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Stock in a Closely Held Corporation: Is It a Security for Uniform Commercial Code Purposes?

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Stock in a Closely Held Corporation: Is It a Security for Uniform Commercial Code Purposes?

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I. INTRODUCTION

The term security has many applications. No application, however, is more important than when an interest owned or traded is determined to be within the legal definition of security. Security is defined by statutes and applied by many courts for the purposes of federal securities laws¹ and for state blue sky laws.² When interpreting the term security for federal securities laws, courts have emphasized the underlying congressional purpose of protecting investors.³ State courts also have interpreted the term liberally in an effort to protect the public under blue sky laws.⁴

1. See, e.g., *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974); *United States v. Jones*, 450 F.2d 523 (5th Cir. 1971).

2. State securities laws often follow the federal statute and decisions closely. See *American Mut. Reinsurance Co. v. Calvert Fire Ins. Co.*, 52 Ill. App. 3d 922, 367 N.E.2d 104 (1977), cert. denied, 436 U.S. 906 (1978); *McClellan v. Sundholm*, 89 Wash. 2d 527, 574 P.2d 371 (1978).

3. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953).

4. See, e.g., *Goodyear v. Meux*, 143 Tenn. 287, 291, 228 S.W. 57, 58 (1921) (stating that "the purport of all such [blue sky] laws is to protect investors").

The definition of security in the Uniform Commercial Code (U.C.C.),⁵ however, has no such purpose. The U.C.C. chapter on securities is intended to establish a system of rules for those entities or persons dealing in securities.⁶ As a result, the definition of security is one of function, rather than formality.⁷ This definition is the foundation to approaching a multitude of U.C.C. issues, including transfers of security interests.⁸ While the definition of security appears to be simple and straightforward, applying the definition to stock in a closely held corporation (close corporation) has caused problems for a significant number of courts.⁹ Divergent results have created an anomalous situation among the jurisdictions having the same statutory language.¹⁰

A uniform definition of a close corporation does not exist.¹¹ In some cases, the term is used to distinguish corporations with only a few shareholders from publicly held corporations.¹² In other cases, close corporations are defined as those corporations whose shares are not traded regularly on a recognized securities market.¹³ Another frequently used definition provides that a close corporation is one "in which the stock is held in a few hands, or by a few families, and wherein it is not at all, or only rarely, dealt in by buying or selling."¹⁴ Many other definitions also exist.¹⁵ Consequently, the emergence of a uniform definition of a close corporation is improbable.

5. U.C.C. § 8-102 (1987).

6. U.C.C. § 8-101 official comment (1977), *reprinted in* 7 W. HAWKLAND, UNIFORM COMMERCIAL CODE SERIES § 8-101, at 1 (1986); U.C.C. § 8-101 official comment (1962), *reprinted in* 7 W. HAWKLAND, *supra*, § 8-101, at 2.

7. U.C.C. § 8-102 official comment (1962), *reprinted in* 7 W. HAWKLAND, *supra* note 6, § 8-102, at 14. Federal securities laws also are functional, rather than merely formal. *See, e.g., Howey*, 328 U.S. at 298.

8. U.C.C. § 8-102 official comment (1977), *reprinted in* 7 W. HAWKLAND, *supra* note 6, § 8-102, at 20.

9. *See* 7 W. HAWKLAND, *supra* note 6, § 8-102:02, at 24 (stating that "[a]lmost all of the cases construing the term 'security,' for purposes of Article 8, have held the interests being considered fell within the definition").

10. Article 8 of the U.C.C. has been adopted by every state. While 17 states have the 1962 version and 33 states have the 1977 version, the definitional requirements are virtually the same. For further discussion, see *infra* notes 47-52, 156-59 and accompanying text.

11. *Israels, The Close Corporation and the Law*, 33 CORNELL L.Q. 488, 491 (1948) (stating that "no satisfactory all-purpose definition of a close corporation appears to have been worked out").

12. 1 F. O'NEAL & R. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 1.02, at 2 (3d ed. 1986).

13. *Id.* § 1.02, at 3.

14. *Id.* (quoting *Galler v. Galler*, 32 Ill. 2d 16, 27, 203 N.E.2d 577, 583 (1965)); *see also* *Brooks v. Willcuts*, 78 F.2d 270, 273 (8th Cir. 1935) (using the quoted language to define a "close corporation"); *Wasserman v. Rosengarden*, 84 Ill. App. 3d 713, 716, 406 N.E.2d 131, 134 (1980) (utilizing the quoted definition of close corporation in analyzing an oral agreement among all the shareholders in a corporation).

15. *See* F. O'NEAL & R. THOMPSON, *supra* note 12, § 1.02, at 2-5; W. PAINTER, CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS 442-43 (1971).

Other characteristics of a close corporation, besides limited shareholders and the lack of public trading, are rarely found in large, publicly held corporations. For example, restrictions on stock transfers are used to protect the remaining shareholders from undesirable associations.¹⁶ Because restrictions on stock transfers resemble partnership rules,¹⁷ some commentators have referred to close corporations as incorporated partnerships. In keeping with this "partnership" theory, a fiduciary duty is owed by each shareholder to every other shareholder.¹⁸ Also, close corporations generally are smaller than publicly held corporations. This characteristic is evident in the close corporation's operation. Shareholders often are involved directly in the management and daily business operations of the close corporation.¹⁹ While close corporations have many other distinguishing features, it is sufficient to conclude that a close corporation generally has: "(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority shareholder participation in the management, direction, and operations of the corporation."²⁰

Perhaps the most important feature of the close corporation is not related to its internal structure, but rather to its popularity as a business form. The close corporation is by far the most prevalent form of incorporated business. While no exact figure is available, one commentator has suggested that approximately ninety-five percent of all corporations have ten or fewer shareholders.²¹ Because of the special needs of the close corporation, many states have special provisions for dealing with close corporations in their corporation code or have enacted close corporation codes in addition to the regular corporation code.²² Because of the large number of close corporations in existence, the treatment afforded to their stock by the U.C.C. is of critical importance.

Stock in close corporations (close stock) often is used by the corpo-

16. 1 F. O'NEAL & R. THOMPSON, *supra* note 12, § 1.02, at 3.

17. *Id.*; see *Cuppy v. Ward*, 187 A.D. 625, 639-40, 176 N.Y.S. 233, 243-44 (1919) (Shearn, J., dissenting).

18. 1 F. O'NEAL & R. THOMPSON, *supra* note 12, § 1.02, at 3-4.

19. *Id.*

20. *Id.* § 1.02, at 4 (quoting *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 586, 328 N.E.2d 505, 511 (1975)).

21. Conard, *The Corporate Census: A Preliminary Exploration*, 63 CALIF. L. REV. 440, 458-59 (1975); see also Hayes, *Iowa Incorporation Practices—A Study* (pt. 1), 39 IOWA L. REV. 409, 417-18 (1954) (stating that of the 229 Iowa corporations formed during the first half of 1952 only 2 firms had more than 20 incorporators, with the majority of stock held by a very small number of shareholders, often by only one or two).

22. 1 F. O'NEAL & R. THOMPSON, *supra* note 12, § 1.13, at 61-67 (discussing the trend that several states have enacted special close corporation statutes or chapters and other states have been encouraged to enact these specialized statutes).

ration or its owners as collateral for loans.²³ Close stock also may be issued as an incentive to encourage persons to accept employment.²⁴ Close stock may serve a variety of other legitimate and important business purposes, too.²⁵ Nevertheless, in each case the method and ease of transferability is determined by law. For the most part, the U.C.C. provides the rules for trading, selling, securing, or otherwise dealing in securities.²⁶

Thus, the question of whether close stock is a security within the U.C.C. definition is of critical importance. If close stock is a security, then the rules relating to its treatment are established by statute. If close stock is not a security, then some of the explicit rules of the U.C.C. do not apply. Consequently, common law or other statutory measures must be used to provide the rules governing transactions in such stock.²⁷ Part II of this Note analyzes the available case law on the issue of whether close stock is a security for U.C.C. purposes. Part III of this Note sets forth a statutory analysis, considering Article 8, the Comments to Article 8, and the U.C.C. as a whole. Finally, Part IV concludes that a determination that close stock is a security is more in line with commercial needs and the purposes of the U.C.C.

II. JUDICIAL DECISIONS

A. *The Blasingame Decision*

In 1983 the Tennessee Supreme Court, in *Blasingame v. American Materials, Inc.*,²⁸ addressed the issue of whether stock in a close corporation is a security within the U.C.C. definition, and the decision represents a classic example of the old adage "hard cases make bad law."²⁹ Blasingame, the plaintiff, asserted that as one of the promises used to

23. See generally 68 AM. JUR. 2D *Secured Transactions* § 14, at 823 (1973).

24. See, e.g., *Blasingame v. American Materials, Inc.*, 654 S.W.2d 659 (Tenn. 1983).

25. For example, close stock coupled with a buy-back agreement may ease the transfer of a business upon the death of an owner and provide cash to the estate of a deceased shareholder. See generally F. O'NEAL & R. THOMPSON, *supra* note 12, § 7.02, at 2; *id.* § 7.26, at 130-32.

26. See U.C.C. § 8-101 official comment (1962), reprinted in 7 W. HAWKLAND, *supra* note 6, § 8-101, at 1; see also 7 W. HAWKLAND, *supra* note 6, § 8-101:01, at 3.

27. An interest that qualifies as a security will be governed by Articles 8 and 9 of the U.C.C. See *infra* notes 132-48 and accompanying text.

28. 654 S.W.2d 659 (Tenn. 1983).

29. *Northern Sec. Co. v. United States*, 193 U.S. 197, 400 (1904) (Holmes, J., dissenting). Justice Holmes commented:

Great cases like hard cases make bad law. For great cases are called great, not by reason of their real importance in shaping the law of the future, but because of some accident of immediate overwhelming interest which appeals to the feelings and distorts the judgment. These immediate interests exercise a kind of hydraulic pressure which makes what previously was clear seem doubtful, and before which even well settled principles of law will bend.

Id.

lure him to a new job, the defendant, American Materials, Inc. (American), orally promised to sell a one-quarter interest in the company to him at a later date if he performed satisfactorily.³⁰ Blasingame left his job in Mississippi and took the job with American in Tennessee for about one-half of his prior salary.³¹ He worked for almost seven years and never was allowed to purchase his promised shares.³² After repeated unsuccessful inquiries, the plaintiff resigned from the company. He sued for the value of the one-quarter interest in the company that he had been promised, less 25,000 dollars, the amount that he was supposed to pay for the stock.³³

During the trial, some written evidence was produced which suggested that the alleged oral offer in fact had been made to Blasingame. After one of his repeated inquiries concerning the stock, Blasingame had received a letter from one of the shareholders assuring him that he would be allowed to purchase the promised stock. The trial court held that Blasingame had carried his burden of proof regarding the stock-purchase employment offer.³⁴ Moreover, the trial court found that the letter constituted a fraud because it was written to deceive Blasingame.³⁵ The trial court, therefore, ruled in favor of the plaintiff and awarded substantial damages.³⁶ The Court of Appeals ruled that the letter varied too much from the alleged oral contract to serve as a writing sufficient to corroborate the oral offer.³⁷ Additionally, the letter was too indefinite to form a contract on its own.³⁸ However, the Court of Appeals affirmed on the fraud issue and held that the "willful and deliberate" actions of one of American's owners removed the contract from the Statute of Frauds.³⁹ Finally, the Court of Appeals affirmed the trial court's denial of American's motion to amend its answer made after the trial.⁴⁰ This motion would have raised the U.C.C. Statute of Frauds defense.⁴¹ The defendant appealed to the Tennessee Supreme Court.

30. *Blasingame*, 654 S.W.2d at 660.

31. *Id.* Blasingame claimed to have been making \$275 to \$325 per week. His initial salary from American Materials was \$150 per week plus a bonus at the end of the year. *Id.*

32. *Id.* at 660-61. Blasingame began work after July 1969 and ceased working in October 1975. *Id.*

33. *Id.* at 662. Blasingame received a judgment for \$429,000. *Id.*

34. *Id.* at 661.

35. *Id.* (basing conclusion on Statute of Frauds, TENN. CODE ANN. § 29-2-101(5) (1980)).

36. *Id.* at 662. See *supra* note 33.

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.* at 662-64.

41. *Id.* at 664. The U.C.C. Statute of Frauds, U.C.C. § 8-319 (1987), is contained in TENN. CODE ANN. § 47-8-319 (1979).

On appeal to the Tennessee Supreme Court the only U.C.C. issue was whether the defendant should be allowed to amend its answer in order to raise the U.C.C. Statute of Frauds defense. Instead of simply denying the motion to amend or granting the motion with a remand, the Tennessee Supreme Court seized the opportunity to decide the issue of whether close corporation stock is a security. The court held that close corporation stock "[did] not fall within the definition of a 'security'" under Tennessee law.⁴² The court stated that the record showed only one sale of the stock in the history of the corporation. Thus, no market existed for this stock. As Part III of this Note will discuss, the analysis applied not only is inadequate to effectuate the purposes of the U.C.C., but the decision also creates inconsistencies within the U.C.C. and, therefore, should be reversed. While the equities were clearly in favor of Blasingame, this decision creates problems for transactions involving close corporations which probably could have been avoided without causing an inequitable result in the *Blasingame* case.⁴³

Courts are split as to whether stock in a close corporation is a security under the U.C.C. and similar state laws. While *Blasingame* is the focus of this Note, other cases dealing with this question must be compared and analyzed in an attempt to support the contention that close stock must be treated as a security for U.C.C. purposes.

B. Article 8 Generally

The question of whether stock in a close corporation is a security within the U.C.C. definition has been addressed by at least nine courts.⁴⁴ While the question has presented itself in a variety of contexts,

42. *Blasingame*, 654 S.W.2d at 664. For the definition of a security under the Tennessee U.C.C., see TENN. CODE ANN. § 47-8-102(1)(a) (1979).

43. See Aronstein, *U.C.C. Survey: Investment Securities*, 39 BUS. LAW. 1375, 1380-82 (1984). Aronstein noted that at least three possible results could have been reached that would have granted Blasingame the relief he deserved but without removing close stock from the Article 8 definition. The court could have: 1) affirmed the trial court's denial of the defendant's motion to amend its complaint; 2) held § 8-319 was inapplicable because the contract was not one for sale of securities, but rather an employment contract of which the stock transaction was merely an incidental part and thereby ignore the issue all together; or 3) held that § 8-319 was applicable because the stock was a security, but that Blasingame's acceptance of employment in 1969 and performance of services for six years constituted payment within the meaning of § 8-319(b). Aronstein, *supra*, at 1381-82.

44. See *In re Domestic Fuel Corp.*, 70 Bankr. 455 (Bankr. S.D.N.Y. 1987); *In re Sandefer*, 47 Bankr. 133 (Bankr. N.D. Ala. 1985); *Katz v. Abrams*, 549 F. Supp. 668 (E.D. Pa. 1982); *Zamore v. Whitten*, 395 A.2d 435 (Me. 1978); *Gross v. Vogel*, 81 A.D.2d 576, 437 N.Y.S.2d 431 (1981); *Jennison v. Jennison*, 346 Pa. Super. 47, 499 A.2d 302 (1985); *Rhode Island Hosp. v. Collins*, 117 R.I. 535, 368 A.2d 1225 (1977); *Blasingame*, 654 S.W.2d at 659; *Kenney v. Porter*, 557 S.W.2d 589 (Tex. Civ. App. 1977). Additional courts may have raised or passed on this issue and this list does not purport to be exhaustive.

most courts have been concerned with the same part of the definition.⁴⁵ The results have been varied.⁴⁶ By addressing these decisions, the particular facts leading to the lawsuits may prove helpful in determining how and why the decisions were made.

The U.C.C. was completed and ready for nationwide adoption in 1962.⁴⁷ Article 8 was amended in 1977.⁴⁸ This amendment to Article 8 added new sections and changed several of the existing ones.⁴⁹ While these amendments modified the U.C.C. definition of a security, the definition remained essentially the same, merely allowing uncertificated securities to be created and governed by the U.C.C.⁵⁰ Tennessee adopted

45. See Haley, *Article 8 Court Decisions*, 41 BUS. LAW. 1449, 1458 (1986) (stating that "[t]he problem with shares in a closely held corporation arises out of the second of these four criteria [of U.C.C. § 8-102 (1977)]").

46. See *infra* notes 53-131 and accompanying text.

47. See 1 W. HAWKLAND, *supra* note 6, § 1-101:01, at 3-4.

48. 7 W. HAWKLAND, *supra* note 6, § 8-101:03, at 6.

49. *Id.* § 8-101:03, at 7, 10 n.6 (stating that §§ 8-108, 8-321, 8-407, and 8-408 were created).

50. See *id.* § 8-102, at 12, 15-16 (containing the text of the 1962 and 1977 versions). The 1962 version reads as follows:

Sec. 8-102. Definitions and Index of Definitions

(1) In this Article unless the context otherwise requires

(a) A "security" is an instrument which

(i) is issued in bearer or registered form; and

(ii) is of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment; and

(iii) is either one of a class or series or by its terms is divisible into a class or series or instruments; and

(iv) evidences a share, participation or other interest in property or in an enterprise or evidences an obligation of the issuer.

Id. § 8-102, at 12. The 1977 version reads as follows:

Sec. 8-102. Definitions and Index of Definitions

(1) In this Article, unless the context otherwise requires:

(a) A "certificated security" is a share, participation, or other interest in property of or an enterprise of the issuer or an obligation of the issuer which is

(i) represented by an instrument issued in bearer or registered form;

(ii) of a type commonly dealt in on securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment; and

(iii) either one of a class or series or by its terms divisible into a class or series of shares, participations, interests, or obligations.

(b) An "uncertificated security" is a share, participation, or other interest in property or an enterprise of the issuer or an obligation of the issuer which is

(i) not represented by an instrument and the transfer of which is registered upon books maintained for that purpose by or on behalf of the issuer;

(ii) of a type commonly dealt in on securities exchanges or markets; and

(iii) either one of a class or series or by its terms divisible into a class or series of shares, participation, interests, or obligations.

Id. § 8-102, at 15-16. It is interesting to note the differences between the two sections. The 1962 version and the 1977 version applicable to certificated securities are virtually identical. There are only two differences between the 1962 version and the 1977 version and these differences arose because of the creation of uncertificated securities in the 1977 version. The first difference is obvious. An uncertificated share is not represented by a piece of paper and, therefore, it cannot be

the U.C.C. in 1963 and the amendments to Article 8 in 1986.⁵¹

The four-part definition of security generally has been interpreted uniformly, with one notable exception. The second part of the definition requires that a security be "of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment."⁵² This phrase has caused a split among the jurisdictions that have addressed the issue.

C. Cases Deciding Close Stock Is Not a Security

The facts in *Blasingame* have been set forth previously.⁵³ In affirming the judgment in favor of Blasingame, the Tennessee Supreme Court held that the close corporation stock at issue was not a security, and, therefore, the U.C.C. Statute of Frauds did not apply.⁵⁴ The court's analysis applied by the court was conclusory, providing very little discussion of the actual question presented.

The court's analysis focused on the requirement that the instrument in question must be one "of a type commonly dealt in upon securities exchanges or markets, or recognized as a medium for investment." The court emphasized the absence of sales of the American stock. The court announced that the record clearly established that there had been only one sale of the American stock in the ten-year history of the corporation.⁵⁵ Consequently, the court determined that the close corporation stock was not of a type dealt in on security exchanges, and, therefore, did not meet the definitional requirements of a security.⁵⁶ Additional support for the Tennessee Supreme Court's decision was the fact that

issued in bearer or registered form. The other difference is the omission by the 1977 version of the language "or commonly recognized . . . as a medium for investment." This deletion was made to prevent some interests, such as checking or savings accounts, from being recognized as a security because they often are recognized as a medium for investment. U.C.C. § 8-102 official comment (1977), reprinted in 7 W. HAWKLAND, *supra* note 6, § 8-102, at 20.

51. TENN. CODE ANN. § 47-1-101 (1963). See *infra* note 159.

52. U.C.C. § 8-102(a)(ii) (1987).

53. *Blasingame*, 654 S.W.2d at 662-64; see also *supra* notes 28-43 and accompanying text. Blasingame, a one-time employee of American, was suing to enforce an alleged oral offer by an officer of American. The offer was used to encourage Blasingame to work for the newly formed corporation. Blasingame was promised that at some time in the future he would be able to purchase a 25% interest in the corporation for \$25,000. Following a trial which determined Blasingame was entitled to substantial damages, American made a motion to amend its answer. The proposed amendment maintained that even if the alleged promise had been made, it was barred by the Statute of Frauds within the U.C.C. For sales or transfers of securities, this provision demanded a sufficient writing. *Blasingame*, 654 S.W.2d at 664. The Court of Appeals had determined that any writings present were insufficient to satisfy the Statute of Frauds. *Id.* at 662.

54. *Blasingame*, 654 S.W.2d at 664.

55. *Id.*

56. *Id.*

the trial court had discounted the value of the stock because it was closely held, and had determined the value of the stock was impaired because no market existed for the stock.⁵⁷ The court cited several cases as support for its decisions.⁵⁸ In addition, the court pointed out that sales of stock were restricted by the bylaws of the corporation.⁵⁹ These facts and the authority of the cited decisions were determined sufficient to establish that close stock is not a security for U.C.C. purposes in Tennessee.

To support its decision, the Tennessee Supreme Court primarily relied on *Kenney v. Porter*.⁶⁰ As precedent, however, this case is not compelling for at least two reasons. First, it is not a decision by a state supreme court. Second, it only addresses indirectly the question of whether close stock is a U.C.C. security.

In *Kenney*, Porter and Kenney were the sole owners of a close corporation. A written agreement existed whereby, at any time, either of the parties could become the sole owner of the corporation if a disagreement occurred. Upon notice, either owner could offer to buy out or sell out to the other owner, and the offeree had sixty days to respond.⁶¹ In the case, Kenney made the buy-sell offer and negotiations ensued. For unknown reasons, however, the negotiations failed and Kenney sued Porter alleging that Porter had agreed orally to sell but had breached this agreement. While the facts were disputed regarding the oral agreement, it was undisputed that no written acceptance had been signed.⁶² Porter argued in a summary judgment motion that because no written contract existed, the U.C.C Statute of Frauds was not satisfied. Thus, no suit could be maintained on the alleged oral contract.⁶³ The trial court agreed with Porter and granted the summary judgment motion.⁶⁴

Kenney appealed to the Texas Court of Civil Appeals, arguing procedural defect.⁶⁵ Kenney noted that on a motion for summary judgment all questions of fact must be construed in favor of the nonmovant. He argued that a question of fact existed as to whether the stock of the corporation was a security.⁶⁶ If the facts were construed in his favor,

57. *Id.*

58. *Id.* The *Blasingame* court cited the cases: *Kenney v. Porter*, 557 S.W.2d 589 (Tex. Civ. App. 1977); *Zamore v. Whitten*, 395 A.2d 435 (Me. 1978); and *Rhode Island Hosp. v. Collins*, 117 R.I. 535, 368 A.2d 1225 (1977). See discussion *infra* notes 60-82 and accompanying text.

59. *Blasingame*, 664 S.W.2d at 664.

60. 557 S.W.2d 589 (Tex. Civ. App. 1977).

61. *Id.* at 590.

62. *Id.* at 590-91.

63. *Id.* at 591.

64. *Id.* at 590.

65. *Id.* at 590. The first sentence of the opinion stated that "[t]his is a summary judgment case." *Id.*

66. *Id.* at 591-92 (stating that "[t]he fact question allegedly raised [by Porter] is whether or

then the stock was not a security and, therefore, the Statute of Frauds did not apply. The definition of a security has four requirements and the court determined that meeting these requirements was a question of fact.⁶⁷ The court determined that Porter had not produced evidence sufficient to satisfy the summary judgment criteria. The Texas Rules of Civil Procedure require a defendant seeking summary judgment on an affirmative defense to prove all the essential elements of that defense.⁶⁸ Porter had failed to prove as a matter of law that the stock was a security and, therefore, the court reversed the summary judgment ruling and remanded the case for trial.⁶⁹

The Tennessee Supreme Court in *Blasingame* misapplied *Kenney's* procedural decision. In *Blasingame* the court noted that the *Kenney* court had stated that it was a question of fact whether the close stock was traded on securities exchanges or commonly recognized as a medium for investment.⁷⁰ While the *Kenney* court did establish that the question of whether stock in a close corporation is a security is one of fact, this determination was contained within a discussion of the burden of proof that a defendant bears when raising an affirmative defense in a summary judgment proceeding.⁷¹ In addition, while the *Kenney* court stated that the application of the definition of security to stock in a close corporation was a question of fact, the court did not state that the fact question was dependent on whether the stock is traded on a recognized securities exchange.⁷² Thus, it appears that the reliance on *Kenney* by the *Blasingame* court is unwarranted.

The *Blasingame* court also cited *Zamore v. Whitten*⁷³ as support for its decision. In *Zamore* a minority shareholder of a close corporation was fired from his job with the corporation. Subsequently, the majority shareholder sent a letter indicating his desire to buy out the minority shareholder when funds became available. This letter was determined not to be a sufficient writing to satisfy the U.C.C. Statute of Frauds.⁷⁴ After dealing with a complicated and procedural issue, the court addressed the question of whether stock in a close corporation is a secur-

not the stock in Valley Plumbing Supply Company constituted a 'security' as that term is defined by the [Uniform Commercial] [C]ode").

67. *Id.* at 592 (stating "the question itself [whether the stock is a security] is one of fact"). The court acknowledged that the definition contained four parts: "[I]t is apparent to us that a question of fact is raised by the requirements set out in the definition itself." *Id.* at 591. The court failed to indicate that the stock was not a security or even to apply the prongs of the definition.

68. *Id.* at 592.

69. *Id.*

70. *Blasingame*, 654 S.W.2d at 664.

71. *Kenney*, 557 S.W.2d at 591-92.

72. *Id.*

73. 395 A.2d 435 (Me. 1978).

74. *Id.* at 438.

ity. If the court determined that the shares of the close corporation were not a U.C.C. security, then the Statute of Frauds would not apply and the letter in question could be supplemented by oral parole evidence.

The *Zamore* court began its analysis by stating that “[i]t would appear that the *Zamore* stock was not an ‘investment security’” within the meaning of the U.C.C.⁷⁵ After quoting section 8-102(1)(a) verbatim, the court, without discussion or elaboration, made the quantum leap—it decided, without any basis in the record, that the stock was not of a type commonly dealt in upon securities exchanges or markets.⁷⁶ Significantly, the court misquoted the definition when it said that the stock was not “commonly recognized in any area securities exchanges or markets as a medium for investment.” The U.C.C. only requires that the stock be “commonly recognized in any area in which it is issued or dealt in as a medium for investment.”⁷⁷ The difference between the U.C.C. requirement and the requirement of the *Zamore* court can be demonstrated easily. An instrument may be seen as a medium for investment in the area where it is issued or dealt without having an exchange on which it is dealt. For example, limited partnership interests in real estate are a medium for investment, but there is virtually no exchange on which these interests are traded.

*Rhode Island Hospital v. Collins*⁷⁸ also provides support for the *Blasingame* decision. Collins, an individual against whom a judgment of over 12,000 dollars had been obtained, was sued in a proceeding to establish his ability to satisfy the judgment. During the hearing it was learned that six weeks prior to the institution of the suit, Collins had transferred the title of his residence to a corporation of which he was the sole shareholder.⁷⁹ Rhode Island Hospital attempted to invoke U.C.C. section 8-317(2) which allows creditors to reach securities owned by debtors.⁸⁰ The lower court ordered Collins to endorse the stock over to the hospital.⁸¹ On appeal the Supreme Court of Rhode Island addressed the issue of whether this stock was a security and, therefore,

75. *Id.* at 441.

76. *Id.* (stating that “[a]lthough the record is silent thereon, it is apparent that the reference stock in this close family corporate business is not of a type ‘commonly dealt in upon securities exchanges or markets,’ nor is it commonly recognized in any area securities exchanges or markets as a medium for investment”).

77. *Id.*; see *supra* note 50 (containing text of the 1962 and 1977 versions of U.C.C. § 8-102).

78. 117 R.I. 535, 368 A.2d 1225 (1977).

79. *Id.* at 537, 368 A.2d at 1226.

80. U.C.C. § 8-317(2) (1987) (stating that “[a]n uncertificated security registered in the name of the debtor may not be reached by a creditor except by legal process at the issuer’s chief executive office in the United States”).

81. *Collins*, 117 R.I. at 537, 368 A.2d at 1226.

reachable by a creditor. While recognizing that some stocks could be investment securities, the court concluded that Collins's stock was not a security within the meaning of Article 8.⁸² Thus, the court was able to prevent creditors from reaching the residence of Collins in an attempt to satisfy their judgments.

The common thread running through cases holding that closely held stock is not a security is a focus on the requirement that this stock be "of a type commonly dealt in upon securities exchanges and markets or commonly recognized in this area as a medium for investment."⁸³ Two reasons appear to provide support for the decisions that stock in a close corporation fails to meet the U.C.C. definition of a security. First, because only shares of large public corporations are traded on securities exchanges, the certificates representing ownership in a close corporation not traded are, therefore, of a different type than the publicly exchanged shares.⁸⁴ Second, publicly traded stocks differ from closely held stock in the expectation of returns.⁸⁵ Public stocks pay dividends and the corporations are managed by others for the stockholder's benefit. Close corporations generally rely on the entrepreneurial and managerial efforts of the owners.

D. Cases Deciding Close Stock is a Security

Several courts have held that close stock is a security for U.C.C. purposes.⁸⁶ In making this determination, these courts also have focused on the language that requires the stock to be "of a type commonly dealt in on securities exchanges or recognized as a medium for investment." A substantial number of courts have interpreted this language to include stock of close corporations. While recognizing that none of this stock actually is traded on exchanges, these courts maintain that the stock still remains the same type as that which is traded publicly.⁸⁷

*Pantel v. Becker*⁸⁸ appears to be one of the earliest decisions con-

82. *Id.* at 538, 368 A.2d at 1227. The court noted that:

[a] common thread running through all investment securities is the reasonable expectation that dividends will be derived from the profits which in turn are the results of the managerial or entrepreneurial efforts of others. While some stocks may properly be classified as investment securities, we have no doubt that Collins's stock does not fall within the definition [contained within Article 8].

Id.

83. 7 W. HAWKLAND, *supra* note 6, § 8-102:02, at 24.

84. *See Zamore*, 395 A.2d at 441.

85. *See Collins*, 117 R.I. at 538, 368 A.2d at 1227.

86. *See infra* notes 88-131 and accompanying text.

87. *See, e.g., In re Sandefer*, 47 Bankr. 133, 138 (Bankr. N.D. Ala. 1985).

88. 89 Misc. 2d 239, 391 N.Y.S.2d 325 (Sup. Ct. 1977).

cerning stock of a close corporation. The court clearly asserted that because the instruments were stock certificates, they were the type of instrument regularly bought and sold on securities exchanges or markets.⁸⁹ The court admitted that closely held stock rarely was traded in securities exchanges. However, the court determined that closely held stock should be considered a security because most people would recognize this stock as a medium for investment.⁹⁰

The *Pantel* decision was relied on heavily by the court in *Katz v. Abrams*.⁹¹ In *Katz* a federal district court in a diversity action faced the security question without the existence of a decision on the matter under controlling state law. The district court reviewed the available decisions and decided that Pennsylvania probably would follow *Pantel*.⁹² Subsequently, the Superior Court of Pennsylvania in *Jennison v. Jennison*⁹³ adopted *Pantel*, holding that stock of a closely held corporation is a security.⁹⁴

The *Jennison* court then focused on the issue of what effect transfer restrictions placed on close stock by a shareholder's agreement or the corporate charter should have on the characterization of close stock.⁹⁵ While these restrictions might "affect the ease and frequency with which the stock is traded or the desirability of the stock as an investment," the court held that the restrictions do not remove close stock from the statutory definition of a security.⁹⁶ The court also relied on other provisions of the U.C.C. The U.C.C. requires that transfer restrictions must be noted "conspicuously on the security" to be effective.⁹⁷ The court concluded that this language clearly implies that transfer restrictions do not preclude close stock from being a security within the U.C.C.⁹⁸ Additional support for its holding was found in the

89. *Id.* at 241, 391 N.Y.S.2d at 326.

90. *Id.*

91. 549 F. Supp. 668 (E.D. Pa. 1982).

92. *Id.* at 671.

93. 346 Pa. Super. 47, 499 A.2d 302 (1985).

94. *Id.* at 52-53, 499 A.2d at 304. Particularly, the *Jennison* court announced that: [T]he better view is that shares of stock in closely held corporations should be treated as "securities" under Article 8 of the Uniform Commercial Code. The holdings of *Katz* and *Pantel* constitute a more sensible interpretation of the statutory language. Shares of stock in a closely held corporation are, after all, shares of stock, which are clearly instruments "of a type" commonly dealt in on securities exchanges or markets. They also fall within the commonly recognized meaning of an "investment": "An expenditure to acquire property or other assets in order to produce revenue; the asset so acquired. The placing of capital or laying out of money in a way intended to secure income or profit from its employment."

Id.

95. *See id.* at 53-54, 499 A.2d at 304-05.

96. *Id.* at 53, 499 A.2d at 304.

97. U.C.C. § 8-204 (1977), reprinted in 7 W. HAWKLAND, *supra* note 6, § 8-204, at 130.

98. *Jennison*, 346 Pa. Super. at 53, 499 A.2d at 305.

Comment to U.C.C. section 8-204 that cross references the definition of security and states that the definition is designed to encompass the usual restrictions placed on close stock.⁹⁹

Two of the better reasoned decisions on this question have been made in bankruptcy actions.¹⁰⁰ These decisions clearly present the arguments on both sides of this issue. In addition to their well-researched and clearly reasoned conclusions, the decisions are important because their factual and legal surroundings raise questions that are commercially important. The issues are important because they are likely to occur frequently. The underlying transactions are very common business transactions and their resolution is important to both lenders and borrowers.

*In re Domestic Fuel Corp.*¹⁰¹ presented a bankruptcy issue which turned on the status assigned to close stock. The action involved a creditor who filed for relief from the automatic stay of bankruptcy because as a secured creditor he asserted that his interest was not adequately protected. The debtor argued that the creditor seeking protection was not a secured creditor who was entitled to such protection.¹⁰² The facts revealed that the creditor had sold one hundred percent of the stock of two wholly owned corporations to the debtor corporation for 1.6 million dollars. Six hundred thousand dollars had been paid in cash and the debtor agreed to pay the balance over a ten-year period. The stock was to be held in escrow until the time that the full purchase price was paid. At the time of the bankruptcy filing and thereafter, the value of the stock held in escrow began to decline. The creditor wanted to have the stock delivered to him in fear that before the bankruptcy proceedings were completed, the stock would be worthless.¹⁰³

The debtor argued that, even if the stock was losing value, the creditor did not deserve adequate protection because he did not hold a secured interest.¹⁰⁴ The debtor argued that close stock is not a security within the U.C.C. definition. Thus, because no U.C.C. filing had been performed to perfect the interest, the trustee had power to avoid the security interest in the stock.¹⁰⁵ As an unsecured creditor, the creditor

99. *Id.* The Comment states that "[i]f the drafters of the U.C.C. did not intend restricted shares of closely held corporations to be covered by Article 8, Section 8-204 either is surplusage or it is misplaced. Both interpretations are untenable." *Id.*

100. *See infra* notes 101-31 and accompanying text.

101. 70 Bankr. 455 (Bankr. S.D.N.Y. 1987).

102. *Id.* at 456.

103. *Id.* at 456-58.

104. *Id.* at 459.

105. *Id.* at 459-61. Essentially the debtor argued that: (1) The stock in question was not a security; (2) The creditor had possession of the stock but had failed to file a financing statement; (3) The security interest, therefore, was unperfected at the time of the filing of the bankruptcy

would not be entitled to adequate protection. Alternatively, the creditor argued that the stock was a security and, therefore, a security interest could attach without filing when the stock was transferred to the secured party or a person designated by him.¹⁰⁶ In this case, the creditor argued that a security interest had been perfected in the stock when the certificates of stock had been transferred to the bank.

The court had to address the determinative issue of whether the close stock was a security under the U.C.C. definition. The court addressed all of the elements of the definition. As in earlier cases, the element that presented the greatest problem was the second prong—the requirement that the interest be of a type commonly dealt in upon securities exchanges or markets.¹⁰⁷ The position of the debtor was straightforward—to be within the definition of certified securities, the shares must be of publicly traded corporations because the stock of close corporations is not dealt in upon securities exchanges or as a medium for investment.¹⁰⁸ The court, however, rejected this approach.¹⁰⁹ Relying on case law and the Comments supporting U.C.C. section 8-102, the court concluded that stock in close corporations may be within the U.C.C. definition, and the fact that there is not a market for the particular instrument is not determinative.¹¹⁰ In addition, the court noted “that certificates of stock in closely-held corporations are instruments ‘of a type’ of securities that may be publicly traded or ‘dealt in as a medium for investment’ so as to fit the definition of a ‘certificated security’ in Section 8-102(1)(a)(ii).”¹¹¹ The court, therefore, ruled that the interest was not avoidable by the trustee, and the court must determine whether the creditor was receiving adequate protection.

*In re Sandefer*¹¹² raised the question of the status of closely held stock in an important factual situation. At common law, shares of stock in a close corporation were not subject to levy and sale under execution.¹¹³ Because these shares were not capable of manual caption and delivery, they were considered intangible. Most states acted to remedy this “defect in the law” by establishing statutes allowing levy by attach-

petition; (4) Using the strong arm powers of a trustee (he is debtor-in-possession) under 11 U.S.C. § 544(a) (1982), including the rights and remedies of hypothetical creditor, he could avoid the unperfected interest; (5) Creditor, therefore, was unsecured and deserved no adequate protection. *Id.*

106. 70 Bankr. at 460 (basing statement on N.Y. U.C.C. LAW § 8-321(3)(a) (McKinney Supp. 1989)).

107. *Id.* at 461-62.

108. *Id.*

109. *Id.* at 462.

110. *Id.*

111. *Id.*

112. 47 Bankr. 133 (Bankr. N.D. Ala. 1985).

113. *Id.* at 136.

ment or execution.¹¹⁴ These statutes generally applied to "shares of stock."¹¹⁵ The Uniform Stock Transfer Act (U.S.T.A.) replaced many of these laws by allowing levy but requiring seizure upon the officer in charge of shares or surrender of the shares to the corporation.¹¹⁶ The U.C.C. repealed and supplanted the U.S.T.A. with a similar provision. The U.C.C. provision, however, applied to "securities."¹¹⁷ As a result, in Alabama, levy and execution may be made only on securities.¹¹⁸ When a creditor seeks to enforce a valid judgment against the proceeds of a debtor's stock liquidation, the issue becomes clear. For the creditor to assert his judgment in a subsequent bankruptcy proceeding, his execution must be against a security. The enactment of the U.C.C. repealed all previous enabling laws that would have applied to corporate stock. Thus, in *Sandefer*, the debtor argued that the close stock which the creditor sought to levy was not a security. If the stock was not a security, then the levy and execution were not valid and the claim asserted would be avoidable. The common-law rule of unattachability would apply because the U.C.C. repealed and replaced prior statutory treatment under the U.S.T.A.¹¹⁹

The court focused on whether the stock was "'of a type' commonly dealt in upon securities exchanges or commonly recognized in this area as a medium of investment."¹²⁰ Because only shares of large public corporations are traded on securities exchanges, stock in privately held corporations is dissimilar in that respect.¹²¹ The court also recognized that owning stock in public corporations generally involves a different investment motive. Public corporation stock is held by large numbers of persons, and most persons invest in publicly traded corporations for dividend and stock appreciation.¹²² Close corporations usually are owned and operated by persons whose investment motives include reliance on the company as a job or family business.¹²³

While recognizing the contrary holdings in *Zamore* and *Rhode Island Hospital*, the court held that the stock was a security.¹²⁴ The in-

114. *Id.*

115. *Id.*

116. *Id.* at 137 (citing ALA. CODE § 7004(1)-(25) (1928) (repealed by ALA. CODE § 7-8-101 to -406 (1965))).

117. *Id.*; see also U.C.C. § 8-102 official comment (1962), reprinted in 7 W. HAWKLAND, *supra* note 6, § 8-102, at 14.

118. *Sandefer*, 47 Bankr. at 137.

119. See *id.* at 137-39.

120. *Id.* at 138.

121. *Id.*

122. See *id.* at 138; see also F. O'NEAL & R. THOMPSON, *supra* note 12, § 1.07, at 24-26.

123. *Sandefer*, 47 Bankr. at 138; see also F. O'NEAL & R. THOMPSON, *supra* note 12, § 1.07, at 25.

124. *Sandefer*, 47 Bankr. at 138.

strument involved was a stock certificate, and exchanges and markets are involved in trading stock certificates. The court reasoned that while the public and private corporations involved were very dissimilar, the interest represented was essentially identical.¹²⁵ The interest was partial ownership of a corporate entity and, therefore, the stock was of a type commonly traded publicly. Additionally, purchasing shares of stock in a corporation, regardless of its size, was a common medium for investing in an enterprise conducted in the corporate form.¹²⁶

The court also relied on the history of Article 8 of the U.C.C. as support for its holding. The U.S.T.A. was replaced by the U.C.C.¹²⁷ Many of the U.C.C. provisions were derived directly from the U.S.T.A.¹²⁸ Because the U.S.T.A. covered the issue of the status of close stock, the court reasoned that it was unlikely that the U.C.C. would not cover all of the subject matter governed by the U.S.T.A.¹²⁹ This conclusion also was supported by the Comment to U.C.C. section 8-101,¹³⁰ which states that "[Article 8] covers certificates of stock, formerly provided for by the Uniform Stock Transfer Act."¹³¹

E. Problem Areas Created by a Decision that Close Stock is Not a Security

As evidenced by the split of authority, various courts have read the same language of the U.C.C. definition and interpreted the language to have completely different meanings. While this result is not uncommon, these interpretations have produced some widely varied results which might not have been intended by the drafters of the U.C.C. or the courts themselves. While this Note will perform a statutory analysis, it may be useful to present some of the problems created by a decision that close stock is not a security. An exhaustive list of the problems resulting from the *Blasingame* decision is beyond the scope of this Note. However, this limited list is presented as part of an overall argument that the *Blasingame* decision should be overturned.

The most frequently encountered problem is illustrated by the de-

125. *Id.*

126. *Id.*

127. *Id.*

128. U.C.C. § 8-101 official comment (1962), reprinted in 7 W. HAWKLAND, *supra* note 6, § 8-101, at 1.

129. *Sandefur*, 47 Bankr. at 138-39.

130. *Id.*

131. *Id.* at 138 (emphasis omitted). The Official Statement of Reasons for 1977 Changes in Official Text states: "The remaining language of subparagraph (ii) is intended to cover such interests as the stock of closely held corporations which, although not in fact dealt in on exchanges or markets, is 'of a type' that is." U.C.C. § 8-102 official statement (1977), reprinted in 7 W. HAWKLAND, *supra* note 6, § 8-102, at 19.

cisions in *Blasingame* and *Kenney*. According to the U.C.C. Statute of Frauds, a writing is required before the sale of a security may be enforced.¹³² The mere oral assertion of a contract by a party will not be enforceable.¹³³ The decision that close stock is not a security, therefore, will allow the evasion of the statutory directive which requires a writing in order to enforce a contract for the sale of a security. Thus, in an area of commercial law in which written documentation will provide certainty and reliability, the Statute of Frauds may be avoided. A second problem is illustrated by the facts in *Rhode Island Hospital*. While a security of a debtor may be pursued by his creditor under the U.C.C. as an easy method to satisfy a judgment,¹³⁴ if the stock is not a security within the U.C.C., then this statutorily provided avenue of relief is not available to the creditor.

Perhaps the most important question presented by these cases involves the perfection of security interests. Virtually all small corporations must receive credit in order to survive. Loans and credit arrangements are facilitated when creditors are allowed to take a security interest in the corporation and, thereby, protect themselves.¹³⁵ A common method for protection is to take a security interest in the shareholders' stock. Thus, when a potential lender decides to attach a security interest to the shares of the corporation, he merely takes possession of certificated shares or for uncertificated shares, he merely makes a notation on the corporate books.¹³⁶ Perfection is possible without filing or the existence of a written security agreement.¹³⁷

Yet, the creditor faces uncertainty if he desires a security interest in the shares of stock of a close corporation. In states which determine that close stock is not a security, like Tennessee, the creditor also must file to protect his security interest. Security interests may be secured by mere possession on certain types of collateral.¹³⁸ Possession is not suffi-

132. U.C.C. § 8-319 (1987).

133. See *Jennison*, 346 Pa. Super. at 53, 499 A.2d at 305.

134. U.C.C. § 8-317 (1987).

135. See *id.* § 9-101 official comment.

136. *Id.* § 8-321(1) (stating "[a] security interest in a security is enforceable and can attach only if [the security] is transferred to the secured party or [his agent]"); see *id.* § 8-321(3); see also 7 W. HAWKLAND, *supra* note 6, § 8-101:03, at 6.

137. U.C.C. § 8-321(3) (1987).

138. *Id.* § 9-305. Section 9-305 of the U.C.C. states that:

A security interest in letters of credit and advices of credit (subsection (2)(a) of Section 5-116), goods, instruments (other than certificated securities), money, negotiable documents, or chattel paper may be perfected by the secured party's taking possession of the collateral. If such collateral other than goods covered by a negotiable document is held by a bailee, the secured party is deemed to have possession from the time the bailee receives notification of the secured party's interest. A security interest is perfected by possession from the time possession is taken without a relation back and continues only so long as possession is retained,

cient for a security interest in other types of property.¹³⁹ By the process of elimination, if stock in a close corporation is not a security, it is a general intangible.¹⁴⁰ In order to perfect a security interest in a general intangible, not only must the creditors take possession, but they also must file the required financing statement.¹⁴¹ If the holder of a stock fails to file the required statement, his interest is subject to attack. Other creditors cannot perfect a security interest in the stock without possession, but a trustee in bankruptcy might attack the secured status of the claim.¹⁴²

Another problem that arises when close stock is not a U.C.C. security was presented in *In re Sandefer*. Proper execution of a judgment requires that execution be issued against the property.¹⁴³ According to common law, shares of stock in a corporation were not tangible and, therefore, not available for execution.¹⁴⁴ While statutes had been implemented to allow execution on stock, the U.C.C. repealed all of these statutes.¹⁴⁵ As a result, the decision that close stock is not a security removes this stock from the U.C.C. execution provisions. As a result, no statute applies that addresses the ability of creditors to levy and execute on these interests. Thus, these shares are free from execution in the absence of a new statute that enables creditors to levy and execute upon this property.¹⁴⁶

While the problems presented by the *Blasingame* decision are not insurmountable, they are clearly avoidable. As a practical matter, the courts which determine that close corporation stock is a security seem to have made the wisest choice. Their logic and rationale seems to be more in depth than those courts which hold that the close stock is not a

unless otherwise specified in this Article. The security interest may be otherwise perfected as provided in this Article before or after the period of possession by the secured party.

Id.

139. *See id.* § 9-305 official comment (stating “[t]his section permits a security interest to be perfected by transfer of possession only when the collateral is goods, instruments (other than certificated securities, which are governed by Section 8-321), documents or chattel paper: that is to say, accounts and general intangibles are excluded”); *see also id.* § 9-105(h) (definition of goods); *id.* § 9-105(i) (definition of instruments); *id.* § 9-105(f) (definition of documents); *id.* § 9-105(b) (definition of chattel paper). General intangibles are defined in U.C.C. § 9-106 and it is a “catch-all.” *See id.* § 9-106 official comment.

140. *Id.* § 9-106 (stating that “[g]eneral intangibles’ means any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and other money”).

141. *Id.* § 9-401.

142. *See supra* notes 104-11 and accompanying text.

143. *See supra* notes 112-31 and accompanying text.

144. *See supra* notes 112-34 and accompanying text.

145. *See* U.C.C. § 8-101 official comment (1962), *reprinted in* 7 W. HAWKLAND, *supra* note 6, § 8-101, at 1; *see also Sandefer*, 47 *Bankr.* at 138.

146. *See supra* notes 112-34 and accompanying text.

security. Additionally, the U.C.C. specifically was designed to deal with the problems presented when persons deal in stocks and evidences of indebtedness.¹⁴⁷ The U.C.C. is the law in fifty states¹⁴⁸ and represents the will of the legislature. As a result, the courts interpreting the U.C.C. should be aware of its goals and purposes when they decide issues covered by the U.C.C. The problems presented in this Note should be solved by the U.C.C. in accordance with its purposes. The questions presented should be analyzed not only by a statutory reading but also by the Comments and purposes contained within the Code as expressed by its drafters.

III. STATUTORY ANALYSIS

A. *Statutory History*

The cases interpreting the U.C.C. definition of security provide a glimpse of the statutory language. Additionally, several courts have relied on the Comments which accompany the U.C.C. for guidance. In some of the cases, the courts have looked to the purpose of the U.C.C. or how previous statutes treated shares of stock and related transactions. Nevertheless, the starting point for any interpretation must be the definition of security contained in Article 8.¹⁴⁹ This section will scrutinize the statutory language involved. It also will review the Official Comments to the U.C.C., their treatment of this issue, and how the Comments generally are weighed by courts. Finally, this section will discuss the overall purpose of the U.C.C. and suggest some approaches to interpreting the U.C.C. as a code, rather than as a statute. These approaches attempt to provide support for the underlying thesis of this Note—stock in a close corporation meets the U.C.C. definition of a security.

As previously indicated, two versions of Article 8 of the U.C.C. exist.¹⁵⁰ The 1977 version of the Article 8 definition varies slightly from its predecessor. The amendment was made in order to meet the needs of securities dealers and exchanges.¹⁵¹ Because of the increase in the amount of shares that were being traded, a "paper crunch" had occurred. Consequently, the industry needed a way to regulate the trading of paperless securities, or those securities traded only on books without

147. See U.C.C. § 8-101 official comment (1962), reprinted in 7 W. HAWKLAND, *supra* note 6, § 8-101, at 1.

148. All 50 states have adopted Article 8, while only Louisiana has not adopted Article 9. UNIF. COMMERCIAL CODE, 2A U.L.A. 1 (Supp. 1988).

149. U.C.C. § 8-102 (1987). For the full text of the 1962 and 1977 versions, see *supra* note 50.

150. See *supra* note 10.

151. See 7 W. HAWKLAND, *supra* note 6, § 8-101:03, at 6-7.

requiring the actual delivery of the instruments.¹⁵² The 1977 amendments created an "uncertificated security."¹⁵³ While the definition of a security was modified to incorporate and to allow for this development, the other requirements of a security essentially remained unchanged.

The 1977 definition remains virtually identical to the 1962 definition. Nevertheless, the second part of the definition of a security has been changed. Under the 1962 definition, securities included those of a type dealt in on exchanges or commonly recognized as a medium for investment. The 1977 version had the same requirement for "certificated securities." However, the definition for uncertificated securities was narrowed. The "commonly recognized . . . as a medium for investment" requirement was deleted because the drafters of the 1977 amendments desired to exclude certain uncertificated interests that otherwise might be regarded as a medium for investments.¹⁵⁴ An example of such an interest would be bank checking or savings accounts. These interests are recognized as a medium for investment, but they are not of a type commonly traded on the exchanges.¹⁵⁵

B. Official Comments to the U.C.C.

1. In General

Following each section of the U.C.C., the drafters included comments which elaborate on the particular statutory provisions. In the 1977 amendments, a reason for the change is given, in addition to the Official Comments.¹⁵⁶ Because the Official Comments were written by the drafters of the U.C.C., they are invaluable aids to interpretation.¹⁵⁷ Case law suggests that courts are influenced by the Comments more than any other factor, except for decided cases on the same issue.¹⁵⁸ The Comments often are included in state codes, but they are not part of the legislative enactment of the U.C.C.¹⁵⁹

152. *Id.* § 8-101:03, at 6.

153. *Id.* § 8-102:07, at 33.

154. See U.C.C. § 8-102 official comment, official statement (1977), reprinted in 7 W. HAWKLAND, *supra* note 6, § 8-102, at 19, 20.

155. *Id.*

156. See, e.g., 7 W. HAWKLAND, *supra* note 6, § 8-101, at 2.

157. See 1 *id.* § 1-101:02, at 4-6.

158. *Id.* § 1-102:10, at 34.

159. An interesting example of this phenomenon was discovered as this Note was being researched. The 1962 U.C.C. enacted by the Tennessee Legislature in 1963 was passed without the Comments. See 1963 Tenn. Pub. Acts 243. However, the official codification of Tennessee statutes, Tennessee Code Annotated, included the Comments along with the Code. See TENN. CODE ANN. § 47-1-101 (1963). The 1977 version enacted in 1986 also was presented and passed without the Comments. See TENN. CODE ANN. § 47-1-101 (Supp. 1986). The official codification in Tennessee Code Annotated did not include the 1977 Comments or the Official Reasons for Changes in 1977 Official Text. After much research and inquiry the Author called the Tennessee Code Commission.

As a general rule, the language of the U.C.C., if clear and unambiguous, will be followed without resort to the Comments.¹⁶⁰ However, if the statute is unclear, most courts will seek assistance from the Comments.¹⁶¹ Some courts only look to the Comments with questions of first impression.¹⁶² Other courts use the Comments as any type of legislative history would be used.¹⁶³

The Comments, however, are not followed with blind allegiance. For example, at least two courts have refused to follow the Comments. In *Simmons v. Clemco Industries*¹⁶⁴ the Alabama Supreme Court decided not to follow the Comments. The court held that while the Comments are a valuable aid in construction, they have not been enacted by the legislature and, therefore, are not necessarily representative of legislative intent.¹⁶⁵ Similarly, in *American National Bank v. Christensen*,¹⁶⁶ a Colorado appellate court refused to follow the Comments. The court concluded that no presumption or implication of legislative intent may be drawn from the Comments because the Comments are not part of the U.C.C. as enacted in Colorado.¹⁶⁷ Some courts also have refused to follow a Comment if they feel it is wrong or if the statutory language is clear and a resort to the Comments would be superfluous.¹⁶⁸

All courts should review the U.C.C. Comments in order to clarify

The Commission is a legislative committee established to oversee the publication of the Tennessee Code Annotated. TENN. CODE ANN. § 1-1-101 (1985). After a discussion with staff attorneys, one of whom was responsible for the drafting of the 1986 bill which included the 1977 amendment, no conclusory answer was found. No one currently at the Commission was working there when the 1962 U.C.C. was passed. Thus, no one knew why the Official Comments were included. One staff attorney suggested that when the 1962 U.C.C. was passed it was relatively new. The Commission, therefore, might have included the Comments in order to provide some assistance to judges and practitioners in interpreting the Code. But when the 1977 version was codified in 1986, most persons were more familiar with the U.C.C. Additionally, commercial U.C.C. reporters' and commentators' opinions exist and are more readily available than they were in 1962. Another suggestion was that because the 1986 enactment is contained in a pocket part supplement, cost might have been a factor for the Commission. A full code along with Comments and Reasons for Changes might have forced a new volume instead of allowing the pocket part supplement. At any rate, the Commission could have included the Comments, but they were not discussed by the Commission when it discussed publication of the 1986 U.C.C. amendments. Telephone interview with Sally Swainey, Staff Attorney for the Tennessee Code Commission (Feb. 25, 1988).

160. See 7 W. HAWKLAND, *supra* note 6, § 1-101:02, at 6.

161. See, e.g., *In re Augustin Bros. Co.*, 460 F.2d 376, 380 (8th Cir. 1972); *Farley v. Clark Equip. Co.*, 484 S.W.2d 142, 148 (Tex. Civ. App. 1972) (stating "[w]hile the Comment . . . does not rise to the level of judicial precedent, it does present assistance in attempting to clarify and ascertain the meaning to be given to the particular [C]ode section").

162. *In re Rivet*, 299 F. Supp. 374, 376 (E.D. Mich. 1969).

163. 7 W. HAWKLAND, *supra* note 6, § 1-102:10, at 34.

164. 368 So. 2d 509 (Ala. 1979).

165. *Id.* at 514.

166. 28 Colo. App. 501, 476 P.2d 281 (1970).

167. *Id.* at 510, 476 P.2d at 286.

168. See, e.g., *Burk v. Emmick*, 637 F.2d 1172 (8th Cir. 1971).

the requirements of the U.C.C. definition of a security. Particularly, the requirement that shares be "of a type" or "commonly recognized" should be resolved by reference to the Comments. This language raises the only recurring question within the U.C.C. definition of a security on which courts have not agreed.¹⁶⁹ When addressing this question, courts should use the Comments as an interpretive aid.

While no Tennessee decision has outlined specifically when resort to the Comments is proper, many Tennessee courts have used the Comments to settle questions of legislative intent or for other interpretive purposes.¹⁷⁰ Additionally, provisions of the U.C.C. found in Article 1 imply a duty to interpret the Code as a whole.¹⁷¹ Resort to the Comments seems to further this goal.¹⁷² Those scholars who drafted and amended the U.C.C. provided a somewhat uniform approach to commercial law. Thus, their thoughts concerning the legislation which they drafted seem necessary in order to preserve its uniformity and consistency.¹⁷³ Finally, no legislative history generated by the Tennessee legislature exists for this statute. If legislative intent is of any merit, therefore, then the Comments are the only available source of such intent.

2. Official Comments to Article 8

The Comments to Article 8 clearly indicate its purpose. Article 8 "is intended to govern the relationships, rights and duties of the issuers of and the parties that deal with both certificated and uncertificated securities."¹⁷⁴ Essentially, the provision is a negotiable instruments law dealing with securities. Article 8 sets forth the rights and duties of parties dealing with such instruments.¹⁷⁵ Unlike a corporation code, Article 8 does not define any rights that might exist for holders.¹⁷⁶ Rather, it establishes rules governing the transfer of the rights that constitute securities and the establishment of these rights by the holder.¹⁷⁷

Article 8 is not a blue sky law and it does not establish require-

169. 7 W. HAWKLAND, *supra* note 6, § 8-102:02, at 24-26.

170. Many Tennessee courts have resorted to use of the Comments in their decisions. *See, e.g.,* Third Nat'l Bank v. Highlands Ins. Co., 603 S.W.2d 730 (Tenn. 1980); Continental Bankers Life Ins. Co. v. Bank of Alamo, 578 S.W.2d 625 (Tenn. 1979); International Harvester Co. v. Carr, 225 Tenn. 244, 466 S.W.2d 207 (1971).

171. U.C.C. § 1-102 (1987).

172. 1 W. HAWKLAND, *supra* note 6, § 1-101:02, at 5-6.

173. *Id.*

174. U.C.C. § 8-101 official statement (1977), *reprinted in* 7 W. HAWKLAND, *supra* note 6, § 8-101, at 2.

175. U.C.C. § 8-101 official comment (1962), *reprinted in* 7 W. HAWKLAND, *supra* note 6, § 8-101, at 1.

176. U.C.C. § 8-101 official comment (1987).

177. *Id.*

ments for disclosure to the public.¹⁷⁸ The definition provided is unique in that it is exclusive of any definition of that term appearing in federal or state blue sky laws.¹⁷⁹ As an essential part of the U.C.C., the Article 8 security definition is included specifically in Article 9.¹⁸⁰ The definition is functional rather than formal. The drafters of the Code designed it to cover anything that securities markets are likely to regard as suitable for trading.¹⁸¹ This definition includes the over-the-counter markets, as well as the organized exchanges.¹⁸²

The Official Comment to section 8-101 in the 1962 version of the U.C.C. clearly states that Article 8 is to deal with certificates of stock formerly covered by the Uniform Stock Transfer Act (U.S.T.A.).¹⁸³ The U.S.T.A. clearly provided that stock in close corporations was governed by its terms.¹⁸⁴ Thus, when the U.C.C. replaced the U.S.T.A., it was intended to govern those instruments that previously had been covered by the U.S.T.A. While it must be acknowledged that the clear language of the U.C.C. never states expressly that stock of close corporations is within its definition, the implication appears clear.¹⁸⁵

The 1977 version, however, attempted to clear up the controversy. The stated reasons for the changes, as well as the Official Comment, specifically address the close corporation issue. "The . . . language . . . is intended to cover such interests as the stock of closely held corporations which, although not in fact dealt in on exchanges or markets, is 'of a type' that is."¹⁸⁶ The drafters, recognizing that certain courts followed the *Blasingame* rationale, inserted the Comments to clarify their position.¹⁸⁷ The language "of a type"¹⁸⁸ is the part of the definition that allows closely held stock to fall within its parameters. If this language were omitted, the definition of a security only would encompass stock that was "commonly dealt in on securities exchanges." The "of a type" language allows non-traded securities to be within the definition and, therefore, to be controlled by the U.C.C., specifically Articles 8 and 9.

178. U.C.C. § 8-101 official comment (1977), reprinted in 7 W. HAWKLAND, *supra* note 6, § 8-101, at 2.

179. U.C.C. § 8-101 official comment (1987).

180. See 7 W. HAWKLAND, *supra* note 6, § 8-101:01, at 3.

181. See *id.*

182. U.C.C. § 8-102 official comment (1987).

183. U.C.C. § 8-101 official comment (1962), reprinted in 7 W. HAWKLAND, *supra* note 6, § 8-101, at 1.

184. See *Sandefur*, 47 Bankr. at 137; see also Uniform Stock Transfer Act, ALA. CODE § 7004(1)-(5) (1928).

185. *Sandefur*, 47 Bankr. at 138-39.

186. U.C.C. § 8-102 official statement (1977), reprinted in 7 W. HAWKLAND, *supra* note 6, § 8-102, at 19.

187. U.C.C. § 8-102 official comment (1987).

188. *Id.* § 8-102(a)(ii).

Other language within this prong of the test adds additional support for the contention that close stock is a security. Stock in a close corporation is "commonly recognized in any area in which it is issued or dealt in as a medium for investment."¹⁸⁹ This area of issuance or dealing might differ somewhat from the area of publicly traded stocks. Investments in close corporations generally require more personal involvement.¹⁹⁰ The expectation of profit in a public corporation is more likely to result from dividends, while in close corporations the expectation of profit usually is from salary and capital appreciation.¹⁹¹ As the area of large corporate stock presents its own expectation of profit, so does the area of close stock. Both represent an investment by the holder of the stock.¹⁹²

Failure to recognize close stock as a security merely because it is not traded produces another very undesirable result. Under *Blasingame*, when trading has never or has rarely occurred, then the instrument is not a security.¹⁹³ However, when the number of shareholders or sales and exchanges has increased, the stock becomes a security.¹⁹⁴ This increase allows for the stock to be governed by the U.C.C. although it previously was not. The treatment and rules change, but the nature of the underlying instrument remains the same. Furthermore, restrictions placed on the shares could take the shares outside the U.C.C. definition of a security. This result, in effect, would allow the shareholders to remove the instrument from U.C.C. coverage merely by placing restrictions on its resale. This approach would permit persons to dictate the treatment accorded to their interests, notwithstanding a complex legislative enactment providing for a uniform set of rules. It also would create a lack of uniformity of treatment among holders of similar instruments and allow the chance to manipulate legal rights associated with close stock. The language of the U.C.C., however, clearly reveals that restrictions should not remove the interests from the definition of a security.¹⁹⁵

3. Interpreting the U.C.C. as a Whole

While this Note does not attempt to provide a detailed discussion on how to interpret the U.C.C., some discussion of this topic further augments the argument that close stock should be deemed a security

189. *Id.*

190. 1 F. O'NEAL & R. THOMPSON, *supra* note 12, § 1.07, at 25-26.

191. *Id.*

192. *Sandefur*, 47 Bankr. at 138.

193. *Blasingame*, 654 S.W.2d at 664.

194. 7 W. HAWKLAND, *supra* note 6, § 8.102:02, at 25.

195. *Id.* § 8-102:02, at 26.

for U.C.C. purposes.¹⁹⁶ Official Comments follow each U.C.C. section. These Comments were drafted at the same time as the Code, and often contain cross references to other relevant sections. Most Comments attempt to explain the purposes and policies of the relevant section.¹⁹⁷ They also might differentiate the U.C.C. from pre-Code law and explain the reason for the change.¹⁹⁸ The Comments have been described as "indispensable features."¹⁹⁹ They serve the goal of uniformity by emphasizing the Code as a whole through the use of cross references.²⁰⁰

The U.C.C. is designed as a uniform code to clarify the commercial law and to encourage certainty in commercial transactions.²⁰¹ Section 1-102 of the U.C.C. clearly states that the Code should be construed liberally and applied to promote its underlying policies and purposes.²⁰² Those policies include simplifying and modernizing the law governing commercial transactions, allowing the expansion of commercial practices, and making the law uniform in all jurisdictions.²⁰³ Commentators have argued that the U.C.C., through sections 1-102, 1-103, and 1-104, replaced the common-law method with the civil-law method.²⁰⁴ Whether or not this suggested change in method is accurate, the U.C.C. clearly attempts to cover all commercial transactions in a complete, comprehensive, and uniform manner.²⁰⁵

Because the U.C.C. is a code, it should be interpreted somewhat differently than by the standard legal method.²⁰⁶ First, courts should use analogy rather than outside law in order to fill gaps in the Code.²⁰⁷ Second, courts should investigate other jurisdictions' decisions.²⁰⁸ Finally, courts should give their own decisions less precedential value.²⁰⁹ Even if some courts refuse to recognize that the U.C.C. differs from other statutes, it has been interpreted by code methodology in many

196. For a full discussion, see 1 W. HAWKLAND, *supra* note 6, §§ 1-101:01 to -102:09, at 2-33. For further discussion, see Hawkland, *Uniform Commercial "Code" Methodology*, 1962 U. ILL. L.F. 291, and Hawkland, *Article 9 Methodology*, 9 WAYNE L. REV. 531 (1963).

197. 1 W. HAWKLAND, *supra* note 6, § 1-101:02, at 6.

198. *Id.*

199. *Id.*

200. *Id.*

201. *Id.* § 1-102:03, at 13-17.

202. U.C.C. § 1-102 (1987).

203. *Id.*

204. See Franklin, *On the Legal Method of the Uniform Commercial Code*, 16 LAW & CONTEMP. PROBS. 330, 333 (1951).

205. See U.C.C. § 1-102(2) (1987).

206. 1 W. HAWKLAND, *supra* note 6, § 1-102:01, at 11; *id.* § 1-102:02, at 12-13.

207. *Id.* § 1-102:02, at 12.

208. *Cf. id.* § 1-102:02, at 13 (stating that "cases decided under [the Code] may be interesting, persuasive, cogent, but each new case must be referred for decision to the undefiled [C]ode text").

209. *Id.* § 1-102:06, at 29.

cases.²¹⁰ When interpreting the U.C.C., courts generally have followed the mandate of section 1-102 and construed the U.C.C. liberally.²¹¹ Courts also have relied on case law, Comments to the Code, legislative history, and legal literature when interpreting specific U.C.C. provisions.²¹²

Regardless of whether recognition of the U.C.C. as a code occurs, the U.C.C. is unusual because it provides how courts are to construe its provisions.²¹³ The Comments to Article 1 suggest that the courts should use a two-tiered policy analysis when addressing an issue.²¹⁴ Initially, the court should determine the specific policy behind the particular section, as evidenced by the language of and Comments to the section. Then, support for the decision should be drawn from the general policy of the Code.²¹⁵

Thus, in deciding whether stock in a close corporation is a security, a court first should examine the specific language of section 8-102 and its Comments. The Comments provide that the purpose of the definition of a security is to identify those instruments that are governed by section 8-102.²¹⁶ The definition was meant to be a functional, working definition. Coverage of the definition should include those instruments that are likely to be traded.²¹⁷ The overall purpose of the U.C.C. is to foster certainty in transactions and encourage sound business practices.²¹⁸ Because a finding that close stock is not a security promotes neither of these policies, this finding should not be reached. As a security, certain rules are in place to deal with transactions that commonly involve close stock. As a general practice, persons holding close stock want certainty in their transactions because the stock is an important asset which they may use for a variety of purposes. Thus, from an interpretive standpoint, classifying close stock as a security is clearly in keeping with the U.C.C. policies of promoting certainty and encouraging sound business practices.

IV. CONCLUSION

Central to the application of a statute is the definition of its terms. The definition of a security²¹⁹ under the U.C.C. is the focus of attention

210. *Id.* § 1-102:10, at 33.

211. *Id.* § 1-102:10, at 34.

212. *Id.*

213. *Id.* § 1-102:10, at 33-35.

214. *Id.* § 1-102:11, at 38.

215. U.C.C. § 1-102 official comment (1987).

216. *Id.* § 8-102 official comment.

217. *Id.*

218. *See id.* § 1-102.

219. *Id.* § 8-102.

when shares of stock in a close corporation are involved. To be a security, and thus fall within the statutory scheme of the U.C.C., all the requirements of the U.C.C. definition must be met.

In *Blasingame* and a few other cases, the status of security has been denied to shares of stock in a close corporation. This determination solely rested on an interpretation of the second part of the U.C.C. definition. This prong demands that the instrument be "of a type" commonly dealt in upon securities exchanges or markets, or commonly recognized as a medium for investment in the area in which it is issued.²²⁰ While these decisions to deny security status to close stock might have been appropriate to reach an equitable result, they have created an anomaly among jurisdictions that have enacted the U.C.C. The U.C.C. was designed to simplify and modernize the law governing commercial transactions, to allow expansion of commercial practices, and to make the law among the jurisdictions uniform.²²¹ The cases which hold that close stock is not a U.C.C. security fail to promote any of these goals.

The decisions which hold that close stock is a security are more in line with the needs of organized commerce and the purposes of the U.C.C. These decisions are better reasoned and do not require such a strained reading of the statute. They also allow the U.C.C. to govern the instruments, thereby preventing a gap in the law of one jurisdiction and encouraging conformity among jurisdictions. Additionally, these decisions provide the greatest support for the dictates of the U.C.C., that the law be construed and applied liberally in order to promote its underlying goals.²²² Uniform coverage of commercial transactions is at the heart of the U.C.C. A determination that close stock is a security means that the U.C.C. becomes the governing instrument for a host of transactions. Thus, the law is less subject to change and uncertainty, and the desired objective of the U.C.C. is achieved.

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220. *Id.* § 8-102(a)(ii).

221. *Id.* § 1-102(2).

222. *Id.* § 1-102(1).