

## SECURITY INTERESTS IN STOCK CERTIFICATES

### I. INTRODUCTION

A. In this outline we consider the most basic form of security interest in **investment property** : a security interest in a stock certificate. By use of the term "stock certificate" we mean to refer to a physical piece of paper that provides evidence of ownership of an interest in a corporation. When ownership of an interest in a corporation is represented by a physical certificate, the Uniform Commercial Code ("UCC") refers to the interest as a "Certificated security". See **§8-102(4)** . Note that the *interest* in the corporation is distinct from its mode of representation. Article 8 of the UCC separately defines a "Security certificate" as a "certificate representing a security." See **§8-102(16)** . And, an ownership interest in a corporation need not be represented by a certificate. In such a case the ownership interest is an "Uncertificated security". See **§8-102(18)** . This outline does not discuss security interests in uncertificated securities.

B. We know that an ownership interest in a corporation is a "security" because **§8-103(a)** includes the following definition:

**"A share or similar equity interest issued by a *corporation, business trust, joint stock company, or similar entity is a security.*"** (Emphasis supplied.)

Note that **§8-103** is not the only section that contains the definition of a "security". Also, you must consider **§8-102(15)** , which provides a general definition. These definitions are discussed in a separate e-Presentation™ which considers security interests in other types of business entities.

C. We must distinguish an ownership interest represented by a physical certificate from an ownership interest held through a brokerage account. If you own stock that is held through a broker (such as Merrill Lynch or Smith Barney), you do not actually own a security. In such a case you hold a "Security entitlement", **§8-102(17)** , and you are an "Entitlement holder", **§8-102(7)** , with a claim against your broker. Your broker is a "Securities intermediary" **§8-102(14)** . This is true even though the ultimate ownership interest in the corporation is in fact certificated and the certificate is held directly by your broker or by a clearing corporation such as The Depository Trust Company. This outline does not discuss security interests in security entitlements, which are discussed in another e-Presentation™.

### II. TRANSFERS

A. If you examine Article 8, you will see that its subject matter is "Investment Securities." See **§8-101** . It's scope is not limited to the creation of security interests.

Indeed, Article 8, does not expressly refer to the creation of security interests. In general, Article 8 as enacted by a particular state, governs all transfers of interests in securities, including stock in a corporation, to which the laws of that state apply. **Section 8-104(a)** provides that:

**"A person acquires a security or an interest therein, under this Article, if:**

**(1) the person is a purchaser to whom a security is delivered pursuant to Section 8-301; or**

**(2) the person acquires a security entitlement to the security pursuant to Section 8-501."**

Note that **§8-104(a)** specifically refers to acquisition of a security or *an interest therein*. The "interest therein" that concerns us is the transfer of the limited interest known as a "security interest". Our focus is on **§8-104(a)(1)**, and not subsection (2), because we are here interested in how to acquire a security interest in a certificated security issued by a corporation and not a security entitlement. Because **§8-104(a)(1)** applies to acquisition of interests in securities generally, it applies to our particular case of certificated corporate securities. (Note that this subsection also applies to uncertificated securities.)

B. Close reading of **§8-104(a)(1)** requires consideration of the terms *purchaser* and *delivered* which are both defined in the UCC. "Purchaser" is defined in Article 1, **§1-201(33)**, to mean "a person who takes by purchase". In turn, "purchase" is defined in **§1-201(32)** as follows:

**"Purchase" includes taking by sale, discount, negotiation, mortgage, pledge, lien, issue or re-issue, gift or any other voluntary transaction creating an interest in property."**

Thus we find that, in Article 8 terminology, a person who acquires a lien on a security (or a pledge of security) is a "purchaser". Happily, the term "person" is generously defined as an individual or an organization, **§1-201(30)**, so we need not worry whether our secured party is a natural person or an institution.

1. We might worry that **§1-201(32)** simply refers to mortgages, pledges and liens but not to *security interests*. Recall, however, that "security interest" is defined in **§1-201(37)** to include "an interest in personal property or fixtures which secures payment or performance of an obligation". And, old Article 9, former **§9-102(2)**, provided that it applied to security interests created by contract, including pledges, assignments and other liens. Although Revised Article 9, **§9-109**, does not make specific mention of mortgages, pledges or liens, the comment to that section states that, although the

provision has been shortened, no change in meaning was intended from that of old Article 9. **See also §8-301 , Official Comment 1** ("Sale and pledge are different kinds of transfers, but both may be implemented by delivery.").

C. The scope of the term "delivery" is set forth in **§8-301** . That section contains three cases in which delivery of a certificated security to a purchaser occurs. It provides as follows:

**"(a) Delivery of a certificated security to a purchaser occurs when:**

**(1) the purchaser acquires possession of the security certificate;**

**(2) another person, other than a securities intermediary, either acquires possession of the security certificate on behalf of the purchaser or, having previously acquired possession of the certificate, acknowledges that it holds for the purchaser; or**

**(3) a securities intermediary acting on behalf of the purchaser acquires possession of the security certificate, only if the certificate is in registered form and has been specially indorsed to the purchaser by an effective indorsements."**

Sub-clause (a)(1) applies to the paradigm case where a debtor delivers stock certificates to the secured party at the closing of a loan transaction. Sub-clause (a)(2) applies to two common cases. The first case under (a)(2) permits a single collateral agent to hold stock certificates on behalf of a syndicate of lenders. In this circumstance, the debtor would deliver stock certificates to the collateral agent at the closing. The second case under (a)(2) permits a second lien. For example, a collateral agent for a group of senior lenders that is in possession of stock certificates might agree to hold those same certificates also on behalf of a second group of additional lenders by making the requisite acknowledgement. Sub-clause (a)(3) is the most unusual case in a secured loan transaction. For example, if a broker acquired a registered security in the name of a debtor and the debtor endorsed the security certificate to the secured party by effective indorsement, then the secured party would have a direct interest in the security and not a security entitlement. This last method is rarely used to secure a syndicated commercial loan.

1. Note that sub-clause (a)(2) does not apply in the case of a securities intermediary. Thus, it would seem that a bank or a broker would be prevented from acting as a collateral agent in a syndicated loan transaction. Fortunately, this is not the case. A bank or a broker is only a securities intermediary when it "is acting in that capacity". See **§8-102(14)** . When acting as a collateral agent, the bank or broker is not acting as a securities intermediary.

2. Unlike sub-clauses (a)(1) and (a)(2), use of sub-clause (a)(3) requires the presence of an *effective indorsement*. "Indorsement" is defined in §8-102(11) and includes either a signature on the security certificate itself or on a separate document. Such a separate document is sometimes referred to as a "stock power" or an "alonge". An indorsement is *effective* only if it satisfies the requirements of §8-107.

D. The rights of a purchaser of a security, including our transferee of a security interest in corporate stock, are described in §8-302. That section provides as follows:

**(a) Except as otherwise provided in subsections (b) and (c), upon delivery of a certificated or uncertificated security to a purchaser, the purchaser acquires all rights in the security that the transferor had or had power to transfer.**

**(b) A purchaser of a limited interest acquires rights only to the extent of the interest purchased.**

**(c) A purchaser of a certificated security who as a previous holder had notice of an adverse claim does not improve its position by taking from a protected purchaser.**

1. Sub-section (a) states the familiar "shelter principle". A purchaser acquires all the rights that its transferor had to transfer. The interest of the purchaser is sheltered or protected to the extent of the interest that the transferor had power or right to transfer. Of course, in general a transferor may not transfer a greater interest than it in fact possessed. (However, we will see that certain purchasers of negotiable property may be granted good and clear title even though the party from whom they received the property did not have clear title to transfer. This result was designed for policy reasons relating to the need for certainty and finality in the capital markets.)

2. Sub-section (b) contemplates the transfer of limited interests in property such as the security interest granted in corporate stock. It is an exception to the shelter principle in that the transferee or purchaser of a limited interest, such as a security interest, does not acquire *all* right, title and interest of the transferor. The interest of the purchaser is limited by the portion of the interest in property transferred. Thus, an owner of a security may transfer all of its interest in a security by an outright sale transaction or it may transfer some limited subset of the rights that comprise its ownership interest. In the case of the security interest, the owner has transferred to the secured party the conditional right to sell the property subject to the security interest and apply the proceeds to repay an obligation. The condition to exercise of this right typically is the failure of the obligor to make payment on the secured obligation. Additionally, the secured party may effect a complete transfer of the collateral to itself in satisfaction of the obligation.

3. Sub-section (c) is an anti-fraud provision. It also is an exception to the shelter principle. If a former holder of a security who had notice of an adverse claim to a security purchased that security from a protected purchaser, the former holder does not get clear title. Ordinarily, a protected purchaser would have acquired title to the security free and clear of all adverse claims and thus could transfer clean title to a third party.

E. It is important to note that Article 8 does not contain a comprehensive treatment of all transfers of interests in securities. Creation of a security interest in corporate stock (as well as in other securities) is governed by Article 9. Although a transfer of an Article 9 security interest in corporate stock can be implemented by delivery within the terminology of Article 8, it need not be. **See §8-302, Official Comment 2** . Former Article 9 provided that a security interest in securities may be created by the debtor signing a security agreement that contains a description of the collateral. **§9-203(1)(a)** . Revised Article 9 contains the same provision. **§9-203(b)(3)(A)** .

1. For a security interest to be enforceable against the debtor (and third parties) *value* must have been given, **Former Article 9 §9-203(1)(b); Revised Article 9, §9-203(b)(1)** , and the debtor must have *rights in the collateral* , **Former Article 9 §9-203(1)(c); Revised Article 9, §9-203(b)(2)** . In addition, enforceability requires a third step which may be satisfied in a variety of ways.

2. The third step requires one of the following: the collateral must be in the possession of the secured party pursuant to agreement (but not necessarily written agreement); if the collateral is a form of investment property such as our corporate stock, the secured party must have **control** over the collateral pursuant to agreement (again, not necessarily a written agreement); or the debtor must have signed a security agreement that contains a description of the collateral.

### III. PERFECTION

A. We have seen that a security interest in corporate stock may be created either by an Article 8 delivery or by the debtor signing a security agreement that contains a description of the corporate stock. However, mere creation of a security interest often is not sufficient protection for a secured party. The secured party wants to be protected against third parties and the bankruptcy trustee of the debtor. In order to obtain some measure of protection, the secured party must *perfect* its security interest. Perfection is an Article 9 concept not found in Article 8. In Article 9 terminology, corporate stock is one type of *investment property* . **See Former §9-115(1)(f) and Revised §9-102(a)(49)** .

B. In general, a security interest in investment property may be perfected by the

secured party filing a financing statement, by the secured party obtaining control of the investment property or, in the case a certificated security, by the secured party obtaining possession of the stock certificate pursuant to an agreement. As we shall see, obtaining possession of the stock certificate pursuant to an agreement is something less than control within the meaning of Article 8.

1. If the debtor is a broker or a securities intermediary, the filing of a financing statement is not effective with respect to any form of investment property. Similarly, if the debtor is a commodity intermediary, filing of a financing statement is not effective with respect to commodity accounts or commodity contracts.

2. The description of the corporate stock contained in the security agreement and in the financing statement is sufficient if it refers to the specific stock certificate, makes general reference to certificated securities or simply refers to investment property.

3. If the security certificate is in registered form and is delivered to the secured party pursuant to agreement, a written security agreement is not required for attachment or enforceability of the security interest. Mere delivery suffices for perfection, even if a necessary indorsement is lacking.

C. Under Former Article 9, there were no explicit rules that specified where to file a financing statement to perfect an interest in a debtor's investment property. This is a drafting oversight corrected in Revised Article 9. Under Former Article 9, by analogy to filing requirements for general intangibles, a financing statement containing a description of the investment property was filed in the location of the debtor's chief executive office. If the debtor had only a single location of business or was an individual, the filing was made at the location of the debtor's place of business or residence. Under Former Article 9, care needed to be taken based on local variations in the UCC to determine if filings could be made only with the secretary of state in which the debtor is located or also needed to be made in the applicable county. Under Revised Article 9, a registered organization such as a corporation or a limited liability company that is organized under the laws of a State is deemed located in that State and filing against investment property would be made with the Secretary of State. Filing in the jurisdiction of organization of an entity under Revised Article 9 is a change in existing law. If a debtor is not organized under the laws of a state of the United States, filing may not be an option.

D. The core method by which a security interest is perfected in certificated corporate stock is to obtain **control** over the certificates that evidence the ownership interest in the corporate stock. "Control" is defined in Article 8, **§8-106** . That section provides, in relevant part, as follows:

**(a) A purchaser has "control" of a certificated security in bearer form if the certificated security is delivered to the purchaser.**

**(b) A purchaser has "control" of a certificated security in registered form if the certificated security is delivered to the purchaser, and:**

**(1) the certificate is indorsed to the purchaser or in blank by an effective indorsement; or**

**(2) the certificate is registered in the name of the purchaser, upon original issue or registration of transfer by the issuer.**

1. Note that if the security certificate is issued in bearer form, then mere delivery establishes control. However, issuance of certificated securities in bearer form is rare. Typically, the certificated security is issued in registered form.

2. In the case of a registered security, delivery of the certificate must either be accompanied by an effective endorsement (typically by use of a separate piece of paper known as a "stock power") or the security must be re-registered in the name of the party to have control. In the case of a security interest, the registration method would require that the existing share certificates be cancelled and new share certificates issued in the name of the secured party. Most parties do not wish to undertake the paperwork necessary to effect a re-registration, nor do they wish to place signatures on original stock certificates which they hope will be returned upon repayment of a loan. Thus, it is far more common to use a stock power than to re-issue shares or to place an endorsement directly on the stock certificate.

3. Thus, in the most common case, counsel evaluating the status of a security interest perfected by control must conduct a separate inquiry to determine if the indorsements provided are in fact **effective** indorsements.

E. Central to the concept of "control" in most cases is the concept of *effective indorsement*. An indorsement is defined in §8-102(11) as follows:

**(11) "Indorsement" means a signature that alone or accompanied by other words is made on a security certificate in registered form or on a separate document for the purpose of assigning, transferring, or redeeming the security or granting a power to assign, transfer, or redeem it.**

1. The stock power is just such a separate document described in this definition. It is typically executed by the debtor both in blank and undated. It is executed in blank (i.e. without filling in the name of the transferee) so that the secured party will have the freedom either to fill in its own name or the name of a third party at a foreclosure sale. If the secured party's name were to be filled in on the stock power, then the stock

would need to be transferred first to the the secured party and thereafter to a third party purchaser at a foreclosure sale. This is a needless double transfer and often the secured party does not want to take title to the collateral (even for a short period of time). The stock powers typically are undated so that the date of any actual transfer may be filled in at the time of transfer.

F. The requirements for an effective indorsement are contained in **§8-107(b)** , which provides as follows:

**(b) An indorsement, instruction, or entitlement order is effective if:**

**(1) it is made by the appropriate person;**

**(2) it is made by a person who has power under the law of agency to transfer the security or financial asset on behalf of the appropriate person, including, in the case of an instruction or entitlement order, a person who has control under Section 8--106(c)(2) or (d)(2); or**

**(3) the appropriate person has ratified it or is otherwise precluded from asserting its ineffectiveness.**

In the case of an indorsement, the **appropriate person** is the person specified by the security certificate or by an effective special indorsement to be entitled to the security. If the person so specified lacks capacity, then the appropriate person is the designated guardian, conservator or other similar representative who has the power under law to make transfers for that person.

1. The effectiveness of an indorsement is determined as of the date that the indorsement is made and it does not become ineffective by reason of any later change in circumstances. This means that if an officer of a company properly signed a stock power relating to a security interest in stock owned by the company in one of its subsidiaries, that stock power does not become stale if the officer who signed it leaves the company, resigns, dies, is fired, etc.

G. Although we have seen that evaluation of control can be somewhat involved, we also have noted that control is not required for perfection. Mere delivery of a stock certificate in registered form **pursuant to agreement** will result in perfection. See Former Article 9, **§9-115(6)** and Revised Article 9, **§9-313(a)** and **§9-203(b)(1)(C)** . Given this result, why is such emphasis placed on obtaining control? The answer relates to the priority status of the security interest and not to perfection.

1. Note that Revised Article 9 refers to delivery of the certificate being made pursuant to the "debtor's security agreement" whereas Former Article 9 simply refers to an agreement. Commercial lawyers typically think of a security agreement as a written



agreement signed by the debtor. However, under the definitions used in the UCC, a security agreement is any agreement that provides for a security interest. It need not be in writing.

#### IV. PRIORITY

A. All the work applied to understanding "control" in the context of perfecting a security interest will make the task of understanding priority easier. Simply put, under Article 8 a purchaser (which includes our secured party) may acquire the status of a **protected purchaser**. A protected purchaser acquires its interest in the security free of any **adverse claim**. However, a purchaser must have control over the certificated security in order to become a protected purchaser. The definition of protected purchaser appears in **§8-303(a)** and provides as follows:

**(a) "Protected purchaser" means a purchaser of a certificated or uncertificated security, or of an interest therein, who:**

**(1) gives value;**

**(2) does not have notice of any adverse claim to the security; and**

**(3) obtains control of the certificated or uncertificated security.**

1. The reference to "an interest therein" is the statutory language that permits a holder of a limited interest such as a security interest to acquire the status of a protected purchaser.

B. Recall that value had to be given in order to have an enforceable security interest under Article 9. "Value" is defined in **§1-201(44)** as follows:

**Except as otherwise provided with respect to negotiable instruments and bank collections (Sections 3--303, 4--208 and 4--209) a person gives "value" for rights if he acquires them**

**(a) in return for a binding commitment to extend credit or for the extension of immediately available credit whether or not drawn upon and whether or not a charge-back is provided for in the event of difficulties in collection; or**

**(b) as security for or in total or partial satisfaction of a pre-existing claim; or**

**(c) by accepting delivery pursuant to a pre-existing contract for purchase; or**

**(d) generally, in return for any consideration sufficient to support a simple contract.**

1. In the context of a commercial loan agreement, value is generally provided under subsection (a) of the definition. Although it is relatively easy to see how value is

given, counsel rendering legal opinions generally assume that value has been given (rather than conclude as a legal matter that this section has been complied with) on the theory that this is a factual rather than a legal matter.

C. "Adverse claim" is defined in **§8-102(a)(1)** to mean "a claim that a claimant has a property interest in a financial asset and that it is a violation of the rights of the claimant for another person to hold, transfer, or deal with the financial asset". Recall that "Financial asset" is defined to include a "security", **§8-102(a)(9)**, and that as the context requires, it includes the interest itself or the means by which the interest is evidenced.

1. Whether or not a secured party has notice of an adverse claim is a factual matter. Counsel rendering a legal opinion will always assume that the secured party acquires its interest without notice of any adverse claim. However, a purchaser of a certificated security may have notice of an adverse claim based upon writings that appear on the certificate. See **§8-105(d)(1) and (2)** and **§8-209** (issuer's lien must be noted conspicuously on the security certificate to be valid against a purchaser). Significantly, in general the filing of a financing statement under Article 9 does not, in itself, constitute notice of an adverse claim. Note, however, that exceptions may exist for shares of certain types of corporations, under non-standard local amendments to the UCC (such as New York's amendments relating to co-op shares).

2. Also, a restriction on transfer of a security is valid even against a person without knowledge of the restriction if the security is certificated and the restriction is noted conspicuously on the security certificate. See **§8-204**.

## V. Choice of Law

A. The choice of law applicable to evaluation of the creation, perfection and priority of a security interest in corporate stock is extremely complex. In general, the law of the location of delivery of the stock certificate will apply to determine the ability to assert adverse claims to the security. See **§8-110(c)**. This law will be in addition to the law of the jurisdiction where the security certificate is maintained by the secured party for safe keeping which generally applies to creation, perfection and priority. See **Revised §9-305(a)(1)**. Lastly, the law of the issuer's jurisdiction will govern a variety of matters, including registration of transfers of shares in typical industrial corporations. See **§8-110(a)**. The local law of the issuer's jurisdiction may be of great practical importance in connection with the exercise of remedies.