provisions and the other provisions of section 17A, provided there is a finding that (1) the exemption is in the public interest and consistent with the purposes of investor protection and of prompt and accurate clearance and settlement procedures, and (2) the SEC does not object.<sup>110</sup>

The form and content of the application for registration shall be prescribed by the respective appropriate regulatory agency, and registration will become effective thirty days (or less) following receipt of the application.<sup>111</sup> However, registration may be postponed, suspended, denied, or even revoked upon a finding by the agency that such action is in the public interest or for the protection of investors, or that the transfer agent has willfully violated or is unable to comply with section 17A or the rules and regulations thereunder. In certain of these instances, opportunity is provided for a hearing before the appropriate agency.<sup>112</sup>

Registered transfer agents are now required under section 17(a)(3) of the 1934 Act to keep records, and furnish such records and make reports as the appropriate agency prescribes. These records are subject to examination by the SEC or the appropriate regulatory agency; however, the Act provides for certain safeguards to prevent duplication of examinations by the SEC and

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107. 1934 Act § 3(a)(25). The definition excludes insurance companies or separate accounts with respect to transfer agent functions concerning variable contracts or variable life policies they issue, or registered clearing agencies performing such functions regarding option contracts they issue.

108. *Id.* § 17A(c)(1).

109. *Id.* § 3(a)(34)(B).

110. *Id.* § 17A(c)(1).

111. *Id.* § 17A(c)(2).

112. *Id.* § 17A(c)(3).

the appropriate agency.<sup>113</sup> Moreover, every transfer agent which falls under the jurisdiction of any agency other than the SEC is required to file with the SEC copies of all documentation filed with the appropriate agency, and to file with that agency copies of all matter filed with the SEC.<sup>114</sup> Finally, the appropriate agency and the SEC are expressly empowered to adopt rules and regulations governing the conduct of transfer agents and to enforce compliance.<sup>115</sup>

Other sections of the 1975 amendments (besides section 17A(c)) also pertain to transfer agents and their functions. Section 17A(e) of the 1934 Act now authorizes the SEC to implement procedures to eliminate the physical movement of securities certificates with respect to settlement among brokers and dealers in transactions in securities,<sup>116</sup> and section 12(m) directs the SEC to investigate the practice of recording ownership in securities in "street names" and to report the results to Congress within six months following the date of enactment of the 1975 amendments. The imposition of state transfer taxes on securities or their transfer is now prohibited where the sole jurisdictional basis for imposing such a tax is that the facilities of a clearing agency are physically located within the taxing state.<sup>117</sup> Finally, section 17(f) of the 1934 Act now (1) authorizes the SEC to promulgate rules to require all registered transfer agents to report information to the SEC concerning lost, missing, counterfeit, or stolen securities, and (2) requires partners, officers, directors, and employees of registered transfer agents to be fingerprinted and to submit these fingerprints to the United States Attorney General.

While the overall impact of the Securities Acts Amendments of 1975 on transfer agents is difficult to assess at this point, it is clear that bank transfer agents should commence making plans, if they have not already done so, for the adoption of automated and more efficient controls and processes so that registration with the appropriate regulatory agency will not be denied and the transfer agent may continue to do business without violating federal securities laws.

## V. SUGGESTED SOLUTIONS

In view of the present state of the law, the bank transfer agent should be particularly certain that legends of restrictions on transfer are placed on all certificates representing restricted shares of the issuer-customer's outstanding stock. Transfer agents should require assurance that there are no outstanding restricted stock certificates lacking printed legends and make a thorough investigation of the corporation initially appointing the bank as its transfer agent. If any unlegended, restricted certificates are outstanding, the issuer

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113. *Id.* § 17(b).

114. *Id.* § 12(c).

115. *Id.* § 17A(d).

116. The Senate Committee Report states, however, that *id.* § 17A(e) would in no way preclude individual shareholders from asking for and receiving certificates as proof of ownership of their shares. S. REP. NO. 94-75, *supra* note 106, at 58-59.

117. 1934 Act § 28(d).

should be required to place appropriate legends on the certificates. All necessary warranties and representations to this effect should be required from the issuer.

In the event that a restricted security is presented for transfer without any restrictive legend on the certificate, the bank transfer agent is placed in an unenviable position. If transfer is refused, the agent may be held liable for damages for conversion; if transfer is completed, the agent may be aiding and abetting an unregistered distribution of securities in violation of securities laws. The chosen course of action depends on the particular facts, and on whether the bank transfer agent and its counsel would rather face unfavorable publicity and a possible SEC enforcement action, or a potential action for damages by an individual.

Problems regarding restricted securities will not abate even though use of clearing houses or depositories becomes more prevalent, and the stock certificate is "eliminated" as a medium of transfer. New methods will have to be devised to disclose restrictions on transfer where transfers are made only on clearing house ledgers, and the purchaser, after some effective form of "delivery" under UCC section 8-313, is without any notice of restrictions in the usual UCC fashion, *i.e.*, placed conspicuously on the certificate. Now, with the passage of legislation authorizing doing away with the stock certificate, the UCC draftsmen should investigate methods to handle this problem.<sup>118</sup>

Bank transfer agents presently have a tremendous need for sound internal controls. This was pointed out by Lee H. Pickard in an address before the Stock Transfer Association on November 14, 1974,<sup>119</sup> in which he advised that, due to increasing federal supervision, services such as bank nominees and completely automated transfer systems should be put into use as soon as possible. Moreover, if a paperwork crisis occurs again, as in 1968-1970, the transfer agent could incur unexpected legal problems, including potential liability. More efficient transfer facilities would help alleviate the agent's burden.

One area in which a transfer agent could begin to implement changes would be in the "appointment" documentation with issuers. In addition to outlining all rights and liabilities between the parties in the form resolutions, it is advisable to draft detailed rules and regulations and to provide very simplified form resolutions. The drafter would be wise to expressly incorporate the rules and regulations as a part of the resolutions, and they should be placed in the corporation's minute book.<sup>120</sup> Documentation between bank transfer agents and issuers is generally filled with indemnification provisions whereby the corporation agrees to indemnify the transfer agent for liabilities incurred by the transfer agent on the issuer's behalf. There are potential problems with such provisions. The SEC has maintained that with respect to

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118. One simple solution would be to amend UNIFORM COMMERCIAL CODE § 8-401 to read, in effect, that there exists no duty to register a transfer if the transfer would result in a violation of applicable securities laws.

119. See note 5 *supra*.

120. F. CHRISTY, *supra* note 7, § 282.

liability under section 11 of the 1933 Act for misstatements and omissions in registration statements, indemnification language benefitting underwriters is against public policy and therefore unenforceable. This position was upheld in *Globus v. Law Research Service, Inc.*<sup>121</sup> In one unreported decision, indemnity was disallowed and the transfer agent held liable to the issuer, even though indemnity language was contained in the transfer agent-issuer documentation.<sup>122</sup> Therefore, it is important that these indemnity provisions have some teeth in them. It should be provided that, in addition to rights of indemnity, the transfer agent shall have a right to contribution from the corporation.<sup>123</sup> Also, in case of suit against the transfer agent, the agent should have a specifically enforceable right to obtain records and memoranda of the issuer necessary for the transfer agent in preparing its defense. Provision could be made for the bank transfer agent to have a right of offset against any funds the issuer may have in its account with the bank for any amounts owed to the transfer agent by the issuer. Furthermore, the transfer agent could be granted a security interest in all records, documents, and other property of the issuer which the transfer agent may have in its possession, to secure payment of any amounts or fees owed by the issuer to the transfer agent. A provision should be inserted that any cancelled stock certificates should not be destroyed or disposed of either by the transfer agent or by the issuer until after the running of the applicable statute of limitations, in order to help clear up any questions regarding wrongful transfers which are made within the period of limitations. It should be provided that opinions of the issuer's counsel will be furnished to the transfer agent when requested. The transfer agent and issuer could perhaps work out standardized procedures regarding legal opinions for rule 144 transfers and other more common transfer occurrences calling for legal opinions.

The transfer agent should not be careless in its preparation of shareholders' lists and other data for the issuer or its counsel. This is particularly true with respect to requests for information of amounts of shares owned by officers, directors and ten percent shareholders, for SEC reporting requirements. Often shares owned by the same person are registered in more than one name (*e.g.*, Bob A. Jones, B.A. Jones), and when such a request is made, the computer read-out may disclose the amount of share ownership in one name only, thereby unintentionally understating a person's actual ownership. If such an error results in a material misstatement, there would be potential liability under the 1934 Act.

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121. 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). The second *Globus* opinion, however, upheld contribution to one defendant from others held jointly and severally liable to it. *Globus v. Law Research Serv., Inc.*, 318 F. Supp. 955 (S.D. N.Y. 1970).

122. F. CHRISTY, *supra* note 7, § 281. The corporate resolution had provided for indemnification by the corporation for liabilities for acts performed by the transfer agent in good faith and in reliance upon any stock certificate or instrument believed by the transfer agent to be genuine and signed by any person(s) authorized to sign. The transfer agent had failed to obtain a guarantee of signature on a forged endorsement.

123. See note 121 *supra*.

## VI. CONCLUSION

The transfer agent currently finds itself at a legal crossroads. Agents should implement more efficient transfer systems and improve their internal control processes. The transfer agents failed to distinguish themselves during the paperwork crisis of 1968-1970, indicating that perhaps they cannot effectively handle a large volume of transfers. Now, recent developments in the law may make it more difficult for the transfer agent to avoid liability if another paperwork crisis occurs.

While their overall impact remains undetermined at this time, the Securities Acts Amendments of 1975 present the possibility of a multitude of potential legal and regulatory headaches to the transfer agent, and may, in the cases of some unautomated, haphazard transfer agents, represent the end of their right to do business. A transfer agent nonetheless remains a valuable part of a bank's overall services and should be regarded as an important part of the institution. It is therefore recommended that banks upgrade their stock transfer departments now, before they become expensive and unattractive albatrosses around their necks.<sup>124</sup>

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124. Director Pickard warned of the possible consequences to laggard stock transfer agents when he stated: "To the degree the services offered by transfer agents are an attractive and economical alternative or supplement to what is being furnished by depositories, clearing agencies and other processing entities, there should continue to be an important role for them in the processing area. If the transfer agents adhere to antiquated methods of transferring and recording ownership of stock, their business may suffer." Address by Lee A. Pickard, *supra* note 5, at 84,703.



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