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SECURITIES

On the whole the decisions handed down by the Tenth Circuit last year relating to securities[1] will not change the law in this circuit. Most actions commenced during the term involved alleged violations of section 10 and 10(b) of the Securities Exchange Act of 1934.[2] However, a few cases may clarify some earlier policy statements of the court.

Notable in this past year was the case of *Edina State Bank v. Mr. Steak, Inc.*[3] That case may resolve the direct conflict between the federal securities laws and the Uniform Commercial Code which arises when dealing with the transfer of restricted securities. The *Mr. Steak* case is discussed at length in the final comment of this section.[4]

I. DEFINITION OF A SECURITY—JOINT REAL ESTATE VENTURE PRIVATE OFFERING EXEMPTION

Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973)

In *Andrews v. Blue*,[5] an action for rescission of a securities transaction in which the plaintiff was to receive shares of a merged corporation for his 20 percent interest in a real estate joint venture with defendants, the Tenth Circuit held the transaction did involve a security as defined in section 3(a)(10) of the Securities Exchange Act of 1934.[6] The transaction did not qualify as a private offering under section 4(2) of the Securities Act of 1933[7] and thus was not exempt from registration under section 5 of the 1933 Act.[8] The court upheld the plaintiff's right to recover under the federal and state securities laws.

In holding that the plaintiff's 20 percent interest in the real

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[1] Koch Indus., Inc. v. Vosko, 494 F.2d 713 (10th Cir. 1974); Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, 494 F.2d 168 (10th Cir. 1974); United States v. MacKay, 491 F.2d 616 (10th Cir. 1973), *cert. denied*, 94 S. Ct. 1996 (1974); Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973); Edina State Bank v. Mr. Steak, Inc., 487 F.2d 640 (10th Cir. 1973), *petition for cert. filed* 42 U.S.L.W. 3668 (U.S. June 4, 1974) (No. 73-189); Hadsell v. Hoover, 484 F.2d 123 (10th Cir. 1973).

[2] 15 U.S.C. §§ 78j, 78j(b) (1970).

[3] 484 F.2d 640 (10th Cir. 1974).

[4] *See* p. 338 *infra*.

[5] 489 F.2d 367 (10th Cir. 1973).

[6] 15 U.S.C. § 78c(10) (1970).

[7] *Id.* § 77d(2).

[8] *Id.* § 77e.

estate venture was a security within the meaning of section 3(a)(10) of the Securities Exchange Act of 1934,[9] the court cited with approval the test expounded by the Supreme Court in *SEC v. W. J. Howey Co.*[10] There the Court broadly defined a security as:

> A contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third-party, it being immaterial whether the shares of the enterprise are evidenced by formal certificates or by nominal interest in the physical assets employed in the enterprise.[11]

A major aspect of the venture in the *Andrews* case was investment, with an eye toward profits rather than management. Despite a contract reference to plaintiff as a consultant, plaintiff was a consultant in name only and defendants, the other participants in this venture, treated him as an outsider who had no managerial authority. The court felt that this contract reference to Andrews as a consultant did not deprive the relationship of its character as an investment contract thereby making it a security.[12]

Defendants claimed that the issuance of shares to the plaintiff arising out of the merger was a private offering, and therefore, exempt from registration under the Securities Act of 1933.[13] The court, in rejecting this argument, discussed the criteria developed in the case of *SEC v. Ralston Purina Co.*[14] In that case the Supreme Court was called upon to determine the meaning of the term "public offering." In interpreting section 4(2)[15] it concluded that the transaction is exempt from registration only when an offeree has had sufficient access to information similar to that made available to the offeree in a registration statement. So considered, an offering is private when made "to those who are shown able to fend for themselves."[16] In *Andrews*, the Tenth Circuit found that plaintiff did not have access to all relative information regarding the offering. Furthermore, the court determined that

[9] *Id.* § 78c(10).
[10] 328 U.S. 293 (1946).
[11] *Id.* at 299.
[12] 489 F.2d at 375.
[13] 15 U.S.C. § 77e (1970).
[14] 346 U.S. 119 (1953).
[15] 15 U.S.C. § 77d(2) (1970).
[16] 346 U.S. at 125.

the defendants had induced plaintiff into the investment by materially misleading statements designed to depreciate the plaintiff's interest in the property and enhance the value of their own.[17] The plaintiff had no knowledge of the truth or falsity of these statements. In addition, the court found that the small number of shares issued and the restrictive legend on the face of the shares were not, in themselves, sufficient to make this offering private.[18]

Finally, the defendants claimed that the offering was exempt from registration because they were neither issuers nor underwriters and hence within the purview of section 4(1) of the 1933 Act.[19] The court found the defendants were issuers under section 2(11) of the 1933 Act[20] because they were controlling persons of the issuing corporation, and they were underwriters because they received the shares for redistribution.[21]

II. SECURITIES—FRAUDULENT TRANSACTIONS

Four Tenth Circuit cases during this term arose out of fraudulent transactions and all were commenced alleging violations of section 10(b) of the Securities Exchange Act of 1934[22] and other antifraud provisions of the federal securities laws.

A. *Hadsell v. Hoover*, 484 F.2d 123 (10th Cir. 1974)

In an action by a purchaser of unregistered securities alleging violations of the antifraud provisions against a seller who agreed to repurchase the securities, the Tenth Circuit held, in *Hadsell v. Hoover*,[23] that the repurchase agreement did not preclude the buyer from maintaining an action under section 10(b) of the Securities Exchange Act of 1934.[24] Defendant-appellant, while not contesting the sufficiency or credibility of the evidence, argued that there was no fraud involved in the sale of the securities. At best, the defendant claimed there existed only an action for breach of contract on the repurchase agreement.

In dismissing this argument, the court cited the broad remedial purposes of the federal securities laws and earlier Tenth Circuit cases describing the requisites for an action under section

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[17] 489 F.2d at 373.
[18] *Id.* at 374.
[19] 15 U.S.C. § 77d(1) (1970).
[20] *Id.* § 77b(11).
[21] 489 F.2d at 375.
[22] 15 U.S.C. § 78j (1970).
[23] 484 F.2d 123 (10th Cir. 1974).
[24] 15 U.S.C. § 78j (1970).

10(b) of the Securities Exchange Act of 1934 and rule 10(b)(5) promulgated thereunder.[25]

B. *United States v. MacKay*, 491 F.2d 616 (10th Cir. 1973)

In *United States v. MacKay*,[26] defendants, acting through a corporation, devised and implemented a scheme to take control of an insurance company and strip it of its assets for the fraudulent purposes of purchasing its stock. The scheme was carried out by use of a jurisdictional means, that is, the use of the mails or other instrumentalities of interstate commerce.

In its decision, the Tenth Circuit discusses, in general, the basis of fraud action under the federal securities laws.[27] In its discussion of a jurisdictional means, the court noted that it is

> fundamental that an accused need not carry out the mailing or use of the instrumentality of commerce. If he causes it to be carried out by setting forces in motion which foreseeably result in the use of the mails, his action is sufficient.[28]

Finally, the court reaffirmed the law in the Tenth Circuit in regard to the truth or falsity of fraudulent statements: "The law is that a statement made which is patently false or made with reckless indifference to its truth or falsity can be equivalent to intent to defraud."[29]

C. *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168 (10th Cir. 1974)

In *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[30] an investor brought an action seeking damages against a brokerage house for "churning" of her account. After noting that courts are in general agreement that "churning" in this context constitutes fraud,[31] the Tenth Circuit held the 2-year statute of limitations is not a bar to plaintiff's action claiming her broker engaged in excessive trading of her account in order to generate commissions.[32] As in the case of any action based in fraud, the statute

[25] *Id.* § 78j(b).
[26] 491 F.2d 616 (10th Cir. 1973).
[27] *Id.* at 619.
[28] *Id.*
[29] *Id.* at 623.
[30] 494 F.2d 168 (10th Cir. 1974).
[31] *Id.*
[32] The court held that "the Oklahoma two-year statute applies." *Id.* at 171. OKLA. STAT. ANN. tit. § 408(e) (1965) provides that "[n]o person may sue [for a violation of a security law] more than two years after the contract of sale."

starts running from the date of actual or constructive discovery of the fraud, that is, when the plaintiff has become fully aware that she has been victimized. In this instance, the court held that because "churning" is conduct which is not common to the experience of the ordinary individual, the issue as to whether the plaintiff in a case such as this is to be charged with knowledge is essentially one of fact subject to determination by the jury. The court allowed the plaintiff a trial on the question of when she actually became aware of the "churning" activity, and further held that the sophistication of the investor is an important consideration in determining when the investor had knowledge of this "churning."[33]

D. *Koch Industries, Inc. v. Vosko*, 494 F.2d 713 (10th Cir. 1974)

Koch Industries, Inc. v. Vosko[34] involved an action by the corporate purchaser of all the stock in the second corporation against the seller of the stock and the accounting firm, which prepared the financial report in connection with the sale, of fraud, negligence, and violation of the Securities Act of 1933.[35] The Tenth Circuit found the absence of any fraud on the part of the defendant-seller and the accounting firm, and held that evidence did in fact support a finding of fraud on the part of the purchaser.

This was basically an action for common law fraud in which the plaintiff alleged violation of the federal securities laws. The court found no conspiracy by either the seller or the accounting firm to defraud or to violate the Securities Act, citing *Mitchell v. Texas Gulf Sulfur Co.*,[36] and *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*,[37] as the standard to be followed.

Finally, the court held that where the purchaser of securities knew that the financial report of a corporation being prepared by an accounting firm was being drawn for another potential purchaser and where the purchaser did not show reliance on the representations in the financial statement, the accounting firm was not liable to the purchaser for fraud.[38]

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[33] 494 F.2d at 172.
[34] 494 F.2d 713 (10th Cir. 1974).
[35] 15 U.S.C. §§ 77a-77aa (1970).
[36] 446 F.2d 90 (10th Cir. 1971).
[37] 474 F.2d 574 (10th Cir. 1973).
[38] 494 F.2d at 717.

III. TRANSFER OF RESTRICTED SECURITIES

Edina State Bank v. Mr. Steak, Inc., 487 F.2d 640 (10th Cir. 1974)

Price, who had been an employee of Mr. Steak, Inc. (Mr. Steak), received 2,400 shares of unregistered Mr. Steak stock in January 1969,[1] in a private placement,[2] representing that he was taking the stock for investment purposes. No restriction was noted on the stock certificates and Price did not sign an investment letter.[3] In April 1969, Mr. Steak filed a registration statement covering 300,000 shares of its stock, but Price's shares were not included in the statement. In March 1969, Price negotiated a series of loans with the Edina State Bank (Bank). Those loans were consolidated into a single $27,000 note dated May 5, 1969, secured by Price's 2,400 shares of Mr. Steak stock.

In early June 1969, the Bank attempted to realize on the collateral by turning over 1000 of the Mr. Steak shares to a broker for sale. The broker sold the stock, remitting $37,000 to the Bank. That amount was credited to Price's checking account which was then debited in the amount of the outstanding loan. The $27,000 note was canceled and Price's loan account was closed.

When the broker presented the certificates to Mr. Steak's transfer agent, Central Bank and Trust Company (Central), transfer was refused. Central had received a stop-transfer notice from Mr. Steak covering its shares issued in private offering. The notice required Central not to register a transfer of those shares without first notifying Mr. Steak and getting an opinion of counsel that the proposed transfer would not violate the Securities Act of 1933 (Securities Act).[4] The broker returned the stock to the Bank, which reimbursed the broker out of its own funds.

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[1] The recitation of facts is taken from the opinion of the circuit court in Edina State Bank v. Mr. Steak, Inc., 487 F.2d 640, 642 (10th Cir. 1973), and Pre-Trial Order, June 14, 1971, and Record of Hearing, Feb. 7, 1972, in Edina State Bank v. Mr. Steak, Inc., D.C. No. C-2611 (D. Colo. Mar. 1, 1972).

[2] A sale of securities is exempt from the registration requirements of the Securities Act of 1933, 15 U.S.C. §§ 77a-aa (1971), if it does not involve a public offering, 15 U.S.C. § 77d(2) (1971). Mr. Steak intended to qualify for that exemption with respect to Price's stock. Stock issued under that exemption must be restricted in the hands of a private offeree in order to insure that no public offering is involved. *See* text accompanying notes 25-30 *infra*.

[3] An investment letter and a notation of restriction on the stock certificate are factors considered by the SEC in determining the availability of the private offering exemption. SEC Securities Act Release No. 33-5121 (Dec. 30, 1970); SEC Securities Act Release No. 33-4552 (Nov. 6, 1962). The precautions assist the issuer in preserving its exemption.

[4] The combination of the stop-transfer notice and the opinion of counsel are also common practices by issuers seeking to protect their exemptions. Folk, *Article Eight: A*

The Bank then requested that Price return the $37,000, but he was unable to do so. Instead, he signed a new note, dated June 30, 1969, for $37,000, secured by the same 2400 Mr. Steak shares. Price defaulted on the loan. The Bank attempted to register transfer of the stock then, and again in April 1970, with no success.[5] By mid-1970, the value of the stock had dropped to $4.00 per share. In September 1970, the Bank sued Mr. Steak and Central in Federal District Court of Colorado for damages for wrongful refusal to transfer the stock under Article 8 of the Uniform Commercial Code (UCC).

Judgment in the district court was for the defendants. Judge Chilson held that the disposition of the case was governed not by the UCC but by the Securities Act, by which the federal government had pre-empted the field. Since the refusal to transfer was based on compliance with the federal law, defendants incurred no liability under state law.

The judgment was reversed on appeal to the Court of Appeals for the Tenth Circuit.[6] The court relied on section 8-204 of the UCC:

> Unless conspicuously noted on the security, a restriction on transfer imposed by the issuer even though otherwise lawful is ineffective except against a person with actual knowledge of it.[7]

Since the certificates contained no notation of restriction and the court felt that the Bank had no knowledge of the restriction, the Bank was allowed to recover. This finding is problematic in two aspects:

(1) At the time the $37,000 note (the note on which the action is based) was executed, the Bank had knowledge of the restriction.

(2) There is no absolute right of recovery under section 8-204 for unnoted restrictions. The remedy is provided by the common law and section 8-401(2), for which

Premise and Three Problems, 65 MICH. L. REV. 1379, 1399 (1967); Israels, *Stop-Transfer Procedures and the Securities Act of 1933—Addendum to Uniform Commercial Code—Article 8*, 17 RUTGERS L. REV. 158, 164 (1962).

[5] The bank was informed that transfer would be registered if it would submit the required opinion of counsel. An acceptable opinion was never tendered. Plaintiff's Exhibits 6-8, Defendants' Exhibits F & G, record, vol. III, at 23-25, 30-31.

[6] Edina State Bank v. Mr. Steak, Inc., 487 F.2d 640 (10th Cir. 1973).

[7] This section of the UCC has been adopted without amendment in every state, 3 R. ANDERSON, UNIFORM COMMERCIAL CODE § 8-204:2 (2d ed. 1971).

there are certain prerequisites not discussed by the court.

These problems will be explored further in the body of this comment.

The court then addressed itself to the pre-emption issue. Disagreeing with the district court, it held that section 8-204 of the UCC could and should be read in harmony with the federal securities laws since there is no evidence of congressional intent to prohibit state regulation in the area.[8] The court refused to reach the questions of whether the contemplated transfer would have violated the Securities Act and what effect such violation would have had on the parties. Instead, the court simply held that the Bank was entitled to damages under UCC section 8-204 and that recovery of such damages "is not violative of the federal prohibition against transfer."[9]

Additionally, the court rejected defendants' contention that the Bank failed to mitigate its damages as it could have by furnishing the necessary opinion of counsel required to register transfer of the shares while the price of the stock remained high. Because the restriction on the stock was unnoted, and therefore ineffective under section 8-204, the court held that the Bank had no such duty to mitigate and was entitled to recover for its full loss.

Presently, the Supreme Court has before it a petition for certiorari in this case, filed by the defendants.[10] The Association of Stock Transfer Agents, Inc., has petitioned for leave to file a brief amicus curiae in support of the petition for certiorari. The petitioners argue that the circuit court's decision places issuers and transfer agents in an untenable position. When a request is made for transfer of an unlegended security that is restricted because of the Securities Act, they must choose between registering the transfer and risking a violation of the Securities Act or refusing to register transfer and thereby incurring liability for refusal to transfer.[11] This comment will discuss whether such a

[8] *See* text accompanying note 41 *infra*.

[9] 487 F.2d at 645.

[10] Edina State Bank v. Mr. Steak, Inc., *petition for cert. filed*, 42 U.S.L.W. 3668 (U.S. June 4, 1974) (No. 73-1789).

[11] Petitioners' Brief for Certiorari at 4, Edina State Bank v. Mr. Steak, Inc., *petition for cert. filed*, 42 U.S.L.W. 3668 (U.S. June 4, 1974) (No. 73-1789); Brief for Stock Transfer Association, Inc. as Amicus Curiae at 9, *id*.

dilemma is the necessary result of the laws governing securities and what alternatives are available.

I. ARTICLE EIGHT OF THE UNIFORM COMMERCIAL CODE

The purpose of Article 8 of the UCC is to render investment securities freely negotiable.[12] Section 8-204 serves this purpose by denying effectiveness to any restrictions on transferability which are not noted on the stock certificate, except against persons with actual knowledge of the restriction.

A. *The Knowledge Requirement*

The Bank argued that the restrictions on the Mr. Steak stock had no validity as to it because they were not noted on the certificates. The facts of the case indicate that the Bank had actual knowledge of the restrictions on Price's stock when the final note, which formed the basis of the suit, was executed.[13] Prior to June 30, 1969, the Bank had attempted to transfer the stock and learned of the existence and nature of the restriction. Thus the Bank had actual and full knowledge of the restriction, in which case section 8-204 affords it no protection.[14]

Neither the district court nor the circuit court took the view that the Bank had knowledge of the restriction. It is clear that the Bank did not possess actual knowledge of the restriction prior to June 1969.[15] If the $37,000 note is viewed merely as a consolidation of the previous loans, then it is arguable that the Bank lacked the requisite knowledge, because a consolidation note does not discharge the prior obligations and rights of the parties.[16] In this case, however, the new note was executed for a new obligation, since money had changed hands in satisfaction of the old note and the amount due was increased.[17] Knowing that Price's finan-

[12] UNIFORM COMMERCIAL CODE § 8-105; § 8-101, Comment; § 8-105, Comment 1; Folk, *supra* note 4, at 1379; Israels, *Investment Securities as Negotiable Paper—Article 8 of the Uniform Commercial Code*, 13 BUS. LAW. 676, 678 (1958).

[13] Record, vol. I, at 29. UCC section 1-201(25) does not define "knowledge" but does distinguish it from "reason to know." The standard is clearly subjective. Adrian Tabin Corp. v. Climax Boutique, Inc., 34 N.Y.2d 210, 313 N.E.2d 66, 256 N.Y.S.2d 606, 608 (1974); McConnico v. Third Nat'l Bank, 499 S.W.2d 874, 882 (Tenn. 1973).

[14] B & H Warehouse, Inc. v. Atlas Van Lines, Inc., 348 F. Supp. 517 (N.D. Tex. 1972), *rev'd on other grounds*, 490 F.2d 818 (5th Cir. 1974); Norman v. Jerich Corp., 263 Ore. 259, 501 P.2d 305 (1972).

[15] Record, vol. I, at 27.

[16] American Trust Co. v. New York Credit Men's Adjustment Bureau Inc., 207 F.2d 685 (2d Cir. 1953); Bowden v. Bank of America Nat'l Trust & Sav. Ass'n, 36 Cal. 2d 406, 224 P.2d 713 (1950).

[17] King v. Edel, 69 Ga. App. 607, 616, 26 S.E.2d 365, 369 (1943); Meinholtz v. Lam-

cial condition was precarious, the Bank went ahead and accepted a new note secured by the stock it then knew to be restricted. Since the Bank then had actual knowledge of the restriction, notation on the certificate was not necessary to make the restriction effective. Factually, then, this case seems not to require discussion of conflict between the federal securities laws and the UCC. Nevertheless, the courts have not resolved the dispute factually.

B. *The Nature of Recovery*

Since the Tenth Circuit took the view that the Bank did not have knowledge of the restriction on the Mr. Steak stock, it granted the Bank recovery under section 8-204 of the UCC. That section, however, provides no remedy; it merely describes the prerequisites for "effectiveness" of a restriction on the transfer of stock. Where an issuer or transfer agent refuses to transfer stock because it is restricted but that restriction is not effective under 8-204, Comment 1 to that section notes that a conversion has occurred and "the issuer can be compelled to register the transfer under the policy of Part 4 of this Article." If a purchaser desires to recover damages rather than compel transfer, he must sue for conversion or proceed under section 8-401 of the UCC.

A common law conversion is said to occur when an issuer wrongfully refuses to register a requested transfer of stock.[18] While no clear definition of "wrongful" has developed under case law, cases under section 15 of the Uniform Stock Transfer Act, the predecessor of UCC section 8-204, indicate that a refusal to transfer based on an ineffective restriction constitutes a form of conversion.[19] Section 15 of the Uniform Stock Transfer Act and section 8-204 of the UCC have been interpreted as having the same meaning.[20]

In this case, Mr. Steak contended that its refusal to register the transfer was not wrongful because a transfer would have

pert, 101 S.W.2d 503, 504 (Mo. App. 1937); Elisberg v. Simpson, 173 N.Y.S. 128, 130 (1918); Liberty Nat'l Bank & Trust Co. v. Dvorak, 199 N.W.2d 414, 416-17 (N.D. 1972).

[18] Annot., 22 A.L.R. 2d 12 (1952); Holly Sugar Corp. v. Wilson, 101 Colo. 511, 75 P.2d 149 (1937); Holmes v. Birtman Electric Co., 18 Ill. 2d 554, 165 N.E.2d 261 (1960).

[19] Age Publishing Co. v. Becker, 110 Colo. 319, 134 P.2d 205 (1943); Hulse v. Consolidated Quicksilver Mining Corp., 65 Idaho 768, 154 P.2d 149 (1944); Doss v. Yingling, 95 Ind. App. 494, 172 N.E. 801 (1930).

[20] Irwin v. West End Div. Co., 481 F.2d 34, 38 (10th Cir. 1973); B & H Warehouse, Inc. v. Atlas Van Lines, Inc., 348 F. Supp. 517, 523 (N.D. Tex. 1972).

caused a violation of section 5 of the Securities Act.[21] This line of argument is discussed in detail in the treatment of UCC 8-401 below, but it should be noted here that a similar argument was rejected in Texas under the Uniform Stock Transfer Act. In *Prudential Petroleum Corp. v. Rauscher, Pierce & Co.*,[22] the corporation was engaged in an offering under Regulation A of the Securities Act.[23] In order to obtain SEC approval for that offering, it closed its books as to transfers of previously-issued stock. As a result, a transfer of previously-issued stock was refused although the restriction was not on the certificates. The court permitted recovery for conversion noting, however, that the refusal to transfer was not wrongful. Seemingly, a refusal to transfer based on a restriction that is ineffective under the statutes constitutes an independent ground for an action for conversion.

In the fact pattern of *Mr. Steak*, the existence of an automatic recovery for an unnoted restriction placed the issuer in the unfortunate position of having to choose between two courses of action both of which could attract liability. A transfer agent, however, can incur no liability under the common law for a refusal to register a transfer of stock.[24] The Bank thus could not recover against Central for conversion. Section 8-406(1)(b) of the UCC changes that rule by imposing on a transfer agent the same liability as that of an issuer. Since the Bank recovered against Central, it must have been under the UCC.

The Bank was seeking the type of recovery granted in section 8-401(2):

> Where an issuer is under a duty to register a transfer of a security the issuer is also liable to the person presenting it for registration . . . for loss resulting from . . . refusal to register the transfer.

The duty to transfer arises when the conditions in section 8-401(1) are satisfied. The only requirement possibly not met in *Mr. Steak* is found in section 8-401(1)(e). In order for there to be no duty to transfer under that section, the transfer must in fact not be rightful and it must not be to a bona fide purchaser. Defendants in *Mr. Steak* made the argument that transfer to the Bank (or its

[21] 15 U.S.C. § 77e (1971).

[22] 281 S.W.2d 457 (Tex. Civ. App. 1955).

[23] 17 C.F.R. 230.251-63 (1974).

[24] Under agency law, a transfer agent is only liable for breach of duty to his principal. Mears v. Crocker First Nat'l Bank, 97 Cal. App. 2d 482, 218 P.2d 91, 92 (1950); Lenhart Altschuler Assocs. v. Benjamin, 28 Misc. 2d 602, 215 N.Y.S.2d 541 (1961).

purchaser) would not in fact be rightful because it would cause a violation of the Securities Act.

Price received his stock in a private placement, exempt from the registration requirements of the Securities Act under section 4(2) as a transaction not involving a public offering.[25] If the SEC finds that the transaction did involve a public offering, the exemption will no longer be available and the issuer will have sold securities in violation of section 5.[26] A public offering is synonymous with a distribution,[27] and anyone who purchases from an issuer with a view to distribution of a security is an underwriter.[28] If the purchaser of a privately-placed security does not hold the stock for a sufficiently long period, he is considered to have purchased the security with a view to distribution, making him an underwriter.[29] Thus the entire private offering loses its exemption on an improper resale of some of the securities and anyone taking part in that sale will have violated section 5.[30]

The stock involved in *Mr. Steak* was issued to Price in January 1969. The Bank attempted to transfer it in the summer of 1969 and again in the spring of 1970. Whether transfer at that time would have caused a violation of section 5 can only be resolved by looking at the facts. The court did not reach this question, and the necessary analysis is outside the scope of this comment.[31] Since the burden of proving the availability of an exemption is upon the party claiming the exemption[32] (in this case, the

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[25] 15 U.S.C. § 77d(2) (1971). *See also* SEC v. Ralston Purina Co., 346 U.S. 119 (1953); United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir.), *cert. denied*, 389 U.S. 850 (1967).

[26] 15 U.S.C. § 77e (1970).

[27] Gilligan, Will & Co. v. SEC, 267 F.2d 461, 466 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959); H.R. REP. No. 1838, 73rd Cong., 2d Sess. 41 (1934); SEC, DISCLOSURE TO INVESTORS 162 (1969) [hereinafter cited as Wheat Report].

[28] 15 U.S.C. § 77b(11) (1970).

[29] United States v. Sherwood, 175 F. Supp. 480, 483 (S.D.N.Y. 1959); Crowell-Collier Publishing Co., SEC Release No. 33-3825 (Aug. 12, 1957); Israels, *Problems Incident to the Use of Stop-Transfer Procedures*, 18 BUS. LAW. 85 (1962).

[30] SEC v. Guild Films Co., 279 F.2d 485, 490 (2d Cir. 1960); 4 L. LOSS, SECURITIES REGULATION 2657 (Supp. 1969).

[31] Today, rule 144, 17 C.F.R. 230.144 (1974), would provide a method of resale that would protect all involved parties. SEC Securities Act Release No. 33-5223 (Jan. 1, 1972); SEC Securities Act Relase No. 33-5306 (Sept. 26, 1972). For discussion of permissible resale of privately-placed stock outside of rule 144, see SEC Securities Act Release No. 33-4552 (Nov. 6, 1962), and Crowell-Collier Publishing Co., SEC Securities Act Release No. 33-3825 (Sept. 20, 1957).

[32] SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953); United States v. Custer Channel Wing Corp., 376 F.2d 675, 678 (4th Cir. 1967). The Bank would have had to show that Price was not an underwriter, thus entitling the Bank to transfer the shares without

Bank) and the Bank never supplied the opinion of counsel requested by defendants that would have indicated the availability of the exemption, the court could have found that a transfer of Price's stock would have caused a violation of section 5.[33]

The UCC does not specify what transfers are "in fact rightful" within the meaning of section 8-401(1)(e), but a transfer that would cause a violation of the federal securities laws would appear not to qualify. One of the leading commentators on Article 8 has said that such a transfer "is hardly rightful."[34] However, the only cases holding that a transfer which would cause a violation of the Securities Act would be wrongful involved restrictions which were noted on the certificates.[35] Clearly, such a transfer would be wrongful, as would an attempt to transfer stock not owned by the transferor. The word "wrongful" here should probably apply to the transfer itself and not the effect of the transfer. That construction substantially weakens the contention that any transfer that would cause a violation of the Securities Act is not rightful.

In order to show that there is no duty to transfer under section 8-401(1)(e), it is also necessary that the transfer not be requested by a bona fide purchaser. For the purpose of Article 8, a bona fide purchaser is one who purchases without notice of an adverse claim.[36] A claim that a transfer would be wrongful is an adverse claim,[37] and notice includes "reason to know" based on all the facts and circumstances.[38] The determination of whether

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registering them under a section 4(1) exemption, 15 U.S.C. § 77d(1) (1970), for a transaction not by an issuer, underwriter, or dealer.

[33] Had a violation of section 5 been found, Mr. Steak would have lost its section 4(2) exemption for the entire private offering and Central would have been liable as an aider and abettor. SEC v. Guild Films Co., 279 F.2d 485, 490 (2d Cir. 1960). The Bank could also be a violator under the rule of that case, depending on its state of mind when it took the pledge of stock. *See* Fox v. Glickman Corp., 253 F. Supp. 1005 (S.D.N.Y. 1966); Sargent, *The Guild Films Case: The Effect of "Good Faith" in Foreclosure of Unregistered Securities Pledged as Collateral*, 46 VA. L. REV. 1573, 1578 (1960).

[34] Israels, *supra* note 29, at 89. Israels makes the same point in 17 RUTGERS L. REV. *supra* note 4, at 164.

[35] Kenler v. Canal Nat'l Bank, 489 F.2d 482, 486 (1st Cir. 1973); Garsarch v. Ormand Indus. Inc., 346 F. Supp. 550, 552 (S.D.N.Y. 1972). *See also* Dean Witter & Co. v. Educational Computer Corp., 369 F. Supp. 757, 764 (E.D. Pa. 1974).

[36] UNIFORM COMMERCIAL CODE § 8-302. *E.g.*, Miriani v. Rodman & Renshaw, Inc., 358 F. Supp. 1011, 1013 (N.D.Ill. 1973).

[37] UNIFORM COMMERCIAL CODE § 8-301(1). *E.g.*, Dean Witter & Co. v. Educational Computer Corp., 369 F. Supp. 757, 764 (E.D. Pa. 1974).

[38] UNIFORM COMMERCIAL CODE § 1-201(25). *E.g.*, Victory Nat'l Bank v. Oklahoma State Bank, 520 P.2d 675, 678 (Okla. 1973).

the transferee is a bona fide purchaser will be a factual one, and the facts[39] in this case tended to show that the Bank was on notice of the possibility that Price's stock was restricted, despite Price's representations otherwise.[40]

It is possible, then, that Central could have avoided liability in this case by showing that the Bank had notice of the fact that Price received his shares in a private offering and that a transfer which would cause a violation of the Securities Act is a wrongful transfer. The circuit court declined to reach this issue, but if it had, it would have found little case law in support of Central's position. Without this defense, Central was subjected to liability for acts completely outside its control. Additionally, the defense would never be successful where a purchaser or pledgee is without notice of a restriction, because he would be a bona fide purchaser entitled to transfer regardless of the wrongfulness of such transfer.

The combination of the UCC and the Securities Act in situations such as that in *Mr. Steak* creates unacceptable results. Both issuer and transfer agent must choose between liability under one of the two acts. When state and federal law clash in this manner, a question of pre-emption arises.

II. PRE-EMPTION

When there is an apparent pre-emption issue, the courts begin by looking at the purposes of the laws in question. The Supreme Court has set up the process as follows:

> Deciding whether a state statute is in conflict with a federal statute and hence invalid under the Supremacy Clause is essentially a two-step process of first ascertaining the construction of the two statutes and then determining the constitutional question whether they are in conflict.[41]

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[39] The officer handling the loan knew that Mr. Steak was a privately-held company that was about to make a public offering. He was also knowledgeable in the securities field. Record, vol. I, at 26-28.

[40] Perhaps it should be noted that the Bank considered Price "financially irresponsible" after July 1969. Record, vol. I, at 4, 24. No action has been taken against him even though he remains liable on the $37,000 note and may also be liable for his misrepresentations as to the restrictions on the pledged stock, Altman v. American Foods, Inc., 262 N.C. 671, 138 S.E.2d 526 (1964).

[41] Perez v. Campbell, 402 U.S. 637, 644 (1971). In *Mr. Steak*, the court primarily focused on congressional intent to pre-empt, 487 F.2d at 645-46, and found none. That inquiry is relevant where "[b]oth regulations can be enforced without impairing federal superintendence of the field," *id.*, which the court found here. There are, however, situations in which UCC section 8-204 and the Securities Act are not harmonious. *See* text accompanying notes 43-46, *infra*.

There have been extensive statements of purpose by the legislatures, courts, and commentators concerning both the UCC and the Securities Act. Article 8 of the UCC has as its purpose the promotion of free trading in securities, and in order to achieve that aim it gives investment securities the attributes of negotiability.[42] The basic purpose of the Securities Act is to protect the investing public by insuring that purchasers are fully informed about the venture in which they are investing.[43]

The Securities Act requires a registration statement and the use of prospectus in the sale of securities in order to achieve the Act's purpose.[44] An exception from those requirements has been granted for private offerings because the private offerees do not require the protection of the Act.[45] The exemption is closely circumscribed, however, to insure that the unregistered securities do not get into the hands of uninformed investors, the persons the Act was designed to protect. Since an issuer is liable if its privately-placed securities are distributed to the public,[46] restrictions on sales are imposed on those securities. These restrictions exist at the time of the original issue of the stock and can be noted on the certificates at that time. There are situations, however, in which issuers will be unable to note the restrictions on the certificates.[47] Whether restrictions are noted or not is irrelevant under the Securities Act; when any restricted security is sold in violation of the Act, liability arises. The UCC's purpose of full negotia-

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[42] *See* note 11 *supra*.

[43] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963); A.C. Frost & Co. v. Coeur d'Alene Mines Corp., 312 U.S. 38, 40 (1941); Wilko v. Swan, 127 F. Supp. 55, 58 (S.D.N.Y. 1955); Israels, *supra* note 11, at 78.

[44] 15 U.S.C. § 77e (1971).

[45] *See* note 24 *supra*; WHEAT REPORT at 160.

[46] *See* text accompanying notes 25-30 *supra*.

[47] For example, private placement restrictions may lapse after a few years and holders of that stock may require the issuer to remove the legend from their certificates. SEC No-Action Letter, May 22, 1970 (unpublished). At a later date, the issuer may make an offering under Regulation A, 17 C.F.R. 230.251-63 (1974), and the SEC will then require that the transfer books be closed as to the earlier-issued stock as in Prudential Petroleum Corp. v. Rauscher, Pierce & Co., 281 S.W.2d 457 (Tex. Civ. App. 1955). The temporary moratorium on transfer cannot be shown on the certificates.

Another troublesome situation arises when an issuer seeks to protect itself from secondary liability on a distribution by a control person by giving its transfer agent a stop-transfer notice on stock registered to control persons. Such stock may well have been acquired on the open market, making it very difficult for the issuer to get notice of the restriction onto the certificates. This problem arose but was not resolved in Travis Inv. Co. v. Harwyn Publishing Corp., 288 F. Supp. 519 (S.D.N.Y. 1968). For a discussion, see Israels, *supra* note 28, at 86-89.

bility runs counter to the aim of the Securities Act in this situation. There is a potential conflict here that manifested itself in the fact situation of the *Mr. Steak* case.

Under the supremacy clause of the Constitution, a conflict between a state and a federal law must be resolved in favor of the federal law.[48] The federal law will oust state law only to the extent necessary to effectuate the purpose of the federal act.[49] According to that formula, the conflict between section 8-204 of the UCC and the Securities Act should be resolved by reading section 8-204 as invalidating all unnoted restrictions except those placed on securities in order to insure compliance with the Securities Act. Arguably, the latter restrictions need not be noted on the certificate in order to be effective.

Farmer's Educational & Cooperative Union of America v. WDAY, Inc.,[50] supports the type of resolution made above. In that case, the defendant permitted a political candidate air time in compliance with the federal equal time law.[51] As a result of the candidate's broadcast, the defendant was sued for libel. The court noted that WDAY was forbidden to censor a candidate's remarks under the equal time law and also that the station ran the risk of not having its license renewed if it denied air time to all candidates. In other words, in order to keep from running afoul of the FCC, WDAY had to give time to all candidates and allow them to say whatever they chose. The court refused to "sanction the unconscionable result of permitting civil and perhaps criminal liability to be imposed for the very conduct the statute demands of the licensee."[52] As a result, the court read the equal time statute as necessarily immunizing broadcasters from libel actions arising out of candidates' remarks.[53]

In this case, the statute demands that the issuer keep its unregistered stock out of the hands of the uninformed public. In most situations, that requirement will not cause any problems with state law because issuers do try to place a legend on their restricted stock. Even where issuers cannot note restrictions on all

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[48] *See, e.g.*, Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142 (1963); Colorado Anti-Discrimination Comm'n v. Continental Airlines, Inc., 372 U.S. 714 (1963).

[49] Elliott v. Blumb, 356 F.2d 749, 755 (9th Cir. 1966); Dix v. Rodgers, 269 F.2d 84, 88 (2d Cir. 1959).

[50] 360 U.S. 525 (1959).

[51] *Id.* at 526.

[52] *Id.* at 531.

[53] *Id.*

certificates,[54] the Securities Act still requires that the stock not be transferred in violation thereof, but state law says the restriction is ineffective against anyone without knowledge of it. In order not to frustrate the underlying purposes of the federal law, the courts should give precedence to federal laws.[55] In other words, where an issuer or a transfer agent stands faced with the choice that defendants in *Mr. Steak* had—transfer and be in violation of the Securities Act or refuse to transfer and be subject to liability under state laws—the courts should immunize them from liability under state law for acting in consonance with the federal law. This resolution will protect issuers and especially transfer agents from liability where they cannot effectively control the behavior that creates the liability, while at the same time leaving the purchaser several paths of recourse against the person selling him the restricted security.[56] This is probably the best possible judicial resolution of the case. It does, however, have the additional effect of immunizing issuers from liability for an unnoted restriction when noting the restriction would have been a simple task. The court in *Mr. Steak* may well have declined to find preemption by the Securities Act in order to avoid the frustration of the UCC. Unfortunately, the decision in *Mr. Steak* will lead to equally frustrating and inequitable results in other fact situations.

III. CONCLUSION

The aim of Article 8, and section 8-204 in particular, was to enable a stock purchaser to know what he was getting simply by looking at the stock certificate. If issuers need to restrict their stock, they are given the burden of making that restriction effective. In most cases, issuers will have no difficulty noting restrictions on their stock certificates and they should be responsible for doing so. They should not be subject to liability on an unnoted restriction when it is beyond their power to get legends onto the necessary certificates.[57] Perhaps the ideal rule would be to immunize issuers from liability for an unnoted restriction only when

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[54] *See* note 47 *supra*.

[55] Hill v. Florida *ex rel.* Watson, 325 U.S. 538, 542 (1945).

[56] The seller would incur potential liability on the underlying contract, as well as liability for misrepresentation of the transferability of the stock under the theory of Altman v. American Foods, Inc., 262 N.C. 671, 138 S.E.2d 526 (1964), and possibly under rule 10b-5, 17 C.F.R. 240.10b-5 (1974). Also the seller will have breached his warranty that transfer is rightful under UCC section 8-306(2)(a).

[57] *See* note 47 *supra*.

they are diligent in noting restrictions whenever possible. In those situations, the purchaser's recovery would have to be from the seller, who failed to disclose the restriction. When a restriction is unnoted due to the issuer's negligence, no immunity from UCC section 8-204 would result. This rule would allocate liability on the basis of fault and could easily be incorporated into sections 227 and 1603 of the American Law Institute's proposed Federal Securities Code. Transfer agents should be completely immunized from liability for refusal to transfer based on an unnoted restriction, since they are not in a position to make sure that restrictions are noted on the stock they handle. This rule would have saved Central but not Mr. Steak in the instant case.

The rule that comes out of *Mr. Steak* makes it imperative that issuers note all restrictions.[58] Issuers with unlegended restricted stock would be well advised to call in those certificates and stamp them. Transfer agents would do well to demand indemnification agreements from issuers covering liability for unnoted restrictions. The only way to be absolutely safe would be to legend all certificates that might possibly be or become restricted with a notation of that possibility. That course of action would clearly frustrate the aims of the UCC by decreasing the negotiability of investment securities, but that seems to be the only way to avoid a potential liability about which the parties can do nothing.

Mary-Ann Wilson

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[58] State law will support issuers here in that it will require those who take stock knowing it to be restricted to take legended certificates, General Dev. Corp. v. Catlin, 139 So. 2d 901 (Fla. Ct. App. 1962); Short v. Soil Builders Int'l Corp., [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,188 (Tenn. Ct. App. 1962).