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RIGHTS OF MARGIN CUSTOMERS IN BROKERS' FAILURES

By Jay T. McCamic

Upon a failure of a broker two general classes of persons are interested in the assets of the bankrupt's estate, viz: his general creditors and his margin customers.

The general creditors naturally seek to bring all securities held by the broker into a common pot to enhance the dividend. Those purchasing on margin, however, set up their claims to securities as property to which they are entitled by reason of a relationship existing between them and the broker which gives them priority as regards particular securities purchased for their account. If the margin customer establishes, in respect to particular securities, some property right, either legal or equitable, the controversy narrows to a contest between the margin customers, for it is obvious that in such case the general creditor can have no claim upon them.\(^1\)

When a customer opens an account with a broker he generally advances and agrees to maintain a percentage of the market price of the securities to be purchased. The broker secures the remainder of the price charging interest and his commission therefor. This purchase of securities on credit is a purchase on "margin," that is, they are either pledged by the broker to secure the purchase price of the stock which he has had to borrow, or if he advances the money himself the stock is held by him until demand and payment of the purchase price. Either by express agreement or by custom the securities purchased by the broker are mingled with those purchased for other customers. His obligation is to keep always on hand sufficient of the securities to deliver to the margin customer when he may so require.\(^2\)

So long as the broker borrows on the total securities held by him on margin no more than the total of what the customers owe,

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\(^o\) Member, Wheeling, West Virginia Bar.

\(^1\) In re Solomon & Co., 268 Fed. 108 (1920).

\(^2\) For the typical contract, see Richardson v. Shaw, 209 U. S. 365, 374, 28 Sup. Ct. 512, 52 L. ed. 835 (1908).
he is, of course keeping within the pale of safety, but it is when he excessively pledges or converts the securities, so that when financial difficulties assail him, he has on the whole fewer securities on hand than the total required to meet the demands of his margin customers, that the conflicting claim of the margin customers arise to the securities remaining "in the box."

Though liquidation generally occurs in a court of bankruptcy, the bankruptcy law has little to do with the settlement of the conflicting rights suggested. A bankruptcy court is one of equity and its familiar principles are resorted to: novelty arises merely in the new situations to which the ancient principles are applied. The representative ownership consequent upon the increasingly wide-spread use of the corporate form of business organization and the buying of stocks on credit have created these new situations, and though equitable principles are long settled their applications to the situations canvassed herein are by no means complete.

Between the dozens, scores, and hundreds, say, of those who have purchased securities on margin, some with right to hypothecate, others with no right to hypothecate, or those who have deposited independent securities as collateral, which have been unlawfully pledged or converted or those cash customers whose stock has been also pledged or converted by the broker, equities of various degrees arise, the determination of which depends first upon the relations existing between the customer and the broker, of which there are two views in this country. The minority or Massachusetts' Rule can merely be referred to and not discussed. It is supposed to recognize no fiduciary relationship between customer and broker created by a purchase of securities on margin but merely that of debtor and creditor, which seems to arise from the supposition that no title to the securities pass until they are paid for, the title of which remains the while in the broker. The customer, however, has the equitable interest therein. Although this seems to have so developed that the broker is the trustee of the stock for the customer, the cestui, with all consequent obligations of that relationship resulting.

The other doctrine originating in New York in 1869 is more generally followed, the leading case of which is Richardson v. Shaw, supra, under which doctrine the broker is, first, the agent in purchasing the securities and, second, a creditor to the extent of

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3 See Furber v. Dane, 204 Mass. 412, 90 N. E. 859 (1910); In re Swift, 105 Fed. 493 (1900 D. Mass.).
4 Markham v. Jaudom, 41 N. Y. 235 (1869).
the money which he advances, and, third, a pledgee in holding the securities to secure the advances. There is no delivery and re-delivery to satisfy the demands of a common law pledge, but this could only be a mere formality changing the essentials of the relationship in no particular. The dividends on the securities belong to the customer who pays interest on the advances, who takes all risk of loss and all gain in appreciation. The only interest the broker has is in his commission on the transaction. Any suggestion that the broker not being required to deliver identical certificates is inconsistent with ownership by the customer, is well answered by an examination of the nature of a security, which as stock, represents an undivided interest and can only be the mere evidence thereof. A share of stock is as fungible as grain in an elevator; stocks are like receipts for gold coin or grain "indistinguishable tokens of identical values."

Through fateful coincidence, Mr. Justice Holmes who took part in the development of the Massachusetts doctrine, was a member of the Supreme Court of the United States when the Richardson Case was decided. He comments, following Mr. Justice Day’s opinion, that personally he would have decided it otherwise. "I have submitted a memorandum of the reasons that prevailed in my mind to my brethren, and, as it has not convinced them, I presume that I am wrong." He then says that a customer is an "equitable tenant in common of all the stock of that kind in the broker’s hands," which seems to concede ownership in the customer. He concludes his short note with saying that deference to the court prevents dissent yet he "cannot but feel a lingering doubt."

Having gotten rid of the general creditors and having established the ownership of the shares of stock in the customer, now comes the situations arising as to them in case of liquidation of their broker. To eliminate a portion of the margin customers: If a claimant cannot trace his securities or its identifiable proceeds, however grievous may be his condition, however innocent, and however unjustly enriched the estate of the bankrupt may be, he becomes a mere general creditor and takes what in a court of bankruptcy can only be euphemistically termed, "pot luck." This narrows the circle to those who have "ticketed" their securities or their proceeds.

In the simple case where the broker has bought various lots of the same stock in the same corporation for various customers and there has been no delivery prior to liquidation and is then
short of that stock, the customers who were long of the stock are entitled to share *pro rata* therein.\(^5\)

If, however, the customer can identify his stock by the certificate number he is entitled to reclaim that stock.\(^6\)

The so-called "Rule in Pippey's Case" has been much discussed. On March 14, 1908, Pippey, owning a certificate for eighteen shares of Pullman stock standing in his name, endorsed it and delivered it to McIntyre & Company as security for future transactions but with no right to hypothecate. After some transactions and a closing of the same there was a credit balance due Pippey on April 9th. On April 23rd McIntyre & Company pledged Pippey's stock as substituted collateral on its general loan with a Trust Company. The next day an involuntary petition was filed against the firm and a receiver appointed. The following day Pippey demanded his stock from the receiver who advised him that it was in the possession of the Trust Company. The Trust Company refused to deliver the certificate and it was not used in liquidation of the loan of McIntyre & Company and therefore remained "in the box," upon which happening Pippey's title was unquestioned. The District Court, however, directed the stock to be sold and placed in a fund allocated to repay other customers whose stock had been converted by the broker. The Circuit Court of Appeals allowed Pippey the eighteen shares of stock on the theory that he owned the specific stock and had identified it and could have brought *replevin* for it.

Pippey, it appears,\(^8\) was the only one prosecuting an appeal. Suppose there were several claimants before the Court precisely situated as Pippey but whose stock had been dissipated by the Trust Company to liquidate the McIntyre general loan. It would be a mere matter of chance that the Trust Company had selected not Pippey's stock but that of others to clear the loan. And should the operation of chance among a number similarly situated prefer one, as between the two women at the mill, and leave the others bare handed? If the act of the repledgee (the Trust Company) decides, under a strict application of the Rule in Pippey's Case, what customer is to be preferred, the accidental evil of a chance selection of the stock to be sold is swallowed up in the greater evil of probable consciously and designedly preferential

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\(^8\) *See in re J. C. Wilson & Co.*, *supra*. 
choosing of the securities to be used to liquidate the loan, by the repledgee. In spite of the apparent holding in the Pippey Case, Federal Courts have refused to follow it where there are several claimants similarly situated, and instead of permitting favoritism of chance or design inherent in the Pippey’s rule, the principle of general average is adopted.9

Both Pippey and Mrs. Ricker in the Archer Case had an equity of outstanding merit. The act of their brokers in pledging their stock without authority was a conversion and perhaps tantamount to embezzlement. If authority exists to pledge, the equity of those permitting it is obviously inferior to those who do not.

One who has originally given authority to hypothecate may acquire the superior and perhaps primary equity of one not giving authority to hypothecate, if upon conversion of the securities rightfully pledged, and upon a restatement of the whole account, as a result of the conversion there exists a credit balance in favor of the one originally giving authority to hypothecate, such restatement being made as of the date of the filing of the petition in bankruptcy.10 The apparent theory upon which this is based seems to be that at the moment the debit of the customer is wiped out the right of the broker to hypothecate no longer exists; otherwise the customer would be financing the operations of the broker on his own account.

The foregoing has been only an enlargement of the general proposition that those who as marginal customers have a community of interest arising from the employment of a common agent are necessarily similarly situated and should bear the losses pro rata: First, in the case of excessive pledging; Second, in the case where there is a failure to keep a sufficient amount of a particular kind of stock on hand. These claimants form two general classes. If there is sufficient of a particular kind of stock on hand to meet the demand of the claimants therefor, there is no obligation that these claimants contribute to the loss suffered by claimants for another class of stock of which the broker has an insufficient amount on hand at the time of bankruptcy. The doctrine of general average is applied within the class and not between the classes except in the case of excessive pledge, and

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9 In re Archer, Harvey & Co., 289 Fed. 267 (1923). See 35 Yale L. J. 92. A suggestion is here made that a suit for marshalling of the securities would probably lie against the Trust Company by one of the original owners of the wrongfully pledged securities.

10 Black on Bankruptcy 474; In re Ennis (Ex parte Bamford), 187 Fed. 720 (1811).
there may be many claimants of many kinds of stock excessively pledged, yet they are all similarly situated so far as excessive pledging is concerned.

As has been said the re-pledgee (generally a bank financing the broker) has a lien upon the securities, the general property thereof being in the customers who are subrogated to the place of the bankrupt broker and have of course the right of redemption. Though the general theory of law is that a converter can pass no title as against the owner of the converted chattel or personal property, yet no case has been found denying the right of the re-pledgee to a lien upon the securities wrongfully pledged by the broker. This is probably due to the fact that the loan by the re-pledgee is made in good faith coupled with an estoppel against the customer to dispute the re-pledgee’s right because he has put the broker in a position of dealing with his securities as his, the broker’s own; and also because of the high degree of transferability of shares of stock.

It is said in the case of In re Mason (Dier v. Steer):¹¹

“Marginal traders, who may have desired to save themselves any loss could have paid up the amount due on their purchases and demanded their stock, and thus put themselves in a preferred class, on an equality with those who paid for their stock in full before bankruptcy.”

Also in another controversy growing out of the same liquidation,¹² it is said that a claimant is entitled to reclaim stock pledged without authority by the bankrupt from the trustee in bankruptcy.

In the nature of things this right of redemption must be limited to the securities coming into the actual possession of the trustee in bankruptcy. In the case of excessive pledging the bank could not be forced to surrender single securities since its advance was made upon the security of the entire hypothecation; its whole loan must first be paid. The unanimity required among claimants for the redemption of the whole loan would reduce the worth of any supposed individual right of redemption to zero. Practically, then, redemption is limited to the securities in the hands of the trustee.

But in the case of excessive re-pledging which always accompanies a brokerage failure, what rights have the marginal traders against the general estate of the bankrupt for the excess above the amount due upon their stock?

¹² In re Mason (Kier v. Burch), 284 Fed. 714 (1922).
There can be no obligation to supply a deficiency of stock, the breach of the fiduciary obligation to keep a proper amount on hand occurred before bankruptcy, and the trustee cannot be required to perform the bankrupt's fiduciary obligations. However the bankrupt has a right to redeem pledged stock up to the moment of bankruptcy. And as a corollary to that, the bankrupt should have the right to repair deficiencies in amounts of stock up to bankruptcy. To return to the original question, the general estate of the bankrupt should not be liable for the excess of the pledging by the broker. It seems in that case that a state of equality is reached with the situation in which claimants find themselves where there is a deficiency of stock "in the box," and the loss occasioned by the excess of re-pledging should be born pro rata among the members of the class. In either of the above cases, the bankrupt has been using customers' funds to pay his own debts.

At the present time a discussion of the question herein involved, aside from the principle of general average, is in a large part conjectural, for the situations of various claimants in a brokerage failure have a multitudinous diversity and variance from one another, many of which have not yet been before the courts of last resort.