

NON-CERTIFICATED STOCK

BY DAVID A. DREXLER *

MR. DREXLER: I am going to talk about a statute that's in the process of being considered. But unhappily, unlike Professor Loss, I am in no way involved in writing the statute. However, I tried to read up on it and learn something. I hope that afterward in your questions you won't subject me to the same degree of cross-examination that Professor Loss opened himself to.

The proposal concerns non-certificated stock.¹ Generally speaking, it is an effort to eliminate or reduce the dependence upon stock certificates or security instruments as the principal indicia of ownership and to permit the free alienation of such security instruments without the need for physical delivery of the endorsed stock certificates or debentures or other security instruments.

Basically, the background of this arose in the late 1960's in which is now known as the "Backroom Crunch" which resulted in the collapse or merger of many of the large, supposedly solid Wall Street brokerage houses. In analyzing what had occurred, it was learned that there was a great deal of stolen and lost certificates. Above all, an enormous amount of expense and trouble was being incurred in the mere physical handling of the certificates, the commodity in which they were dealing, which could not be traced. So the idea arose that there might be a better way in which securities transactions could be handled.

In addition, the increased use of computers and other forms of quick retrieval of data was obvious. It seemed a little anomalous, at the least, that a computer system to keep track of all this information regarding ownership of securities, could be set up and yet allow a whole series or a whole class of transactions to avoid entering into that system.

Any lawyer who has dealt with the problem of lost stockholders in the dissolution of a corporation has frequently found that it is not stockholders that they have lost, but the stock. The record stockholder at some point in time before the dissolution has signed an endorsement, given the stock certificate over to someone, and received his consideration for it, with a subsequent disappearance of the stock certificate. The problem is that the ownership interest becomes embodied in a document only, and no one knows the identity of the

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1. U.C.C. §§ 8-101, 8-408 (proposed revision of article 8, 1977).

owner or the location of the document. This type of transaction would occur wholly outside of stock registration requirements, which are computerized.

These considerations led, in 1971, to the appointment of an Ad Hoc Committee under the ABA Section of Corporation, Banking and Business Law, to study the problem and determine if they could formulate a procedure for securities transactions which would eliminate the need for exchange of the security instrument itself. The focus of the committee, as it developed over the years, was obviously not on the corporation laws of any state or states, but on article 8 of the Uniform Commercial Code and the Uniform Stock Transfer Act.

The committee learned that in many areas the use of non-certificated stock transactions had grown far beyond the code provisions, and there were and are now a number of routine securities transactions not involving exchange of stock certificates, which are handled effectively up to a point. Those of you who own stock in open-end mutual funds usually do not have a certificate, although the option remains. In lieu of a certificate, a custodial agency is set up who is responsible for an accounting each month which lists the number of shares owned.

Similarly, many large corporations now have what they call stock purchase or dividend reinvestment plans under which a stockholder can elect, each dividend period, to take his dividend in the form of a purchase of additional shares of the corporation, usually at a discount. I learned, upon inquiry concerning a plan in effect at AT&T, that millions of their shares are now represented only by the statements that are sent to the shareholder investors each quarter.

Brokers and custodians in many instances surrender all their shares to CEDE, which is a repository organized by the stock exchanges to enable a large number of transactions between stock brokers dealing with stock, without any transfer of certificates. CEDE, functioning as repository, records the ownership and number of shares owned of any security. All of this is accomplished without security instruments being delivered or received.

Each of these devices is, in a sense, ignoring some provision of law. The Delaware Corporation Law provides specifically that each share of stock must be represented by a certificate, and sets forth certain statutory requirements for the information which must appear on such certificates.² However, certificates do not exist in the situations I have mentioned. I inquired about the stock that AT&T is

2. DEL. CODE ANN. tit. 8, § 158 (1975).

holding for the stockholders who chose the stock dividend reinvestment plan, under which the shares are not represented by certificates. Upon request, AT&T merely issues a certificate to the stockholder. Likewise, I doubt that mutual funds issue a certificate which is turned over to the disbursing agent each time a new investment is made by a stockholder.

As shown, there is a system in this area now working, but it is not adequate. Inadequacies arise from problems with alienability, and particularly use of non-certificated stock as security or collateral for loans or other types of transactions. Open-end mutual funds function well, at least for purposes of transfer, since, generally speaking, all transactions in the stock are with the mutual fund itself, and there is no problem regarding buying or selling shares. However, a problem arises if a gift of the mutual fund shares is desired.

With respect to problems arising under stock purchase plans, AT&T provided information concerning the sale of stock held in the plan. I learned that if a shareholder with less than twenty-five shares on deposit wishes to sell all of his shares, the company will arrange a market transaction and send the proceeds to the stockholder. On the other hand, a certificate must be requested if more than twenty-five shares are involved in the dividend reinvestment plan, if all the shares are not to be sold. It takes somewhere between fifteen and twenty days to process the issuance of a certificate, which I assume with AT&T stock does not make a great deal of difference. It certainly could make a difference, however, in the timing of the transaction where a more volatile stock is involved.

All of the difficulties encountered led to the conclusion that it would be desirable to develop a system whereby the stock could be transferred without certificates. The ABA Committee attempted to devise a system which would allow flexibility now available with certificates, without requiring delivery of them. Amendments to article 8 of the Uniform Commercial Code were proposed which I will try to summarize generally.³

There was no substantive change that was proposed in respect to the transfer of certificates, the law applicable remaining the same. However, several sections were added, including a provision whereby the ownership would be reflected by registration and delivery would be accomplished by a change of that registration. This bookkeeping entry recognizing the ownership on the books of the issuer was considered as non-certificated stock. To accomplish this end, the proposal involved a new document called an "initial transaction state-

3. U.C.C. §§ 8-101, 8-408 (proposed revision of article 8, 1977).

ment.”⁴ The authors of the amendments, recognizing the propensity to develop acronyms, termed it as “ITS.” If the proposal is enacted, ITS could become a subject of fairly common usage comparable to SEC and various other acronyms.

Basically, an ITS is a document which would be issued to reflect a transaction and certain other things. As far as the books and records of the issuer are presently concerned, the transfer is accomplished by the presentation of a duly endorsed certificate with instructions to transfer. For non-certificated shares which are in existence, an instruction would be provided, probably written and unlike a stock power form, which would be signed by the registered owner and which would direct the transfer of the stock on the books.

The proposal envisions that the issuer will have the right to demand, as support for such a written instruction, the same type of authentication he is now able to demand with respect to a stock power, which is a guarantee of signature and proof of the authority of an agent or fiduciary to request a transfer. It also provides that the liabilities and responsibilities of the issuer to comply with the instruction will remain the same with respect to registration and delivery of a new certificate. In this respect the law would not change, but the proposals would affect the issuance of new certificates. Within two business days the issuer would be required to send an ITS to both the transferor, the former registered holder, and the transferee, the proposed new registered holder, which would serve as a notification or confirmation that the new registration has taken place. Since the transferor would have notice within two days, he would have immediate notice if an unauthorized transfer had taken place.

Those of us who are practitioners are familiar with cases involving an unauthorized person who enters a safety deposit box, obtains the certificates, forges a signature and submits them for transfer. Some years later, the true owner, by means of the safety deposit box or some circumstance, suddenly discovers that he has lost his stock. Theoretically, under this system, within two days the registered owner will get a notification. If there is something amiss, he will be in a position to complain of it immediately.

With respect to the purchaser, or transferee, such a notification of lack of authority would prevent payment. I suspect in practice, after the adoption, there may be an escrow in the funds. In other words, the payment will be made on the day of the transaction to some independent escrow agent. Upon notification by receipt of an ITS that the transaction had been recorded on the books of the issuer,

4. U.C.C. § 8-408 (proposed revision of article 8, 1977).

the funds would be released to the transferor. With the ITS, the buyer would be informed of any restrictions on sale. If the transaction involves preferred stock, he would get the copies of the material to which he is normally entitled. With respect to a preferred stock certificate, the buyer would receive information concerning the rights and preferences and other statutory data.

With respect to pledges, the same procedure would be followed. A notification of the pledge would be sent to the issuer, who would issue an ITS, acknowledging that the pledge had been registered on the books of the corporation. Where a pledge transaction is made, the difference would result in the owner, the pledgor, retaining all rights of ownership in the stock except the right to transfer. That right to transfer would pass to the pledgee. The pledgee would then have the right to: transfer it free of a pledge, which would release the pledge; permit the transfer of ownership subject to the pledge, which would permit a sale to someone who is subject to the pledge; transfer his security interest in it; or terminate it.

There is one substantive difference from current law in the handling of pledged securities. The committee attempted to parallel certificated transactions completely but were unable to cope with one area. In a typical pledge transaction, a stock certificate is surrendered to the lender in order that money can be borrowed against it. The lender retains the certificate along with an executed stock power in his safe. The pledgor remains as the registered owner on the books of the corporation. As a result, all stock dividends which might be declared and issued on the stock are paid to the registered owner free of the pledge. If the share involved is non-certificated, however, stock dividends entered on the books of the corporation become automatically subject to the pledge, which results in the right to transfer passing to the pledgee.

Basically the difference between the ITS and the stock certificate itself is that the ITS is not an indication of ownership; it is not a document of title. It speaks only at the time of its issuance, and the only person who is entitled to rely on it is the addressee, the person to whom it was sent.

As to the present status of the proposals, last summer the Uniform Law Commissioners finally approved the amendments to article 8⁵ and presented them to the various states with the recommendation that they be adopted. A committee of the Delaware Bar Association, as well as the Uniform Code Commissioners from Delaware, are now

5. U.C.C. § 8-317 (proposed revision of article 8, 1977).

reviewing the article 8 amendments and placing them in a form suitable for adoption by the legislature.

In addition, there are changes which will be required in the Corporation Law for the reasons discussed. Under the present Corporation Law there is a statutory requirement that a stock certificate be issued.⁶ In many instances, with respect to preferred stock and other matters, what must be contained on that certificate is mandated by statute. A subcommittee of the Corporation Law Committee has concluded amendment of the statute will be necessary, and I think that, in principle, the whole Corporation Law Committee of the Delaware Bar Association is committed to this conclusion. When the drafting is done, those amendments, too, will be submitted to the legislature.

The fundamental premise of the Corporation Law Committee is that the proposal will be optional both to corporations and to the stockholder. If a corporation chooses to become involved in non-certificated stock, it must elect to do so by a resolution by the board of directors. Furthermore, a stockholder is still entitled to a certificate. In that connection, the code will provide that you cannot have both. In other words, before a share can become a non-certificated share it must be surrendered to the issuer. Similarly, if one having a non-certificated share wants to get hold of a certificate that is a share, it will be removed from the rolls of non-certificated shares.

These proposed amendments to the corporation law are presently being formulated. Hopefully they will be in final form in a month or so, with a chance of adoption at this session of the general assembly.

From what has been heard from representatives of corporation trust and others who deal with the corporate secretaries, there have been mixed feelings among the larger corporations as to whether this is a viable concept, but I think it is an idea that is progressing and will probably find its way into the conventional practice in the near future.

6. DEL. CODE ANN. tit. 8, § 169 (1975).