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**EDITOR'S HEADNOTES: THE BOTTOMLESS PIT
OF BANKRUPTCY JURISDICTION**

Gerald T. Dunne

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

*Mark G. Lake
and Henry Bregstein*

**GLASS-STEAGALL UPDATE: PROPOSALS TO
MODERNIZE THE STRUCTURE OF THE
FINANCIAL SERVICES INDUSTRY**

Edward D. Sullivan

**UNEXPECTED ALLIES: THE BANKRUPTCY
JUDGE AND DEBTOR'S COUNSEL**

*Jonathan M. Landers
and Kathryn A. Coleman*

**PENNSYLVANIA BANKS RIDE THE
INTERSTATE EXPRESS**

Jonathan L. Levin

**BHC FORMATION UNDER THE COMMUNITY
DEVELOPMENT BANKING ACT:
LITTLE STREAMLINING,
LESS SIMPLIFICATION**

*Douglas V. Austin
and Jeffery E. Smith*

- 1995 Digest Index
- 1995 Table of Authors and Articles
- 1995 Table of Cases

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

Mark G. Lake and Henry Bregstein*

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

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

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¹ UCC § 9-307(1).

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

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

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

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

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

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

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

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

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

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

to locate a stock certificate representing one-third of the shares of the borrower-subsiary. The shares were intended to be pledged by the guarantor to the lender. The guarantor requested that a new certificate representing the missing shares be issued and undertook to indemnify and hold the borrower-issuer harmless should another party show up with the lost certificate.⁷ Without the borrower's or guarantor's fraud or negligence,⁸ a holder of the "lost" securities could have no real hope of prevailing in a claim against the issuer, guarantor, or lender, because under Article 8 the new holder of the lost certificate could not become a bona fide purchaser without the indorsement of the registered owner⁹ unless the issuer issued a new certificate in the holder's name.¹⁰ However, such fraud or negligence should not entirely displace the lender's rights in the stock constituting its collateral, but should only dilute the collateral to the extent of the pro rata percentage of ownership represented by the fraudulently issued certificates.¹¹

Similarly, fraudulently issued securities acquired by a bona fide purchaser (BFP)¹² subsequent to the time when the lender perfected its security interest would dilute the lender's collateral¹³

⁷ See UCC § 8-405(2). Of course, if the guarantor's principal asset is its interest in the subsidiary, or the guarantor is otherwise not creditworthy, such indemnity may be of little or no value, and the issuer may require an indemnity bond from a creditworthy surety. Even if the guarantor is independently creditworthy, its indemnity is of no added value to the lender, which in any event is entitled to look to the credit of the guarantor.

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

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

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

¹¹ See UCC § 8-405(3).

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

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

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

Perfection of Security Interests in Securities

The perfection of security interests in securities is controlled for the most part by Article 8 of the Uniform Commercial Code, as adopted (with certain nonuniform provisions) in the various states, and to a lesser extent by Article 9.¹⁵ Section 8-313 provides the exclusive means of transfer of a security or a limited interest (including a security interest) in a "security."

The operative subsection for a pledge of closely held stock is Section 8-313(1)(a) of the UCC, which provides that a transfer of a security interest occurs "when he [the secured party] or a person designated by him acquires possession of a certificated security"¹⁶— here, certificates representing the outstanding stock of the borrower, its subsidiary, or other closely held corporation (hereinafter, such certificates sometimes are referred to as "Pledged Securities"). In the usual case the lender or an agent for the lender acquires possession of the certificates¹⁷ together with undated stock powers

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

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

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

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

endorsed in blank, with signature guaranteed. Moreover, the lender would presumably take its security interest (1) in "good faith";¹⁸ (2) without "notice" of any adverse claim;¹⁹ and (3) with a given "value."²⁰ As a result, the lender would be a BFP under Article 8.²¹

Section 8-302 provides that a BFP acquires its interest free of any adverse claim to the security.²² The definition of "adverse claim" apprehends a broad range of claims that may be either legal or equitable.²³ "Adverse claim" includes the claim that a third party is owner of the security. Whether the issuer fraudulently issued the security to facilitate a double financing or the BFP's transferor acquired the security by means of *theft* or *fraud* does not impair the bona fide purchaser protection afforded by Article 8.²⁴ Achieving BFP status affords protection from all *prior* claims (other than certain tax claims²⁵ and state-by-state exceptions),²⁶ but it most

¹⁸ UCC § 1-201(19).

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

²⁰ UCC § 1-102(44).

²¹ UCC § 8-302(1)(a).

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

²³ UCC § 8-302 (Official Comment 4).

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

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

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

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

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

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

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

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

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

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

³⁰ Revised UCC § 8-106 provides:

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

(b) A purchaser obtains "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.

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

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

plished by "delivery" of the security,³¹ as opposed to by "transfer" under present Article 8.³² Of course, in the usual case, the stock of a subsidiary or other closely held corporation is not recorded on the books of a financial intermediary (e.g., a broker holding stock in street name), although that could be the case if a portion of the outstanding shares is publicly traded.

Robert Maxwell's Fraud Illustrates the Risks

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

Facts in *Bishopsgate*

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

³¹ Revised UCC § 8-301.

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

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

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

³⁵ Transcript, supra note 33, at 1-17.

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

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

Notice on the Part of the Pledgees

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

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

³⁷ Transcript, *supra* note 33, at 512.

