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DAMAGES FOR CONVERSION OF STOCK BY BROKERS

Purchasing stock on margin has been, is, and probably will continue to be a common practice in Pennsylvania. In a transaction of this nature the buyer furnishes a portion of the purchase money, or none at all as the case may be, and the broker through whom he purchases furnishes the balance or all of it. The broker who uses his funds to make the purchase secures himself by retaining the buyer's newly acquired stock until the buyer pays the balance due plus commissions and expenses. The relationship thus established by this retention is that of pledgor and pledgee, the customer being the former, the broker the latter.¹

In his position as pledgee the broker has the right to use the pledged stock in certain ways without being guilty of conversion. His rights in this regard may be summed up briefly as follows :

"One to whom stock has been pledged for a loan has full power to hypothecate it so long as the original pledgor may obtain possession of it upon payment of his debt; but if it has been mingled with other securities of the pledgee, or has been rehypothecated by him to secure a different or larger debt than that for which it was pledged to him, or if the collaterals have been transferred, but the obligation they were given to secure retained, or if it has in any way been placed beyond the control of the pledgee, this is a conversion."²

This statement is by way of dicta, it is true, but it is sufficient to indicate some ways in which brokers can convert their customer's stock. Again our problem is not what constitutes conversion but assuming a conversion occurs, what are the respective remedies and rights of the broker and customer?

There are, it seems, two particular problems which arise in the situation where a broker converts his principal's stock; first, the broker's right against the buyer to recover any balance due on the purchase price, and, second, the buyer's right to recover damages from the broker.

Taking up the first point it is to be noted that ever since the case of *Sproul v. Sloan*³ Pennsylvania has held, until very recently, that the broker by converting the stock has lost all right to recover from the customer any balance due. In the words of the court :

"The conversion operated as a matter of law as an extinguishment

¹Learock v. Paxson, 208 Pa. 602 (1904).

²Sproul v. Sloan, 241 Pa. 284 (1913).

³Supra note 2.

of the entire indebtedness of the customer for the purchase price of the securities converted."

In the recent case of *Otis v. Medoff*¹ the court finally concluded that its prior ruling in *Sproul v. Sloan* was fallacious. The court says, *inter alia*,

"The cases of *Sproul v. Sloan*, *Darr v. Fidelity Title and Trust Co.*, *Sterling's Estate*, and *Berberich's Estate*, are expressly over-ruled so far as they hold that a conversion by a broker operates as a matter of law as an extinguishment of the entire indebtedness of the customer for the purchase price of the securities converted."

At first glance the old rule seems more equitable than the new one. It seems only proper that the broker should be punished for his breach of trust. On the other hand, conversion by a broker is a criminal offense² and thus the broker would be punished twice for the same misdeed. The court in *Otis v. Medoff* says concerning the old rule,

"It results in palpable injustice. It deprives the broker of all right to recover even though the customer's loss may actually be only a fraction of the broker's claim. It is an exception to the general rule that the measure of damages for a wrong done is compensation for the loss sustained. There is no reason, in law or equity, why an exception should be made in this class of cases."

Indeed the only case³ which attempted to give a reason for the extinguishment of the broker's claim based its reasoning on an unnecessary and false premise; namely, the broker having breached the contract could not demand performance. The court in *Otis v. Medoff* in speaking of its reasoning in *Sproul v. Sloan* says,

"This argument is fallacious. A broker's claim arises when he purchases stock for a customer and advances the purchase price. Immediately upon the purchase the stock becomes the customer's property, but it remains in the broker's possession as security for the advances and commissions. The relation between the parties is that of pledgor and pledgee. If the broker makes a wrongful repledge of the stock it is undeniably a conversion, for which he is liable in damages, but it is not a breach of contract to advance the price and purchase the stock, which is the foundation of the customer's indebtedness. It is at most only a breach of his duty as pledgee. This breach can be fully compensated for by an off-set of the customer's damages for the conversion against the broker's claim."

¹311 Pa. 62 (1933).

²Fraudulent Conversion Act, the Act of May 18, 1917, P. L. 241; 18 P. S. 2486.

³Supra note 2.

This, then, brings up the second problem; the customer's right to recover damages from the broker. Perhaps the leading case on this question is *Gervis v. Kay*.⁷ It is true that the rule laid down in this case must be confined to conversion by honest mistake. In such case the measure of damages is the highest value of the stock between the date of the conversion and a reasonable time after notice thereof. However, the court in an exhaustive opinion clearly holds that the only time when the rule of *Sproul v. Sloan* and *Learock v. Paxson*⁸ is to be applied is when there is a deliberate breach of trust by the broker or a failure to deliver specific stock when it is the intention of the customer and the broker that the customer is to receive such stock. In other words, where the broker deliberately converts the buyer's stock to protect or further his own interests at the expense of the customer's, then the customer may recover the highest value of the stock between the date of the conversion and the date of the trial. Hence it seems that the further implication is that inasmuch as the above rule applies only to deliberate breach of trust then the rule of *Gervis v. Kay* would apply to all other cases of conversion by brokers.

However this may be, all controversy is apparently eradicated by the Act of 1929, P. L. 476. This statute, in brief, is as follows;

"In any proceedings * * * * in which damages are claimed for the conversion of stocks, bonds, or other like property of fluctuating value, the damages shall be limited to the difference between the proceeds of the conversion, or that portion thereof duly paid or credited to the owner, and such higher value as the property may have reached within a reasonable time after he had notice of the conversion. Where the facts are not in dispute this period shall be fixed by the court as a matter of law."

Unfortunately, there are as yet no appellate decisions on this statute. There are, it is true, several lower court cases,⁹ only one of which is directly on the statute.¹⁰ This case, in short, says that the Act of 1929, P. L. 476 is the case of *Gervis v. Kay* codified and hence interprets the statute as making the measure of damages the difference between the value of the stock at the time of the conversion and the highest value it attains within a reasonable time thereafter. The rule as stated in this case is unfortunately ambiguous. There is a vast difference between the measure of damages when the rule is "a reasonable time *after notice* of conversion" and "a reasonable time after conversion." However, inasmuch as the case cites the statute as its author-

⁷294 Pa. 518 (1928).

⁸Supra notes 1 and 2.

⁹*Fitchthorne v. Barclay, Moore & Co.*, 14 D. & C. 83 (1930); *Pollock's Estate*, 15 D. & C. 147 (1931).

¹⁰*Calloway v. Clucas, et al.*, 16 D. & C. 453 (1932).

ity and speaks of it as *Gervis v. Kay* codified, it seems that the court must have meant "a reasonable time after notice of the conversion."

Examining the so-called New York rule, which is the basis of the decision in *Gervis v. Kay*, it appears that the rule there is that the measure of damages is the highest value of the stock between the date of the conversion and a reasonable time after notice thereof.¹¹ Thus it seems, with the ruling of the courts of other jurisdictions, that Pennsylvania will interpret the Act of 1929, P. L. 476 as making the measure of damages the highest value of the stock between the date of the conversion and a reasonable time after notice thereof. It must be kept in mind that the statute applies to all cases of conversion by brokers whether it be by honest mistake or deliberate fraud.

There remains but one additional matter to consider; namely, what constitutes a reasonable time. By the statute such time is a matter of law when the facts are not in dispute. Normally it means sufficient time under the circumstances (the financial ability of the customer not considered)¹² in which the customer can go into the market and purchase additional shares of like stock as those converted.¹³ In one late case¹⁴ the court held that under the circumstances that normally occur a reasonable time varies from fifteen to sixty days after notice.

In summing up, then, the law in Pennsylvania seems to be, in cases of conversion by brokers, as follows: first, the broker is entitled to recover any balance of the purchase price due him less the damages for the conversion.¹⁵ Second,

¹¹In a note in the *Pennsylvania Law Review*, Vol. 78, December issue, No. 2, the writer states that the New York rule is that "the measure of damages is the highest value the stock attains a reasonable time after notice of the conversion", and not "the highest value the stock attains between the date of the conversion and a reasonable time after notice thereof". For example, suppose the broker converts the stock on July 1st, and the buyer gets notice of the conversion on July 21st. Suppose further that a reasonable time is ten days. According to the rule as stated by this writer for New York, the buyer could recover the highest value of the stock between July 21st and July 31st. According to the rule which he says does not apply, the buyer could recover the highest value the stock attained between July 1st and July 31st. The writer of this article further contends that the rule in Pennsylvania is the same as he claims is applied in New York, by force of the Act of 1929, P. L. 476. A careful examination of the New York cases will show that although this interpretation might readily be drawn from a hasty examination of them, the rule is in fact both in New York and Pennsylvania, "the measure of damages is the highest value the stock attains between the date of the conversion and a reasonable time after notice thereof."

Baker v. Drake, 53 N. Y. 211 (1853); *Gruman v. Smith*, 81 N. Y. 25 (1880); *Keller v. Halsey*, 115 N. Y. S. 564 (1909); *Peschke v. Wright*, 156 N. Y. S. 773 (1916); *In re Dickinson*, 157 N. Y. S. 248 (1916); *Langford v. Fessenden*, 203 N. Y. S. 301 (1924).

Other jurisdictions apply the New York rule as well; *Galigher v. Jones*, 129 U. S. 193 (1888); *Ling v. Malcom*, 77 Conn. 517 (1905).

¹²*Ling v. Malcom*, 77 Conn. 517 (1905).

¹³*Supra* notes 7 and 12.

¹⁴*Mayer v. Monzo*, 221 N. Y. 442 (1917).

¹⁵*Supra* note 4.

the measure of damages to which the customer is entitled is the highest value which the stock may attain between the date of the conversion and a reasonable time after notice¹⁶ thereof.¹⁷ Third, a reasonable time is that period in which the customer could after notice of the conversion go into the market and purchase like shares of stock as those converted by the broker.¹⁸ Fourth, this period is a question of law and hence determined by the court,¹⁹ it normally being a period of fifteen to sixty days depending upon the circumstances.²⁰

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APPEALS BY THE COMMONWEALTH IN CRIMINAL CASES

Lawyers as well as legal teachers and students undoubtedly will recognize the importance of the Court's holding in the recent case of *Commonwealth v. Simpson*¹ as to the right of the Commonwealth to appeal in criminal cases. It marks a step forward in the protection of both personal and property rights. Quoting from the decision—

"This is what we intended when we said in *Commonwealth v. Wallace*, 114 Pa. 405, 411, 6 Atl. 685, 687, 'For error in quashing an indictment, arresting judgment after verdict of guilty, and the like, the Commonwealth may remove the record for review without special allowance of the proper writ'. By the words 'and the like' we meant cases in which the ruling is against the Commonwealth on pure questions of law. Our determination is therefore that the Commonwealth has the right to appeal."

¹⁶Notice of conversion may be actual or constructive. In other words, the customer may acquire notice of the conversion by written or oral information from the broker or, the circumstances may be such that although the customer has received no actual notice he could not have possibly been ignorant of it.

Dinock v. U. S. National Bank, 55 N. J. L. 296 (1893); *Galigher v. Jones*, 129 U. S. 193 (1888); *Mayer v. Monzo*, supra note 14.

¹⁷Supra note 7; Act of 1929, P. L. 476.

¹⁸Supra notes 7 and 12.

¹⁹Supra note 7; Act of 1929, P. L. 476.

²⁰Supra note 14.

¹310 Pa. 380, 165 Atl. 498 (1933) where the Commonwealth appealed from an order of the lower court in overruling its demurrer to plea of former jeopardy entered by defendant to an indictment of murder on which he was about to be tried, giving judgment for him on the plea and discharging him from the indictment.