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SOME LEGAL PROBLEMS CONNECTED WITH STOCK MARKET TRANSACTIONS

By S. Ashley Guthrie and Henry F. Tenney*

IF any one were asked what was the most dramatic event of the last year, he probably refer at once to the collapse of the great Bull Market on the New York Stock Exchange. This was not only a dramatic event, but it was literally a tragedy for hundreds of thousands of people. Securities shrank to less than half their former inflated values and hundreds of millions of dollars in cash and paper profits were lost over night, or possibly we should say over two nights, for the crash occurred in two stages, one in October and one in November, and many of those who staggered through the first were annihilated by the second. Never before had so many people been involved in stock market speculation, and, consequently, never before had so many people been directly hit by any stock market panic. Never before had so many dreams of El Dorado been shattered.

With the meteoric decline in the values of securities, margins quickly disappeared, and thousands of accounts were closed out by forced sale at whatever the market would bring. Some brokerage houses—though not so many as might be expected—were unable to protect themselves and failures resulted. Out of this situation there has arisen considerable litigation, with many more threats of litigation, all of which has served to focus the attention of brokers, and of many lawyers advising them, on the question as to just what their legal rights and obligations are, and what they are required to do to protect themselves.

The problems involved and the principles of law which must be applied in their solution are in no sense new. They have been the subject of discussion in the courts for many years, and many of the leading cases were decided more than a half century ago. The principles discussed and applied in these cases, however, are as applicable today as they were when the decisions were made, for in the absence of clear proof of a special agreement, the courts still

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follow the rules of the common law in determining all questions incident to the relationship between the stock broker and the customer for whom he trades.

Without further introduction, we shall proceed to the consideration of some of these problems and the principles governing their solution. They are really connected with the late stock market crash only in that that crash has given them a timely interest and importance.

The Underlying Legal Relation Which Exists Between a Broker and His Client

In order to determine the legal consequences of the dealings between a broker and his customer, it is first necessary to examine the relationship which exists between them, particularly in the case of margin transactions, which constitute a vast majority of all such dealings.

In the ordinary margin transaction, the customer deposits with the broker a certain amount in money, or its equivalent, and directs the broker to purchase for his account securities of much greater value, the deposit, or margin, to be held by the broker pending the close of the transaction as protection against the possible decline in value of the securities purchased. The broker is required under the rules of all exchanges to purchase and actually does purchase on the customer's account and pay in full for the securities ordered. He holds the securities subject to the order of the customer until the account is closed out, either by payment by the customer of the full purchase price and the delivery to him of the securities, or by sale of the securities, either on the customer's order or by the broker without such order to protect himself against loss.

There are also margin transactions connected with "short sales." These are far less frequent than the purchases, and the relationship created between the broker and the customer, as a result of them, is somewhat different. It is in fact a purely contract relationship. This article deals mainly with purchases on "long" account.

The courts have frequently had before them the problem as to whether a broker holding securities purchased for a customer but on which the broker has advanced the greater part of the purchase price, is a pledgee of those securities so that the title is in the customer,

or whether the broker has the title and is merely under a contract obligation to deliver them, or their proceeds, to the customer, if and when the balance of the purchase price is paid. Upon the solution of this problem rests in large measure the determination of the rights of the parties in many of the controversies that arise between them. For its solution—as well as for the solution of most of the problems which arise in connection with transactions between stock brokers and their customers—we must look mainly to the New York decisions. New York is the state where most of these transactions occur and the courts in the other jurisdictions (with the exception of Massachusetts) pretty generally follow the New York courts. As was said by the United States Supreme Court in *Richardson v. Shaw,*[1] "The rule thus established by the courts of the State where such transactions are the most numerous, and which has long been adopted and generally followed as a settled rule of law, should not be lightly disturbed."

It was early decided in New York that where stock is purchased by a broker for a customer on margin, the broker is a pledgee holding the stock purchased as security for the payment by the customer to him of the balance of the purchase price.

The leading case in New York and the one which has been most cited in nearly every case in the United States dealing with the subject is that of *Markham v. Jaudon.*[2] In that case which arose in 1869, briefly stated, the facts were that the customer, who was the plaintiff, authorized the broker to buy certain stock for his account and to pay for it and hold it subject to his order as to the time of sale. The customer advanced ten per cent of the market value and he agreed to keep a ten per cent margin with the broker. The broker demanded more margin, but it was not supplied, and he thereupon sold the stock without giving notice of the time and place of sale. The suit was brought for conversion. The plaintiff claimed that the relationship was that of pledgor and pledgee, the title being in the plaintiff, and that the sale was a conversion. The defendant broker claimed it was a contract relationship and the customer having defaulted on his contract to furnish additional margin on demand, that he (the

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[1] 209 U. S. 365.
[2] 41 N. Y. 235.

broker) was released from the obligation of his contract to hold the stock and had a right to sell it without further notice. As we shall point out later, the broker's position was correct if the relationship was merely a contract relationship, the broker having the title to the stock. The exact question presented, therefore, was what was in fact the relationship between the parties.

The respective duties of the parties are thus summarized by the court:

The broker undertakes and agrees:—

1. At once to buy for the customer the stocks indicated.

2. To advance all the money required for the purchase, beyond that furnished by the customer.

3. To carry or hold such stocks for the benefit of the customer so long as the margin is kept good, or until notice is given by either party that the transaction must be closed.

4. At all times to have in his name or under his control, ready for delivery, the shares purchased, or an equal amount of other shares of the same stock.

5. To deliver such shares to the customer when required by him, upon the receipt of the advances and commissions accruing to the broker; or

6. To sell such shares upon the order of the customer, upon payment of the like sums to him, and account to the customer for the proceeds of such sale.

Under this contract the customer undertakes:—

1. To pay a margin of ten per cent on the current market value of the shares.

2. To keep good such margin according to the fluctuations of the market.

3. To keep the shares so purchased on his order, whenever required by the broker, and to pay the difference between the percentage advanced by him and the amount paid therefor by the broker.[8]

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[8]In Markham v. Jaudon, supra, it is further said: "The position of the broker is two-fold. Upon the order of the customer, he purchases the shares of stocks desired by him. This is a clear act of agency. To complete the purchase, he advances from his own funds, for the benefit of the customer, ninety per cent of the purchase-money. Quite as clearly he does not in this

The court held that the relationship between the parties was that of pledgor and pledgee, saying that the fact that the customer never had possession of the securities is of no consequence.[4]

Another leading case which is very often cited is that of *Richardson v. Shaw,* supra. Mr. Justice Day wrote the opinion in that case, and it is a very clear exposition of the law on the subject. Briefly stated, the facts were that the customer had a margin account with a broker who failed. While the broker was insolvent, the customer paid off his debit balance and received back the securities. It was then claimed by the creditors of the bankrupt that the securities should be returned, since the payment was preferential.

The court expressly approved *Markham v. Jaudon* and held that the relation between a broker and client was that of pledgor and pledgee and that the customer, having retained title to the securities, was justified in paying off his debit balance and receiving back the collateral, even though the broker was insolvent. It was pointed out that dividends on the securities belong to the customer; that the customer pays interest on the purchase price and is credited with interest on margins deposited; that he has the right at any time to

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act as an agent, but assumes a new position. He also holds or carries the stock for the benefit of the purchaser, until a sale is made by the order of the purchaser, or upon his own action. In thus holding or carrying he stands also upon a different ground from that of a broker or agent, whose office is simply to buy and sell. To advance money for the purchase and to hold and carry stocks, is not the act of a broker as such. In so doing he enters upon a new duty, obtains other rights, and is subject to additional responsibilities."

[4] "While it is true that the dealer, in the present case, never had actual possession of the property, which he claims to have pledged, he had it sufficiently to bring his case within the principles of the law of pledge. * * * * To have delivered the certificates to the plaintiff, and that the plaintiff should then have returned them to the defendants, to be held by them as security for the advance in their purchase, would leave the parties in precisely the same situation as if the defendants had retained them for that purpose; the form of a delivery to the plaintiff, and a re-delivery by him to the defendants, being waived by agreement of the parties. It comes fully within the principle I have already quoted from Story on Bailments, that where the pledgee has the thing in his possession, the contract of pledge operates as a delivery, the moment the contract is completed. STORY BAIL., sec. 297." See also JONES ON PLEDGES, sec. 496.

Where a broker advances all the money, he is still a pledgee. Content v. Banner, 184 N. Y. 121.

withdraw the excess of collateral and upon settlement is entitled to receive the securities back. The risk is on the customer. He profits if he succeeds; he loses if he fails.

The court says that the fact that the broker does not have to deliver to the customer any particular certificate of stock has no bearing on the situation. "A certificate of the same number of shares, although printed upon different paper and bearing a different number, represents precisely the same kind and value of property as does another certificate for a like number of shares of stock in the same corporation. It is a misconception of the nature of the certificate to say that a return of a different certificate or the right to substitute one certificate for another is a material change in the property right held by the broker for the customer." And it follows that the fact that the broker carries the stock in his own name does not affect the character of the relationship. This is necessary for the protection by the broker of his lien. He complies with his full duty if he has available at all times for delivery the full number of shares to which his customer is entitled.

The court in *Richardson v. Shaw* refers particularly to the decision in *Skiff v. Stoddard*,[5] and no discussion of this subject would be complete without a reference to that case. It is possibly the ablest and most exhaustive discussion of this subject that will be found anywhere. In that case, as in the other two, the court held that the relationship between the customer and the broker was that of pledgor and pledgee, and that after the failure of the broker, the customer could, by tendering to the broker's assignee the unpaid portion of the purchase price, compel the delivery to him of the stock purchased on his account free from the demands of the general creditors, at least so long as that stock had not been properly pledged by the broker with those creditors to secure those demands.

The decisions in these three cases represent the decided weight of authority and may, we believe, be taken as determining the law in probably every jurisdiction except Massachusetts, where it is held that the relationship between broker and customer is that of

[5] 63 Conn. 198.

debtor and creditor and that the title to stock held in the customer's account is in the broker.[6]

In Illinois the case of *Brewster v. Van Liew*[7] is cited most frequently as indicating the approval by the Illinois supreme court of the general rule that the relationship between customer and broker is that of pledgor and pledgee, and while the rights of the parties under an alleged special contract were to some extent involved in that case, the reasoning of the court is based on the application of the New York rule. In that case the plaintiff customer had deposited with the defendent broker margins to secure the broker in the purchase for the customer of certain shares of stock, the broker advancing the balance of the purchase price. After additional margins had been supplied from time to time, there was finally a request for a margin which the customer did not comply with. This was accompanied by a warning that the stock would be sold, although the notice was not sufficient as a notice of sale. The customer relied to a certain extent on an alleged oral contract that the stock should be held for him in any event and not sold, although the court in its opinion did not refer particularly to this contract, except to assume that the sale was wrongful. The plaintiff, instead of suing for a conversion, brought an action of assumpsit, claiming the right to repudiate the entire transaction and recover back the margins which he had put up, and the trial court allowed him damages on that theory. The supreme court reversed that judgement on the ground that he was entitled only to be put in the same position he would have been if the broker had not wrongfully sold his stock, that is, that the measure of damages was the same as it would have been if the action had been in tort for a conversion. As to *Markham v. Jaudon,* the court said, "The relation which exists between a broker and his customer in the case of the holding and carrying of stocks, as here, is declared in the leading case of *Markham v. Jaudon,* 41 N. Y. 235, defining the relative rights and duties of the broker and customer. It is there laid down, that in advancing the money by the broker to complete the purchase of stock, the relation of debtor and

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[6]Chase v. Boston, 180 Mass. 458; Furber v. Dane, 204 Mass. 412; Furber v. Dane, 203 Mass. 108. Oppenheimer, "Stock-brokerage Bankruptcies," 37 HARV. L. REV. 860.

[7]119 Ill. 554.

creditor is created, and that thereupon the broker becomès a pledgee of the stock for the money advanced in its purchase—that the contract between the parties is, in spirit and effect, if not technically and in form, a contract of pledge."

The rest of the opinion is based on the assumption that the rule thus cited is the correct rule and the measure of damages, therefore, should be that adopted in cases of conversion by a pledgor of the pledgee's property. The decision is certainly based on the theory of the change in relationship between the broker and the customer occurring upon the purchase of the stock which was the basis of the decision in *Markham v. Jaudon* and other like cases, the original contract of agency being terminated when the stock is purchased and a new relationship of pledgor and pledgee thereupon established.

In the case of *People v. Friedman*[8] the supreme court of Illinois considered the relationship between the broker and his customer. The ultimate question in the case was whether an indictment for embezzlement would lie under the existing state of facts. In reaching its conclusion, the court commented at some length on the reciprocal duties and rights of a broker and his customer. These rights and duties were defined in substantially the same terms as those adopted by the court of appeals of New York and by the Supreme Court of the United States. It is not necessary to repeat them here, but the case clearly indicates that Illinois is in line with the general trend of authority on this subject.

In *Whipple v. Tucker*,[9] the court held that an action in trover could be maintained by a customer against a broker who sold stock carried by the broker on margin without demand for additional margin or notice of sale; and that the customer is the owner of the stock.

In *Hughes v. Barrell*,[10] where the question was as to the liability of the broker for closing out a margin account without notice, the appellate court cited *Markham v. Jaudon* and *Richardson v. Shaw*, and also *Brewster v. Van Liew*, and the appellate court cases of *Whipple v. Tucker*, supra, and *Schaefer v. Dickinson*, referred to

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[8]321 Ill. 572.
[9]123 Ill. App. 223.
[10]167 Ill. App. 100.

below, as holding that the relation between the customer and the broker as to the stock bought and carried by the latter for the former was that of pledgor and pledgee.

In *Schaefer v. Dickinson,*[11] cited in *Highes v. Barrell,* supra, the court cited *Brewster v. Van Liew,* and said that the New York rule "may be assumed to have been also approved in this case"; and we should be amply justified in making the same assumption if it were not possibly for the late case of *People v. Wildemann*[12] which, while not bearing directly on the point here involved, is hard to reconcile in theory with the other cases.

In *People v. Wildeman* the facts were as follows: A woman left a certain bond with a broker with instructions to exchange it for another bond. The broker sold the bond with intention of using the proceeds to complete the exchange and deposited the proceeds in his own bank account. He then failed before having purchased another bond in place of the one deposited with him by the plaintiff. He was indicted for larceny by a bailee. The court reversed the judgment of conviction in the lower court on the stated ground that the defendant was not a bailee, because "when there is no obligation to restore the specific article and the receiver is at liberty to return another thing of equal value or the money value, he becomes a debtor to make such return and the title to the property by such transaction passes to him." The court cites a number of Illinois cases holding that the transaction there involved constituted a sale and not a bailment, or that the general deposit of funds in a bank creates the relation of debtor and creditor and not bailor and bailee between the bank and the depositor. These cases do not support the decision in the principal case. The effect of that decision is to hold that a deposit with a broker, or with any agent, of property for the purpose of exchange—or of sale, which amounts to the same thing—is equivalent to a sale to the broker or agent, and is a complete transfer of the title to him.

This holding is in direct conflict with the decision in *Fleet v. Hertz,*[13] and *Lenz v. Harrison,*[14] where it was held that a deposit

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[11] 141 Ill. App. 234.
[12] 325 Ill. 99, 52 A. L. R. 500.
[13] 201 Ill. 594.
[14] 148 Ill. 598.

of property with an agent for the purpose of sale by the agent on the principal's account was a bailment and the title remained in the depositor. This is in accord with the general rule, which is well stated in 6 C. J. 1091, where it is said: "The rule that where a person receiving property is not bound to return the identical thing received, but may account therefor in money or other property, or thing of value, the transaction is a sale, is not applicable to bailments or consignments for sale."

The decision in *People v. Wildeman*, if followed, would certainly involve the holding that wherever stocks of a customer were held by a broker for sale, the title to those stocks was in the broker. It is doubtful whether this same rule would necessarily be applied if stocks were purchased by the broker with the customer's money and held for the customer not necessarily for sale. The decision seems so inherently unsound that it very probably will not be adhered to or extended, and, in our opinion, the general rule is applicable in Illinois that the relations between a customer and a broker purchasing securities for him on margin transactions, is that of pledgor and pledgee, and that the title to the securities purchased by the broker for the customer is in the customer.

Sales by Brokers of Stocks of Customers Held in Margin Accounts

The question of most importance here, and the one most frequently arising, is what are the rights of the broker and of the customer as to the sale of the customer's securities held on margin accounts and the liability of the broker to respond in damages in the event of a wrongful sale. So long as there are no abnormal market movements, either up or down, few transactions occur which give rise to any serious problem, but when a situation arises such as that which arose in the stock market last fall when a highly inflated bull market collapses and securities drop in a few hours to a fraction of their former value, the problem presented is very practical. The time element is important, and the broker must be sure of his rights and do that quickly which is necessary to protect them.

Thousands of margin calls were made during the recent crash, some of which were responded to and some of which were not, and thousands of accounts were closed out. Many suits have already

been filed by customers who claimed that they were improperly closed out without proper notice or the allowance of sufficient time to put up further margins. It is worth while, therefore, to take up in some detail the respective rights and obligations of the broker and the customer in connection with margin calls and forced sales.

The law is well settled that in the absence of special agreement the broker can not sell securities held by him for his customers on margin account unless he first gives the customer an opportunity to put up further margins and notifies the customer of the time and place of sale if such margins are not put up.[15]

The obligation, therefore, to call for margins is absolute and so strict is the requirement that if the customer is out of town, at least to the knowledge of the broker, a notice served at the customer's usual place of business is not sufficient, but the broker must find out where he is and notify him personally. (*Hughes v. Barrell,* supra.)

The Broker's Right to Make a Margin Call

The recipient of a margin call is faced with an extremely practical problem. He must decide quickly whether to respond—if he can—or to reduce his income tax by taking a loss. On the other hand, the broker, in the face of a collapse of the market, must act quickly or he himself will be carried down in the crash.

Unquestionably, it is the duty of the customer to keep his account properly margined and undoubtedly the broker has a right to call for more margins. In the New York case of *Markham v. Jaudon* already cited, it was held that the customer was required to maintain his original margin—that is to say, if he started with a ten per cent or a twenty per cent margin, he must continue to maintain that ratio. In another New York case, *Gruman v. Smith,*[17] it was said: "In such a transaction [meaning a broker's transaction], it is expressly or impliedly agreed that the margin shall, if the stock depreciates, be replenished and kept good upon demand and upon failure to do so the stock may be sold upon reasonable and customary notice."

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[15]Markham v. Jaudon, supra; Richardson v. Shaw, supra; Lazare v. Allen, 47 N. Y. 340. For collection of cases, see 43 Harv. L. Rev. 628.
[17]81 N. Y. 25.

There is little doubt that the Illinois court will follow these decisions, as there can be no question of a broker's right to call for more margins. This is one of the cardinal principles of a brokerage transaction, and it is the right upon which the entire structure of stock exchange transactions is based.

In *People v. Friedman*, supra, the court said: "Under such a contract, the customer is, first, to pay the margin required; second, to keep such margin good according to fluctuations of the market." It is clear from this that the broker has the right to call for more margin, which the customer is required to produce.

In the absence, however, of special agreement, the customer ordinarily does not have to follow the market and come in and tender more margin any time that the market quotations show that his percentage is falling too low, but is as a rule entitled to notice and demand for more margin if and when his margin falls below the required percentage, and he is not in default until he receives such a call and fails to respond to it.

The Character of the Margin Call and the Customer's Compliance Therewith

The form of the call issued by the broker must be specific and certain and must state the amount of money or security demanded. In *Boyle v. Henning*,[18] it is stated: "All demands by a stock broker upon his customer for margins must be specific, definite and certain, and the customer is entitled to a reasonable time under all the circumstances of the case within which to comply with any demand which may be made by his broker upon him. No demand for margins is specific unless it mentions a particular amount of money or unless it states facts from which a particular amount of money may be certainly ascertained." The customary printed form of call used by brokers is generally sufficient, but where brokers are dealing with out-of-town customers by telegraph or otherwise, care must be taken to include in the call all the legal requisites.

After the call is made, the customer has a reasonable time within which to furnish the additional margin.[19] Stating the proposition in

[18] 121 Fed. 376.

[19] See note 15 above; also Stewart v. Drake, 46 N. Y. 449; Small v Housman, 208 N. Y. 115; Sanger v. Price, 114 N. Y. App. Div. 78.

this general way is not very helpful either to a customer or to a broker. What is a reasonable time depends upon the particular circumstances of each case and is usually a question for the jury to decide.

The fact that the margin is in a state of panic or the Exchange is about to close or the customer has previously refused margin calls are all circumstances to be taken into consideration. In the case of *Lazare v. Allen,* supra, it was said that the broker was not justified in selling within an hour after the margin call had been made, but the delay of a day has been held sufficient, as has also a delay of two days. No doubt the customer must act with all reasonable dispatch in supplying the collateral called for, but it is not possible to lay down a more definite standard by which to measure the reasonableness of the customer's compliance. It is a question of fact in each case.

Notice of Time and Place of Sale

A call for margins, uncomplied with, is not, however, in the absence of special agreement (assuming the relationship of pledgor and pledgee to exist) a sufficient basis for the sale by the broker of his customer's securieties. The broker must also give notice of the time and of the place of sale. As was said in *Markham v. Jaudon:*[20] "To authorize the defendants to sell the stock purchased, they were bound first to call upon the plaintiff to make good his margin; and, failing in that, he was entitled, secondly, to notice of the time and place where the stock would be sold; which time and place, thirdly, must be reasonable."

In fact, so strict is this rule that in one New York case[21] it was held that a notice stating that the stock would be sold on the New York Stock Exchange, unless the margin was supplied by a certain hour, was defective for failure to state that that hour was the ***time*** of the sale. And in another New York case[22] the broker had advanced all the money for his customer for the purchase of a certain stock and sent to the customer a notice asking for margin, stating:

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[20]However, the broker does not have to sell when the margin is exhausted. Little v. McClain, 134 N. Y. App. Div. 197.

[21]Fairchild v. Flomerfelt, 79 Mis. 42, 139 N. Y. S. 44.

[22]Content v. Banner, supra. See also Mayer v. Monzo, 221 N. Y. 442, where it was held that a broker who failed to give the customer notice of a sale by a sub-pledgee, was guilty of conversion.

"If, however, you do not make suitable arrangements in this respect before Monday next, we shall sell this stock for your account and hold you responsible for the loss." Margin was not supplied and the stock was sold at a loss on the New York Curb on the day fixed. It was held that the broker was a pledgee and therefore required to give notice of the *place* of sale, and that the notice was therefore defective. The customer was thereupon held entitled to recoup, against a suit by the broker for his advances, the amount of the loss occasioned by the wrongful sale of the stock, being the highest market value between the time of the sale and a month thereafter.

This strict requirement as to notice of *time* and *place* of sale is the ordinary rule applied to sales by pledgees.[23] The rule, which is at least highly technical where sales are made on a public exchange, grows entirely from the relationship of pledgor and pledgee and the special conditions precedent with which a pledgee is required by law to comply before he can foreclose his lien on pledged property, irrespective of whether or not the pledgor is in default in meeting the obligations with respect to which the pledge was made. The rule does not apply, for instance, in a case of a purchase by a broker of securities to close out a short sale. It does not apply to executory contracts such as purchases or sales for future delivery on the Board of Trade.[24] In neither of these cases is a notice of sale required. The relationship of pledgor and pledgee does not exist and the broker is not bound to fulfill his contract to keep the deal open where the customer has failed to comply with his dependent covenant to maintain his margin at the required percentage, and to furnish the necessary additional margin on demand.

In the cases we are here considering, however, where the relationship of pledgor and pledgee does exist, the requirement as to notice of *time* and *place* of sale can not safely be ignored.

It is necessary, therefore, if a broker wishes to protect himself that he should accompany his margin call with such a notice. Otherwise, the sale might well be held to be a conversion, in the absence at least of an established custom of the market to the

[23]McDowell v. Chicago Steel Works, 124 Ill. 491, where it was held that notice to redeem without notice of sale was not sufficient to justify sale in absence of special agreement.

[24]Corbett v. Underwood, 83 Ill. 324.

contrary. The Illinois cases go a long way in holding that a customer is bound by the established custom of the market in which he trades, even though he does not know the custom.[25]

In this connection we should possibly mention the case of *Taylor v. Bailey*,[26] a suit by a broker for unpaid advances. In that case, it seems to be held that when a customer failed to furnish margin on demand, the broker, after waiting a reasonable time, could under the custom of the New York Stock Exchange, sell the customer out and recover the excess of his advances over the amount received on the sale. The question of whether notice of sale was required is not discussed, nor did the customer, apparently, claim any right to recover damages on account of a conversion, as probably no damage was suffered. The defense was that the transaction was a gambling transaction and this defense was not sustained. The case is not authority for the proposition that no notice of sale was required, or that there is any custom of the New York Stock Exchange waiving that requirement. On the contrary, the uniform holding of the New York cases is that such requirement is mandatory. Reliance on a custom, however, is dangerous, in any event, as the existence or non-existence of the custom is almost certainly a jury question.

Responsibility is also upon the broker to see that the customer actually gets the notice. It would seem logical that if a customer leaves town without leaving a forwarding address, a notice sent to his place of business should be sufficient, but this is not so, at least if the broker knows that the customer is going to leave town. In *Hughes v. Barrell,* supra, it was held incumbent upon the broker to obtain a forwarding address and to send the notice to the customer at that address. The court said that the broker if he wished protection might have protected himself by special agreement.

The Measure of Damages for Wrongful Sale

The question of the measure of damages for a wrongful sale by a broker of his customer's securities has been a fruitful subject of discussion in the courts. The ordinary rule in cases of conversion is of course that the measure of damages is the value of the property

[25] De Stefano v. Associated Fruit Co., 318 Ill. 345; Samuels v. Oliver, 130 Ill. 73; Canning Co. v. Brokerage Co., 213 Ill. 561.

[26] 160 Ill. 181.

converted at the time of the conversion, but, except in Massachusetts, it was early recognized that stocks are a subject of extreme fluctuation, and that the ordinary rule would not in most cases—at least where there was an immediate rise in value of the securities sold—compensate the plaintiff for his actual damage.

In *Markham v. Jaudon,* the court approved without discussion a rule of damages which gave the plaintiff the benefit of the highest value of the securities between the date of the conversion and the date of the trial, but this manifestly unfair rule has been abrogated in New York and in Illinois which follows the New York decisions on the subject. In *Baker v. Drake*[27] the court discussed the question of damages at length, and held that the proper measure of damages was highest market price within a reasonable time after the sale, and expressly disapproved the rule as laid down in *Markham v. Jaudon.* This is now the established rule in New York. In *Brewster v. Van Liew,* supra, and *Hughes v. Barrell,* supra, this rule of damages was approved and may be taken to be the rule generally followed. What is meant by a reasonable time again becomes a question of fact, sometimes difficult to determine. It at least includes a reasonable time after notice of the conversion. This interpretation of the rule is supported by a long line of cases.[28] It is the most equitable rule which could be established. Its theory is that the damages must be fixed by what the customer could have purchased the stock for within a reasonable time, assuming that he had chosen the time most disadvantageous to him to purchase it, while of course it does not require the customer to make the actual purchase, which he might not be able to do.

If after the sale and up to a reasonable time thereafter, there is no time when the securities sold reach a price as high as their selling price, then under the rule stated the damages would be nominal, as the customer might at any time repurchase without suffering a loss. This is the rule when the customer has already been allowed credit for the full amount received on the sale, but not otherwise when there is in fact no repurchase made. It stands

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[27]53 N. Y. 211. See also Colt v. Owens, 90 N. Y. 368; Wright v. The Bank, 110 N. Y. 237; Minor v. Beveridge, 141 N. Y. 399; Mullen v. Quinlan, 195 N. Y. 109.

[28]See L. R. A. 1917 C-753.

to reason that if the customer wishes to take the benefit of the sale as made, he may do so and insist, after payment of his indebtedness, that he receive the full amount received by the broker on that sale. Any other rule would permit the broker to make a profit by virtue of his wrong.

There is an interesting New York case[29] on this subject which is worthy of comment. In that case the facts were as follows: The brokers converted to their own use stock of the plaintiff which they were carrying for him on margin worth at the time of the conversion $45,000. Plaintiff's indebtedness to them was then $40,000. He thereafter paid them $25,000 in reduction of his loan, without knowledge of the conversion. He later discovered the conversion and tendered the $15,000 which he still owed the brokers, to their assignee in insolvency and demanded the shares of stock. This demand was, of course, not complied with. The highest market price of the stock between the time of the discovery of the conversion and the time of the demand and refusal was $26,000. The lower court, applying the general rule, allowed to the plaintiff only the difference between the $26,000 and the $15,000 which he still owed. In reversing that decision, the appellate division held that he was entitled to the difference between what he owed and $45,000, the amount of the sale, holding that the rule in *Baker v. Drake* could not be applied to this sort of a case. The court pointed out that in every case where that rule had been applied, there was no question that the customer was entitled to the proceeds of the sale, the only question being as to what, if anything, more he was entitled to, and remarked: "The fact that the defendants purchased the stock as agents for the plaintiffs did not give them the right to convert it to their own use on the chance that it might decline in value, thereby enabling them to replace it at a profit."

In *Taussig v. Hart*,[30] the same rule was applied where the brokers had sold the stock to themselves and later replaced it by other stock which they purchased on a declining market, plaintiff being given the market price on the day of the sale.

[29]McIntyre v. Whitney, 124 N. Y. S. 234, aff'd. 201 N. Y. 526.
[30]58 N. Y. 425.

It is stated generally in Campbell's Law of Stock Brokers, supported by a number of New York authorities, that if the market price after the sale within a reasonable time does not exceed the price realized, the price realized is the measure of damages, and may be recovered less any indebtedness from the customer to the broker on account of the transaction.

The question has also been raised as to whether the customer may upon conversion by the broker repudiate not only the wrongful sale, but the whole transaction from its inception, and recover from the broker the amount deposited as margins. The Illinois supreme court held in *Brewster v. Van Liew,* supra, that the customer can not so recover, but is confined to his damages as in case of conversion, the broker being therefore entitled to credit for his advances.

As the original transaction can not be repudiated, it follows that the broker may recover from the customer the amount of his advances even though he has converted the stock by a wrongful sale, the customer being entitled to recoup any damage which he has suffered by reason of the conversion.[31] This holding would seem to follow logically if we admit that the customer became the owner of the stock and the broker was merely a pledgee of it. The original purchase of the stock was a completed transaction, and the liability of the customer to the broker on account of that transaction would therefore not be affected by his subsequent misconduct. Where the transaction is not one of pledge (as in the case of purchase of grain or short sales) a different rule would be applied.

The Effect of Special Agreements

It is a common practice for brokers to require their customers to sign an agreement authorizing the broker:

1. To pledge securities deposited as a margin along with other securities on broker's general loans;

2. To close out the account and sell the securities whenever the margin is deemed insufficient by the broker without demand for margin and notice of closing or of the time and place of sale.

There is nothing contrary to public policy in such an agreement, and where proved it has been uniformly upheld and enforced against the customer.

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[31]Minor v. Beveridge, 141 N. Y. 399.

The Supreme Court of the United States in *Hitchcock v. Knapp*[32] held that a pledgor may waive his common law rights of notice of the time and place of sale and may even authorize the pledgee to buy at its own sale. The supreme court of Illinois has also upheld such special agreements.[33]

Such agreements are undoubtedly strictly construed and should be explicit. Thus where a special agreement merely reserves the right to sell "without notice," the broker need not state the time and place of sale, but is required, nevertheless, to make a demand for additional margin.[34] The agreement should therefore include both the right to sell without notice and the right to sell without demand of additional margin. If it is clear in this respect, it is good and will be enforced, provided it is actually signed.

The broker, however, to protect himself, should procure a signed agreement. Provisions commonly written on the bottom of confirmation notices or statements to the effect that all transactions are subject to the right of the broker to sell without demand for margin and without notice, etc., are of very doubtful efficacy. The burden is upon the broker to prove that these provisions were assented to, and usually there is a question of fact raised which must be determined by a jury. In the case of *Levitan v. Bickley*[35] decided in the circuit court of appeals for the second circuit this question was discussed at length. It was there held that statements on a confirmation slip do not form part of the contract between the broker and client. The court said that in order to make them binding, the broker was bound to prove that the customer knew the terms of the confirmation slips and understood them to apply to his transactions. His mere receipt of them was not conclusive evidence of a contract in accordance with the terms stated. The decision in *Evans v. Hubbard*[36] is to the same effect, and in discussing this question in *Thompson v. Baily*[37] the court held that a previous transaction in which slips containing these statements had been sent to

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[32]206 U. S. 28.
[33]McDowell v. Chicago Steel Works, supra.
[34]Stenton v. Jerome, 54 N. Y. 480.
[35]35 F. (2d) 825.
[36]220 App. Div. (N.Y.) 423.
[37]220 N. Y. 471.

the same customer did not establish a course of dealing, and said: "The perfunctory warnings of the printed blank express at the utmost the defendants' general practice. They will readily yield to other and more specific statements of the practice to be followed in dealings with the particular customer * * * The lines of the contract are not so sharply defined that the court is free to trace them unaided by a jury."

In a Michigan case[38] the trial court was held justified in finding from printed statements on the invoices, coupled with the testimony that the defendants had called the plaintiff's attention to these statements, that there was a special contract permitting sale without notice.

On the whole, therefore, it seems quite clear that no reliance may be placed on any special contract that is not signed by the customer who is sought to be held bound by it.

Once a broker has a signed agreement from the customer, he must be careful not to make any statements verbally which would lead the customer to believe that the strict letter of the agreement would not be enforced. Such loose statements as, "We will take care of you,"—"We will carry you along,"—"We won't sell without notice," frequently lead to misunderstandings, and it does not take very much to constitute a waiver on the part of the broker of the rights reserved to him in a special contract. In the late case of *Rosenthal v. Brown*,[39] it was said, "If the broker waives the right to exact strict performance and gives time and indulgence to the customer, he can not recall this waiver at his own option without giving notice to the customer to the end that the latter may have an opportunity of protecting the account."

Is a Customer Required Affirmatively to Repudiate a Wrongful Sale?

The question as to whether a mere silence by a customer after receiving notice of a wrongful sale can be taken as a ratification of the sale is not different in principle from any other question of ratification by acquiescence. Where the New York rule of damages applies, it might well be said that there can be no injury to the broker from a failure to repudiate because the damages in any event

[38]Stibbard v. Owen, 243 Mich. 138.
[39]247 N. Y. 479.

are limited to the highest value within a reasonable time after the transaction and will already have been fixed within such reasonable time whether or not the customer fails to repudiate. In the late federal case of *Levitan v. Bickley*, supra, it was held, however, that a silence of nine weeks, coupled with acceptance by the customer of payment of his balance, was a ratification, and certainly a reliance by the broker, to his detriment, on the failure of the customer, with full knowledge of the facts, to repudiate the transaction would amount to a ratification on the plainest principles of estoppel. Whether in a given case failure to repudiate over a long period of time would or would not constitute a repudiation, would usually be a jury question. It does not call for extended discussion here.

The Right of the Broker to Pledge the Customer's Securities for His Own Loans

The rule in the case of the ordinary pledge at common law is that the pledgee can not repledge for his own debt property which he holds for the pledgor. This rule, however, is not strictly applicable to the special kind of pledge we are now considering. Where a customer employs a broker to purchase stocks for him on margin, it is uniformly recognized that the broker has a right to repledge the securities purchased for an amount at least not exceeding the amount of his advances. The same rule, in fact, applies to securities deposited with a broker by a customer as collateral to secure advances for margin transactions.

As was said in *In re Ennis*,[40] "It is the better view, in our opinion, that so long as the bankrupts, as brokers, fulfilled their obligations to the appellant, as customer, they had the right to rehypothecate the securities pledged to them. That was substantially the only way in which the collateral could have been made available, and, in view of modern business conditions, we think that such use must have been within the contemplation of the parties."

In *Austin v. Hayden*,[41] it was said: "That Currie & Co. (the broker) had the right to subpledge and borrow money on margined stock, which they held from separate customers, *en bloc*, commingled

[40] 187 Fed. 720.
[41] 171 Mich. 38.

and delivered for the purpose of obtaining capital required to carry their customers' purchases, is borne out by a strong line of authority."

The court refers to *Skiff v. Stoddard,* supra, as a leading case on the subject. In that case the court reviews at some length the general custom among brokers trading on the New York Stock Exchange to repledge securities held by them on margin accounts, and cites authorities to the effect that a customer is held to be bound by, and to have intended that the transaction between his broker and himself should be in accordance with, this established custom, citing, among other cases, *Samuels v. Oliver,*[42] which supports that holding. The court then continued as follows: "In view of the character and necessities of the business undertaken by brokers in carrying for their customers stocks bought upon a margin, and of the purposes which the custom of repledging was intended to serve, we are not prepared to say that it is open to any of the enumerated objections. Courts have commonly sanctioned it."

While a broker may have the right to repledge the stock or securities of his customer, it is his duty always to have available for delivery, or within his control, stock of the kind and quantity purchased or deposited with him by the customer whenever full payment for the stock is made or the indebtedness to the broker is paid. If he repledges the customer's stock for an amount greater than the amount owed to him by the customer, to that extent he disables, or at least he may disable, himself from fulfilling that obligation, and there are authorities holding that such a repledge is a violation by the broker of his duty.[43] It would just as clearly be a violation of duty if the customer's securities were pledged *en bloc* with other securities for an amount not greater than the total amount advanced on all of them, unless the condition of the pledge was such that the payment of a part of the debt would release a proportionate part of the securities pledged.

It does not follow, however, that the mere making of the repledge is a conversion, for if the broker remains solvent he is always in a position to redeem his loan or that part of it secured by the stock of any particular customer and make delivery to the customer if and

[42]130 Ill. 73.

[43]Quinn v. Schwartz, (Md.) 24 A. L. R. 444; 24 HARV. L. REV. 444 See also Horton v. Morgan, 19 N. Y. 170; People v. Friedman, supra, at p. 575.

when required to do so. The authorities are not uniform as to whether there is a conversion at the time of the repledge, or whether the conversion occurs only when there is a demand by the customer for delivery of the stock and that demand is not complied with. The Pennsylvania cases[44] and many of the early New York cases[45] hold that the mere repledge of the stock in such a case is in itself a conversion. In *Mayer v. Munzo* in the New York appellate division[46] this earlier New York rule seems to have been abandoned and although the court of appeals reversed this decision on the ground that the sub-pledgee sold the securities without notice to the customer and that such sale amounted to a conversion by the broker, the court does not hold that the repledge itself constituted a conversion.

It would seem on principle that no conversion should take place until there has been a refusal or inability of the broker to make delivery and that as to this point the decision of the appellate division should stand. This rule gives the customer all the protection to which he is entitled, for if the securities are delivered to him on payment of the amount of his advances, he is in no way injured by what the broker did with the stock in the meantime, and it is hard to see why he should be entitled to any damages on an alleged prior conversion. This is in accord with the holding in the Supreme Court of Canada in *Clark v. Baille.*[47]

However, a broker dealing on the New York Stock Exchange who pledges his customer's stock, mingled with other stock, in such manner that it can not be redeemed by payment of the amount of the customer's advance thereon, may very well render himself liable to imprisonment under the New York penal code. By a section of that code passed in 1913 it is provided that a stockbroker is guilty of a felony who, having in his possession securities of a customer on which he has a loan for indebtedness due to him by the customer, pledges the same for more than the amount due him thereon and thereby causes the customer to lose, in

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[44]Sproul v. Sloan, 241 Pa. 284; Ann. Cases 1915 B 941.

[45]Douglas v. Carpenter, 17 N. Y. App. Div. 329; Stickland v. Magown, 119 N. Y. App. Div. 113, 104 N. Y. S. 425, aff'd. 190 N. Y. 545.

[46]Mayer v. Monzo, 151 N. Y. App. Div. 866. (Reversed on other grounds, 221 N. Y. 442.).

[47]45 Can. Sup. Ct. 50.

whole or in part, such securities and the value thereof. Rules of the New York Stock Exchange require that surplus margin in a broker's possession should be kept separate and not repledged.

It is quite clear, therefore, that the broker to be on safe ground should have a special agreement with the customer permitting the pledging of collateral for an amount greater than that due from the customer.

Where a sub-pledgee in good faith advances money on securities delivered by a broker endorsed in blank, as to him the pledge is good and will be enforced, and the burden would be upon the customer to show that such repledgee had knowledge of facts sufficient to put him on notice that the broker is exceeding his authority. The broker has a right under the contract of pledge to carry the stock in his own name, and the customer or real owner is therefore estopped from maintaining his title to the stock. As was said in *Austin v. Hayden,* supra: "They (the subpledgees) knew that the legitimate loans for such business represented margins, and that the greater part, at least, of the securities deposited with them by Currie & Co., (the brokers) were primarily the property of customers, and the right to repledge them was limited to the unpaid balance due on them. In the regular course of business, dealing with a reputable, and presumably honest, brokerage firm, they had the right to assume, in the absence of anything to the contrary, that the securities were lawfully repledged; but, when proof is offered that irregularities and questionable practices came to their knowledge, their good faith is to be tested in the light of all they knew, including the fact that others besides Currie & Co. were owners of, or interested in, much of the collateral they relied on."

The good faith or the bad faith of the subpledgee is to be determined by substantially the same rules as determine the good faith or bad faith of a holder of negotiable paper.

RIGHTS OF THE CUSTOMER ON BANKRUPTCY OR INSOLVENCY OF THE BROKER

Space will not permit a very extended discussion of this question,[48] but, for the sake of completeness, we shall state very briefly what seem to be the controlling rules of law on the subject. In *Skiff v. Stoddard,* supra, almost every possible question in regard to the rights of a customer in the securities purchased on his account by an insolvent broker was involved. The several situations are thus classified:

1. Where the precise certificates of stock purchased in the execution of the customer's order were held for him by the broker.

2. Where particular certificates of stock or evidences of title were allocated to the customer's order, although not apparently the precise ones originally purchased in its execution.

3. Where no more precise identification is possible than that a block of stocks of the particular kind is on hand sufficient to satisfy the demands for that kind of stock of all the customers and the brokers themselves.

4. Where a block of stock of a particular kind was held by the brokers sufficient to satisfy the demands of all the customers, but not sufficient to satisfy both the demands of the customers and the demands of the brokers themselves for stock claimed to be owned by them.

5. Where a block of stock of the particular kind was held by the brokers not capable of identification, and the whole amount was insufficient to satisfy the demands of all the margin-buying customers, exclusive of the brokers.

It must be remembered that the question involved was as to the right of several customers to pay to the broker's assignee in insolvency the respective amounts due for the advances by the broker on their account and secure as against the general creditors the right to delivery of the particular stock purchased.

As to classes 1, 2, and 3 the court held that the right to redeem was clear, and that each customer by payment of the amount due was

[48]For an excellent treatise on this subject, see Oppenheimer "Stockbrokerage Bankruptcies," 37 HARV. L. REV. 860.

entitled as against the general creditors to delivery of the stock carried on his account.

As to class 4, it was held that in the absence of any evidence as to whether the stock carried was stock belonging to the brokers or to their customers, it would be assumed that the brokers had done their duty and disposed of their own stock and not that of their customers, so that the customers would be entitled to the full amount of their stock from the block on hand, the brokers, that is, their general creditors, only getting what was left. It was held, however, that this presumption would yield to proof to the contrary, so that if it was shown that any of the stock on hand actually represented purchases by the brokers on their own account, this stock would be taken by the assignee for the benefit of the general creditors, the customers dividing *pro rata* what was left.

As to class 5, it was held that the customers were entitled to a *pro rata* distribution.

This determines the rights between the customers and the assignee in insolvency of the brokers as to stock held by the brokers. Some of these stocks were, however, sub-pledged for loans made by the sub-pledgees to the brokers. As to those stocks, it was held that each customer in order to reduce his stock would have to pay his *pro rata* share of the excess of the amount for which the stock was sub-pledged over the total amount owed by the customers to the broker on the stock.

The court held that there was no difference between the rights of creditor and debtor customers, that is, between the customers who owed no money on the stock held for them at the time of the insolvency and those who after the insolvency paid in or offered to pay in what they owed so as to extinguish their indebtedness. These rules laid down in *Skiff v. Stoddard*, supra, as to the rights of customers in an estate of a bankrupt broker may be taken as representing the law on the subject. They are in accord with the decision of the Supreme Court of the United States so far as the same questions were involved in *Richardson v. Shaw*, where it was held that a redemption by a customer immediately before bankruptcy did not constitute a preference.[49]

[49]Re Toole, 274 Fed. 337, 24 A. L. R. 470 and note. Re Wilson, 252 Fed. 631.

The foregoing is not intended as an exhaustive treatment of the law of Stock Exchange transactions, or as a complete annotation of all the cases on the subject. We have attempted merely to state some of the more fundamental principles which underlie most of the dealings between broker and customer. During the so-called crash last fall the seeds of much future litigation were undoubtedly planted, upon the germination of which the law of brokerage transactions will take on a very practical significance for brokers and customers. The legal principles involved will have to pass the searching scrutiny of both bench and bar. Undoubtedly, new legal history is in the making.