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STOCKBROKERS' BANKRUPTCIES: PROBLEMS CREATED BY THE CHANDLER ACT†

By JOHN A. GILCHRIST* 

One of the most difficult problems facing the draftsmen of the recently enacted amendments¹ to the Bankruptcy Act related to stockbrokers' bankruptcies. Under the prior law which contains no provision specifically dealing with proceedings involving stockbrokers, the rights of the brokers' customers had been judicially determined in accordance with widely divergent state laws. Customers were ranked in a variety of classes depending on the circumstances of their dealings with the bankrupt. Decisions on this subject were consequently in hopeless conflict.

Sound administration of federal statutes depends largely upon their uniform application. Where federal law rests on state jurisprudence, uniformity is impossible. Therefore, the framers of sec. 60e of the Chandler Act, as this recent legislation is known, wisely intended² to exclude the application of conflicting state rules by formulating a scheme of distribution of the assets of bankrupt stockbrokers based to a large extent, although not completely, on the so-called Massachusetts rule.

Designed to bring order out of chaos, sec. 60e constitutes a great and desirable advance over the old law. Yet, while it lays to rest old conflicts, it gives birth to new problems which issue principally from the inconsistencies of the language of that section, but also, to some extent, from its constitutional aspects.

A thorough understanding of the purpose, operation and effect of sec. 60e is of vital importance to the investing public, and their legal representatives, who wish to protect their rights in stockbrokers' bankruptcies. Prerequisite to an analysis of that section, however, is a brief consideration of the law which it was intended to supplant.

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†Acknowledgment is made of the invaluable assistance received from Mr. Paul Cleveland, former assistant professor of law at the University of Chicago, now of New York City.
¹Public—No. 696—75th Cong., approved June 22, 1938.
²Sec. 60e (5) specifically excludes the application of "the laws of any state" from a determination of the rights of customers inter sese.
Customers' Right of Reclamation Under Prior Law

Under the applicable state law two conflicting views developed as to the trustee's title to stock which the broker had in his possession or which he had repledged as security for loans at the time of the bankruptcy.

By the so-called Massachusetts rule the broker in margin transactions was regarded as the owner of the security purchased on margin and his title thereto in general passed to the trustee. By the so-called Massachusetts rule the broker in margin transactions was regarded as the owner of the security purchased on margin and his title thereto in general passed to the trustee. The Massachusetts courts looked upon the broker as carrying the stock on an executory contract to purchase or sell, and held that the relationship between him and his customer was that of creditor and debtor. A similar debtor-creditor relationship was regarded as extending to securities deposited by the customer with the broker for use as margin.

However, this theory was not consistently applied in bankruptcy cases; both state and federal decisions in Massachusetts have held that, upon payment of the balance due, a customer who had deposited stock as margin which was still identifiable, could reclaim it upon the insolvency or bankruptcy of the broker. In addition, the customer under the Massachusetts rule was regarded as the owner of securities delivered for safekeeping or which, if purchased by the broker for the customer's account, had been fully paid for and could be specifically identified by certificate number, by tags attached to the certificate, or by similar means.

Although the Massachusetts rule treated the relationship between customer and broker as debtor and creditor, in practice it

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7As used throughout this discussion, "reclaim" means "recover property belonging to the claimant or customer."
8To be sure, if the customer could not identify his stock and had not
approached the so-called New York rule, which was the prevailing view. Under the latter doctrine the broker was the agent for the customer in purchasing or selling securities.\(^8\) In margin transactions he became a pledgee as well.\(^9\) The customer was regarded as the owner of the shares, if he could identify them as his own, whether they had been delivered for safekeeping and segregated, or delivered to the broker as margin or purchased by the broker for the customer's account and held in pledge.\(^10\) Moreover, this ownership extended even to securities which the customer could not identify by specific certificate number or which had not been tagged with his name.\(^11\)

fully paid therefor, the Massachusetts cases indicate that he could not reclaim, but was in the position of a general creditor. (See footnote 4, supra.) The federal bankruptcy cases, however, in the first circuit, though paying lip service to the Massachusetts rule, which they were supposed to follow (Bryant v. Swofford Bros. Dry Goods Co., (1909) 214 U. S. 279, 29 Sup. Ct. 614, 53 L. Ed. 997), in fact tended to permit reclamation in cases where it was difficult to see that the debtor-creditor relationship had ended and title had passed to the customer. See Lavien v. Norman, (C.C.A. 1st Cir. 1932) 55 F. (2d) 91; Denton v. Gurnett & Co., (C.C.A. 1st Cir. 1934) 69 F. (2d) 750; Leonard v. Hunt, (C.C.A. 1st Cir. 1929) 36 F. (2d) 13. Of course, if a specific certificate had been re-transferred and registered in the customer's name, or if the customer could specifically identify his stock by certificate number as stock allocated to him in the memorandum of sale, or if a specific certificate had been segregated for him physically and his name marked thereon, he was entitled to reclaim, if he had fully paid for the stock. (See Lavien v. Norman, (C.C.A. 1st Cir. 1932) 55 F. (2d) 91; Denton v. Gurnett & Company, (C.C.A. 1st Cir. 1934) 69 F. (2d) 750.) The recent cases, however, went even further and permitted a customer to reclaim where he had a free credit balance even though he originally bought on margin. One first circuit case went to the extent of holding that where a customer had ordered certain utilities stock and that was the only order in such stock given that month and the stock was found in the broker's possession, unidentified by certificate number, unsegregated and held in a "street name," nevertheless the customer could reclaim, upon tender of the amount still due, even though he had not fully paid for the stock. Denton v. Gurnett & Company, (C.C.A. 1st Cir. 1934) 69 F. (2d) 750. Another recent case, presumably applying the Massachusetts rule, held that the relation of pledgor and pledgee, rather than creditor-debtor, existed with respect to securities deposited with the broker for margin. Lavien v. Norman, (C.C.A. 1st Cir. 1932) 55 F. (2d) 91.

\(^8\) See Meyer, Stock Brokers and Stock Exchanges (1931) secs. 39 and 41, and cases there cited.


In order to reclaim his securities from the broker's trustee in bankruptcy the customer had to be able to trace them. That is, he had to find them among those in the possession of the bankrupt or of the person to whom the broker had rehypothecated them. If he could not trace he could not reclaim, and would be relegated to his rights as a general creditor. Tracing, however, did not require specific identification of particular certificates of stock or of specific bonds. Securities were deemed sufficiently traced if securities of the same kind were found in the possession of the broker or of the broker's pledgee. Thus, the courts accepted the business viewpoint that shares of stock, like bushels of wheat, are fungible. The Supreme Court also felt that the broker should be presumed not to have wrongfully disposed of his customer's stock. Thus, when insolvency occurred, the customer as owner of 100 shares of United States Steel could specifically reclaim any 100 shares, provided the broker had enough of that stock on hand to meet his obligations.

If the securities could be identified by certificate number, the customer could reclaim them in full if they were found "in the box," i.e., in the possession of the broker. If found in the possession of the broker's pledgee, they could be reclaimed in full subject to the "burden of the loan."

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13In re Byrne, (C.C.A. 2d Cir. 1929) 32 F. (2d) 189.
14See cases cited in footnote 12, supra.
15In Richardson v. Shaw, (1908) 209 U. S. 365, 28 Sup. Ct. 512, 52 L. Ed. 835, Mr. Justice Holmes stated:
16"... it is possible to say that after a purchase of stock is announced to a customer he becomes an equitable tenant in common of all the stock of that kind in the broker's hands, that the broker's powers of disposition, extensive as they are, are subject to the duty to keep stock enough on hand to satisfy his customers' claims, and that the nature of the stock identifies the fund as fully as a grain elevator identifies the grain for which receipts are out."
17See cases cited in footnote 10, supra.

"Burden of loan" is descriptive of a situation where the broker's pledgee, after the filing of the petition in bankruptcy, sells the securities of some of the broker's customers and leaves the securities of other customers unsold. In such cases the customers whose securities remain unsold should have no greater rights than the customers whose securities were sold, and such is the general rule. See Sexton v. American Trust Company, (C.C.A. 8th Cir. 1930) 45 F. (2d) 372; Vance Lumber Company v. Frazer, Goodwin & Colver, (1921) 162 Wash. 347, 298 Pac. 438; In re James MacFarlane & Co., (W.D. Wash. 1926) 14 Fed. (2d) 817; Duncan v. Johnston & Co., (C.C.A. 6th Cir. 1925) 3 Fed. (2d) 422; In re J. C. Wilson & Co., (S.D. N.Y. 1917) 252 Fed. 631. But see In re T. A. McIntyre & Co., (Appeal of Pippey), (C.C.A. 2nd Cir. 1910) 181 Fed. 955 (which has
Securities which could not be traced by certificate number but which were found in quantities sufficient to satisfy the demands of all claimants could also be reclaimed in full if found “in the box.” If found in the possession of the broker’s pledgee, such securities could be reclaimed in full, subject again to the burden of the loan and also to the rights of creditors of a superior class, if any such class existed. Typical of a superior class of creditors were customers whose securities were wrongfully repledged by the pledgee; such customers were given priority as “Class A claimants” over those whose securities were rightfully repledged, who were called “Class B claimants.” This priority existed even when the Class B claimants had been able to trace specific securities.

Securities which could not be traced by certificate number and which were found in quantities insufficient to satisfy the demands of all claimants to that particular kind of securities, if found “in the box” could be reclaimed pro rata by the claimants entitled to securities of that particular company and issue. If found in the possession of the broker’s pledgee they could be reclaimed pro rata, again subject to “the burden of the loan” and the rights of any superior class of creditors. Thus, the New York rule, coupled with this doctrine of tracing, often permitted some customers to fare well and others to fare poorly.

repeatedly been distinguished and disapproved); and also Leonard v. Hunt, (C.C.A. 1st Cir. 1929) 36 Fed. (2d) 13 (where the judge, in striving to permit reclamation under the Massachusetts rule, completely lost sight of this doctrine of ratable distribution).

If the proceeds of the pledged securities remaining after the pledgee has satisfied his claims are insufficient to satisfy the demands of all claimants of the same class, the securities which remain after the liquidation by the pledgee are forced to contribute pro rata to those which did not survive liquidation.


In re Ennis, (C.C.A. 2nd Cir. 1911) 187 Fed. 720.


See cases cited in footnote 21, supra.

Suppose a simple case: The broker, at the time of the bankruptcy, had on hand sufficient copper stock “in the box” to cover his commitments.
Where a customer had deposited, against a future purchase, money with a broker who became bankrupt without executing the order, the former was permitted to reclaim his property, or the proceeds thereof, if he could trace it even under the Massachusetts rule. And under the New York rule a customer was permitted to reclaim cash shown to be the proceeds of the securities delivered by the claimant to the broker for sale.

**Primary Purpose and Scheme of Act**

The primary objective of the draftsmen of sec. 60e of the Chandler Act was to eliminate, as far as possible, the old classifications of customers inter sese. Only “cash customers” who owe

to his customers who had dealt in copper stock. Those customers would lose nothing. Those who had completely paid for their stock would be entitled to the number of shares purchased. The margin customers would be entitled to the shares which they had purchased on payment of the amount due on their margin account. They would, in effect, be treated as tenants in common and pledgors of the fungible mass of copper stock. If there was only 90 per cent enough copper to satisfy the broker’s commitments, the copper customers shared pro rata in the amount on hand, thus receiving a 90 per cent dividend, and became general creditors for their remaining 10 per cent claim. On the other hand, suppose the broker had no stock on hand or in pledge to cover his commitments to customers who had dealt in a rail stock. These customers would be general creditors for their full claims and might perhaps receive only a small dividend. Particular customers fared well or poorly, depending on the chance circumstances of whether or not the broker had much or little of the particular stock in which they were interested at the date of bankruptcy.

24In re Tracy, (S.D. N.Y. 1911) 185 Fed. 844.

25Thus, where the broker deposited such money in his bank account, the customer was entitled to satisfy his claim therefrom. In re Wettengel, (C.C.A. 3rd Cir. 1916) 238 Fed. 798; In re Ruskay, (C.C.A. 2nd Cir. 1925) 5 F. (2d) 143; In re Shapiro Bros., (S.D. N.Y. 1923) 298 Fed. 196.

26In re Brown, (C.C.A. 2nd Cir. 1910) 185 Fed. 766; In re Pynchon, (C.C.A. 2nd Cir. 1933) 63 Fed. (2d) 350. The circuit court of appeals for the second circuit declared in In re Byrne, (C.C.A. 2d Cir. 1929) 32 F. (2d) 189, 190:

“To get any standing, except as general creditors, they must identify the original assets, or trace them into other specific funds which came into the trustee’s hands. It is not enough to show that they were converted by the bankrupts, or indeed that they may have generally enriched their estate.”


28In re Byrne, (C.C.A. 2d Cir. 1929) 32 F. (2d) 189. In Lavien v. Norman, (C.C.A. 1st Cir. 1932) 55 F. (2d) 91, the circuit court of appeals for the first circuit permitted a customer to reclaim cash representing the proceeds of securities purchased through the bankrupt on a cash basis.

29Since the draftsmen of the Chandler Act desired to eliminate the old classifications of margin customers, they concentrated mainly upon the rights of such customers and apparently, so far as the legislative documents bearing upon section 60e disclose, gave no deep consideration to the rights of the customer who did not enter into margin transactions.

At the hearings before the House Committee on the Judiciary, Mr.
nothing for specifically identifiable securities, receive special treatment under the new law; they are permitted to reclaim such securities and thereby gain priority over other customers.

Harry Zalkin, who was a member of the Bankruptcy Conference and the chief draftsman of sec. 60e, declared:

"Subdivision (e) has been added in order to make uniform the rules applicable to the liquidation of the assets of bankrupt stockbrokers and to secure greater approximation to equality in distribution, especially to margin customers. . . . To secure practical equality for the margin customers, the trustee must be put in a position other than that occupied by him under the prevailing rule. . . ."

"Under 'e(2)' it is provided that cash customers unable to identify their property, as prescribed in clause 4, shall be classified with margin customers, and for the purpose of securing equality of treatment of margin customers and such cash customers, they shall participate ratably in a single and separate fund comprised of all property acquired by the broker from the beginning of his insolvency from or for margin customers and such cash customers. Under this subdivision the accounts of margin customers and those of the cash customers who are unable to identify their securities [will be] valued at market prices and the net equity determined by deducting therefrom any debit balances, and on the basis of this net equity they will participate pro rata in the distribution of the separate fund created."

"In such matter there will be avoided the usual situation where customers actually in the same class receive varying percentages out of the same fund."

"Under the prevailing rule stocks are treated as fungible goods, having 'no earmark which distinguishes one share from another, but is like grain of a uniform quality in an elevator, one bushel being of the same kind and value as another.' Accordingly, equality of distribution should not be prevented by the chance circumstance that one margin customer may be able to identify by number a certificate purchased for his account, when as a matter of fact and practice no such significance is attached by the broker to that particular piece of paper in his dealings. Clause 4 therefore provides that unless the certificate is specifically allocated or physically set aside, it must be thrown into the fund for distribution to all customers of the single class." (Hearings on H.R. 6439, House Com. on Judic., 65th Cong., 1st Sess., pp. 96, 97.)

Mr. Zalkin's remarks were embodied in the House Report on this bill, Rep. No. 1409, 75th Cong., 1st Sess., p. 31.

Professor James A. McLaughlin, another member of the Bankruptcy Conference, declared at the same hearings:

"We are trying to put all these customers whose money has gone into the security account of the broker in one boat and do away with the present situation which, as I say in my article, involves discriminations based on mere chance that are more appropriate to a beano party than to the administration of justice." (Hearing on H.R. 6439, ibid., p. 127.)

The rights of "non-margin" customers were discussed by Professor McLaughlin in Aspects of the Chandler Bill to Amend the Bankruptcy Act, 4 U. Chi. L. Rev. 369, 397-398:

"Even the so-called 'cash' customer who delivers his security for sale to the broker and gets caught in a 'last day transaction' has in fact trusted the general credit of the broker when he has not insisted upon the instantaneous payment of cash against delivery and when he has taken no steps to see that the proceeds of his transaction are segregated. The fact that many brokers would not bother with a customer who made such unusual requests merely means that it has become customary for persons dealing
The framers of that statute did not, however, intend to relegate other customers to the status of general creditors. Indeed, sec. 60e bestows on customers, as a group, priority over other creditors of the bankrupt broker by designating the former as a "single and separate class of creditors" who are entitled to share in a single and separate fund created by sec. 60e(2) and then, if their claims are not satisfied therefrom, by permitting them to participate in the general estate with general creditors. Thus, customers receive better treatment under the new Act than under the prior law which classified them as general creditors if they were unable to trace their property.30

In short, sec. 60e sets up a scheme of distribution by dividing claimants into three classes: (1) cash customers, (2) all other customers, and (3) general creditors. The operation of this section is more clearly understood by considering, first, the fund available to customers and, then, the persons entitled to share in that fund.

A. The Single and Separate Fund.—This single and separate fund is created by sec. 60e(2) which stipulates:

"All property31 at any time received, acquired or held by a stockbroker from or for the account of customers, except cash customers who are able to identify specifically their property in the manner prescribed in paragraph (4) of this subdivision and the proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker, shall constitute a single and separate fund; and all customers except such cash with stockbrokers to allow the stockbroker to throw their securities and money into a common pot...."

"If one approaches the problem from the point of view of customers, it is indisputable that the different degrees in which different customers trust the broker run through such a wide range that many possible distinctions might logically be taken. At the same time it is abundantly clear that the existing law turns upon refinements utterly unintelligible to the business man and involves elements of chance more appropriate to a beano party than to the administration of justice. If the problem be approached from the point of view of ease and economy of administration, the solution of the Chandler Bill warrants a high rating. Apart from weaknesses that may lurk in the imperfections of draftsmanship inevitably to be suspected when attempt is made at a partial codification of law governing complicated commercial transactions, the Bill is probably most vulnerable to temperate criticism from the point of view of those who would insist upon priority for cash customers who are diligent in seeing that their cash transactions are executed. As Mr. Glenn has sagely remarked, however, any reasonable man ought to know that a broker's office is no place to leave money or securities for safe-keeping." (Italics added.)

30In re Byrne, (C.C.A. 2d Cir. 1929) 32 F. (2d) 189.
31Section 60e(1) declares, inter alia, that:

"'Property' shall include cash, securities, whether or not negotiable, and all other property of similar character; ..."
customers shall constitute a single and separate class of creditors, entitled to share ratably in such fund on the basis of their respective net equities as of the date of bankruptcy: Provided, however, That such fund shall to the extent approved by the court be subject to the priority of payment of the costs and expenses enumerated in clauses (1) and (2) of subdivision a of section 64 of this Act. If such fund shall not be sufficient to pay in full the claims of such class of creditors, such creditors shall be entitled, to the extent only of their respective unpaid balances, to share in the general estate with the general creditors."

Some confusion, with respect to the property to be included in this fund, is caused by the punctuation in this paragraph. Because of the insertion of a comma after "customers" in the second line and after "stockbroker" in the sixth line and because of the failure to insert a comma after "subdivision" in the fourth line, it might be urged that the fund in which customers are entitled to share would not include the "proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker" and that customers whose property was so transferred or converted should be relegated to the position of general creditors.

Such an interpretation of paragraph (2) cannot be sustained by sound reasoning and is completely refuted by the provision contained in paragraph (4),32 and by the legislative history of this paragraph.33 Consequently, since the single and separate fund shall consist of "All property at any time received, acquired or held by a

32Paragraph (4) provides, inferentially, that property received by a stockbroker, and any substitute therefor or proceeds thereof shall constitute part of the fund for all customers unless such property should remain in its identical form "or unless such property or any substitutes therefor or the proceeds thereof were, more than four months before bankruptcy or at a time while the stockbroker was solvent, allocated to or physically set aside for such customer, and remained so allocated or set aside at the date of bankruptcy."

33The Chandler Bill when first introduced, H.R. 12889, provided merely that "All property at any time acquired or received by a stockbroker from or for the account of margin customers, or from customers whose property has been converted by a stockbroker, or from cash customers, who are unable to identify their property in manner as prescribed in clause (4) of this subdivision, shall constitute a single and separate fund." Substantially the same provision was contained in H. R. 6439. By this provision the single and separate fund would include all property received by the stockbroker from customers except property which would be identified as belonging to cash customers. In H.R. 8046, section 60e(2) first appeared in form substantially like the section as enacted. In that Bill, as of July 28, 1937, no comma was inserted after "subdivision" nor in that Bill as of August 9, 1937. However, in that Bill as of April 20, 1938, a comma was inserted after "subdivision" and the comma was retained in the Bill up to and including June 11, 1938. However, the comma was omitted when the Bill was passed.
stockbroker from or for the account of customers ... and the proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker," it is necessary to trace the customers' property in order to bring it within this fund. In order to accord customers, as a class, priority over general creditors, it would seem that the proceeds of such property need only be traced in substantially the same manner as in bankruptcy proceedings prior to the enactment of this new law.

In addition, paragraph (5) gives the trustee the right to recover, for the benefit of the single and separate fund, property conveyed by the stockbroker which would otherwise have constituted part of such fund where such fund is not otherwise sufficient to pay the claims of the single and separate class, and thereby abrogates the rule of Richardson v. Shaw.

Whenever any property remains after liquidation of a pledge made by the bankrupt, it is, by force of paragraph (3), apportioned between this fund and the general estate in the proportion in which customers' property and the bankrupt's general property contributed to the pledge. The manner of tracing property, for this purpose, should also be similar to that which existed under the former law.

34 Paragraph (2); underscored added.
35 Paragraph (5) stipulates:
"Where such single and separate fund is not sufficient to pay in full the claims of such single and separate class of creditors, a transfer by a stockbroker of any property which, except for such transfer, would have been a part of such fund may be recovered by the trustee for the benefit of such fund, if such transfer is voidable or void under the provisions of this Act. For the purpose of such recovery, the property so transferred shall be deemed to have been the property of the stockbroker and, if such transfer was made to a customer or for his benefit, such customer shall be deemed to have been a creditor, the laws of any state to the contrary notwithstanding. If any securities received or acquired by a stockbroker from a cash customer are transferred by the stockbroker, such customer shall not have any specific interest in or specific right to any securities of like kind on hand at the time of bankruptcy, but such securities of like kind or the proceeds thereof shall become part of such single and separate fund; Provided, however, That a customer shall have a specific title to securities (a) which have been physically set aside by a stockbroker, more than four months before his bankruptcy or while solvent, in safekeeping for such customer, and so retained until the date of bankruptcy, regardless of the name in which such securities are registered, or (b) which a stockbroker, more than four months before his bankruptcy or while solvent, caused to be registered in the name of such customer."

The reference in paragraph (5) to transfers "voidable or void under the provisions of this Act" is to section 60a and b, which relates to preferences, and to sections 67d and 70e, which relate to fraudulent conveyances.

36 (1908) 209 U. S. 365, 28 Sup. Ct. 512, 52 L. Ed. 835.

37 Under the former rule, upon the liquidation of a bankrupt broker's loans, his own property was first used, and then that of his customers, in satisfaction of the loan. See In re Gay & Sturgis, (D.C. Mass. 1918) 251 Fed. 420.
Paragraph (2) excepts from this fund the property of "cash customers," (defined by paragraph (1) as "customers entitled to immediate possession of such securities without the payment of any sum to the stockbroker"), which they can reclaim when they "are able to identify specifically their property in the manner prescribed in paragraph (4) of this subdivision." Coordinately, paragraph (2) excludes such cash customers from the "single and separate class of creditors." The definition of "net equity," contained in paragraph (1), also indicates that only securities are reclaimable.

Yet paragraph (4), to which reference is made in paragraph (2), seems to be irreconcilably conflicting with paragraph (2) with respect to a customer's right to withdraw cash from this fund by reclaiming it. As provided by paragraph (4), "No cash received by a stockbroker from or for the account of a customer [as distinguished from a "cash customer" mentioned in the same sentence] for the purchase or sale of securities . . . or any substitutes therefor or the proceeds thereof, shall for the purposes of this subdivision be deemed to be specifically identified . . . ," unless the conditions, outlined in that paragraph, are satisfied.

Though stated negatively, paragraph (4) would seem to permit a person who delivered cash to a broker against a future purchase, or who delivered securities which were sold, to reclaim his money if he can meet the requirements of that paragraph. Yet such person, not being entitled to immediate possession of securities and therefore not a "cash customer," is denied the right to reclaim his money if he cannot meet the requirements of paragraph (4). Paragraph (4) states:

"No cash received by a stockbroker from or for the account of a customer for the purchase or sale of securities, and no securities or similar property received by a stockbroker from or for the account of a cash customer for sale and remittance or pursuant to purchase or as collateral security, or for safekeeping, or any substitutes therefor or the proceeds thereof, shall for the purposes of this subdivision be deemed to be specifically identified, unless such property remained in its identical form in the stockbroker's possession until the date of bankruptcy, or unless such property or any substitutes therefor or the proceeds thereof were, more than four months before bankruptcy or at a time while the stockbroker was solvent, allocated to or physically set aside for such customer, and remained so allocated or set aside at the date of bankruptcy."

Paragraph (1) also declares that:

". . . the same person may be a cash customer with reference to certain securities and not a cash customer with reference to other securities; . . ."

A possible implication arising from this provision is that a "customer" as well as a "cash customer" is given the right to trace and reclaim cash which he has delivered to a stockbroker in accordance with the provisions of this paragraph.

Paragraph (4) states:

"No cash received by a stockbroker from or for the account of a customer for the purchase or sale of securities, and no securities or similar property received by a stockbroker from or for the account of a cash customer for sale and remittance or pursuant to purchase or as collateral security, or for safekeeping, or any substitutes therefor or the proceeds thereof, shall for the purposes of this subdivision be deemed to be specifically identified, unless such property remained in its identical form in the stockbroker's possession until the date of bankruptcy, or unless such property or any substitutes therefor or the proceeds thereof were, more than four months before bankruptcy or at a time while the stockbroker was solvent, allocated to or physically set aside for such customer, and remained so allocated or set aside at the date of bankruptcy."

Section 60e(1).
trace his property by paragraph (2) which impliedly gives that right only to a "cash customer."\textsuperscript{42} By paragraph (2) the property of such customer constitutes part of the single and separate fund; by paragraph (4) it belongs entirely to the customer if he can identify it.

It would seem exceedingly difficult to solve the impasse created by paragraphs (2) and (4) on the basis of any construction which would give effect to the language of the entire section. A court might hold that the provisions of paragraph (2) are dominant. Under this construction only the identifiable securities of cash customers could be reclaimed. Such a construction would render meaningless a large portion of the language of paragraph (4). On the other hand, a court might hold that the provisions of the latter paragraph are dominant and must be read into paragraph (2). Such a construction would carve out another exception to the property going into the single and separate fund; the "specifically identifiable" cash of ordinary customers, as well as the "specifically identifiable" securities of cash customers, could be reclaimed.\textsuperscript{43}

It would be less of a departure from prior law to adopt the latter position and accord a right to trace property to customers other than cash customers. Such a construction would eliminate some of the possible constitutional objections and many of the harsh results which will be subsequently considered.

No matter how these two paragraphs are construed, sec. 60e may be open to certain constitutional objections. First, it may

\textsuperscript{42}See paragraph (2) and discussion on p. 62, supra.

\textsuperscript{43}To harmonize these two paragraphs it might be urged that paragraph (4) is intended to determine not only the property which a cash customer may reclaim but also the property which belongs to the single and separate fund; that only property which can be specifically identified, by the tests prescribed by that paragraph, as belonging to a customer, goes into the single and separate fund.

This construction, however, would be contrary to the intention of its draftsmen who intended that property which a cash customer could not specifically identify under the requirements of paragraph (4) should fall into the single and separate fund if it was received by the bankrupt from or for the account of the former. (See quotation from Mr. Zalkin’s remarks before the House Committee, footnote 29, supra.) This indicates that it was intended that property may belong to the fund under paragraph (2) even though a particular customer could not have reclaimed it under the requirements of paragraph (4). Further, such a construction would be contrary to the underlying purpose of the section to give priority to customers over general creditors.

Indeed, such a construction would create an absurd result, for securities or similar property, as distinguished from cash, received by a broker from or for the account of a customer, could not go into the single and separate fund.
authorize an unconstitutional taking of property without due process of law since, under any construction, it grants customers only a restricted right of reclamation. Second, it may overstep the federal bankruptcy power by attempting to distribute property not owned by the bankrupt. These objections blend to a great extent.

Suppose, for example, that a customer delivered money to a broker with an order to purchase certain stock at a definite price; that the broker immediately deposited that money in a special bank account for customers and became bankrupt before executing the order; that, by state law, the broker would be deemed a trustee of that money for the customer. Since the customer is not a "cash customer" and since his property has probably not remained in its "identical form" within the meaning of paragraph (4), sec. 60e would seem to deny him the right to reclaim his money from that bank account and to declare it to be part of the single and separate fund.

The Supreme Court has declared that the "bankruptcy power, like the other great substantive powers of Congress, is subject to the fifth amendment." In so far as sec. 60e denies a customer the right to reclaim his property, to which he has a right under state law, and gives that property to members of the single and separate class, it would seem to constitute a taking of property without due process of law.

Further, this provision would seem to exceed the federal bankruptcy power. The scope of that power, one of the purposes of which is to effect a distribution of a bankrupt's property, should be restricted to the property of the bankrupt. Where, under state law, the bankrupt never had an interest in property of a third person, it would seem that the bankruptcy power cannot be utilized to transfer such property to a bankrupt, or his representative, merely because the third person had certain dealings with the bankrupt.


45True, the general doctrine of preferences may invalidate transfers, valid under state law, and thereby transfer title to the representative of the bankrupt, but in all such cases the property affected belonged to the bankrupt when he was insolvent. Under Section 70 the bankruptcy trustee is vested with the title to property owned by the bankrupt at the time of the petition or transferred by him under certain conditions which make the
B. The Single and Separate Class of Creditors.—To qualify as a member of the "single and separate class of creditors entitled
transfer voidable either as a preference or as a fraudulent conveyance.
This section contemplates that property, passing to the trustee, be owned
at some point of time by the bankrupt.

It it well settled that property which the bankrupt held as trustee
does not pass to his trustee in bankruptcy. United States Nat'l Bank in
Johnstown, Pa. v. Blauner's Affiliated Stores, (C.C.A. 3rd Cir. 1935) 75
F. (2d) 826; In re Finkelstein, (C.C.A. 2nd Cir. 1929) 33 F. (2d) 278;
1935) 12 F. Supp. 186; In re Kenney & Greenwood, (D.C. Me. 1928) 23
F. Supp. 681. See Cunningham v. Brown, (1924) 265 U. S. 1, 11,
44 Sup. Ct. 424, 68 L. Ed. 873.

If the identifiable property of third persons does not pass to the bank-
ruptcy trustee and hence should not be administered by him, there should
be no justification for distributing identifiable property of customers among
all customers as a class.

Consequently, if section 60e is construed to deny a customer the right
to reclaim money which he delivered, with a "buy" order which was not
executed, where such money remains earmarked in the possession of the
bankrupt broker (who is deemed, under state law, to be trustee thereof
for such customer), that section would seem to be unconstitutional for
the reasons already stated. This objection can be avoided by construing
paragraph (4) as governing paragraph (2) so as to permit reclamation of
cash remaining in the possession of the bankrupt in the identical form
in which it was delivered to him by the claimant. There is no difficulty as
to reclamation of securities delivered by a customer for sale and remain-
ing in their original form in the bankrupt's possession since the former,
being a cash customer, can clearly reclaim his property.

Where a customer has delivered money for a future purchase to a
broker who immediately deposited it in a special bank account for cus-
tomers or where such money was directly used to purchase, for such cus-
tomer, securities, and these securities (or securities delivered to a broker
for future sale), have been immediately placed in bulk segregation, discussed
hereafter at p. , (and such property remains in its converted form at
the date of bankruptcy), under state law the broker may be regarded as
trustee of the proceeds of the customer's property. Yet section 60e, no
matter how paragraphs (2) and (4) are construed, denies such customer
the right to reclaim such proceeds except under certain conditions.

Where property deposited by the customer with the broker has been
changed into another form, rightfully or wrongfully, by the broker, it
might be urged that there is no constitutional objection to denying a cus-
tomer the right to reclaim. This argument would run: In this situation
it is not original property which the customer seeks to reclaim, but its pro-
ceeds; the right to trace and recapture property converted into another
form is not substantive, but merely a remedial right extended by equity
courts; therefore, in so far as Section 60e denies the customer a right
to trace and reclaim the proceeds of property which he delivered to the
bankrupt broker, it does not violate the Fifth Amendment which protects
only substantive rights. It is not clear that this argument should succeed
since a right to trace proceeds of property, in this connection, is predicated
on the theory that the bankrupt at no time acquired title to such property
or the proceeds thereof; if this be so, the objections already considered are
here applicable.

Of course, in so far as a customer seeks to reclaim "substitutes" for,
as distinguished from "proceeds" of, his property, the restrictions im-
posed by Section 60e would seem unobjectionable. Substitution contemplates
that the customer's original property, or the proceeds thereof, is gone and
that it is being replaced with different property. Such substitution would
to share ratably in such [single and separate] fund," a customer is not required to trace his property, whether cash or securities, into such fund. In other words, if a person was at any time a customer of the bankrupt, he would be entitled to share in that fund since sec. 60e(2) expressly stipulates that "all customers except such cash customers shall constitute a single and separate class of creditors."

Conceivably, it might be urged that, since "customers" are defined by sec. 60e(1) as including "persons who have claims on account of securities received, acquired or held by the stockbroker from or for the account of such persons" for various purposes, and "shall include persons who have claims against the stockbroker arising out of sales or conversions of such securities," a person cannot participate in the single and separate fund on account of a claim for cash which the former delivered to the latter.

Such an argument should be rejected. In defining "customers" paragraph (1) states, inter alia, "customers of a stockbroker shall include" the specified persons already referred to. The word "include" is essentially a word of enlargement, not of restriction and effect should be given, in paragraph (2), to this quality of enlargement in order to include customers whose claims arise in respect of cash delivered to brokers by customers.

be made from the broker's property and not from property to which such customer was always entitled.

By mere definition Congress cannot take away vested rights without due process of law. For this reason, paragraph (5), (stipulating that property "shall be deemed to have been property of the stockbroker" which would not, under state law, have belonged to him), may not be effectual. Desirable as it may be to create a uniform law governing the rights of stockbrokers and customers, it cannot be done under federal legislation of this kind unless justified on the basis of bankruptcy power. That there is no federal substantive law, except that arising under the powers granted to Congress, is indicated in Erie Railroad Co. v. Tompkins, (1938) 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188.

The Supreme Court held, in American Surety Co. v. Marotta, (1933) 287 U. S. 513, 53 Sup. Ct. 260, 77 L. Ed. 466, that the word "include" as used in section la(9) (which declared that "creditor" shall "include" any one who owns a demand or claim provable in bankruptcy) is a word of "extension or enlargement" rather than one of "limitation or enumeration."

Further, the legislature clearly intended to abolish any distinction
Whether customers, other than cash customers, are excluded from the single and separate class if they can specifically identify their property depends on the answer to the question raised by the conflict, already mentioned, between paragraphs (2) and (4). If paragraph (2) controls, such customers are included in the single and separate class; per contra, if paragraph (4) governs.

Customers are entitled to participate in the single and separate fund "on the basis of their respective net equities as of the date of bankruptcy." A customer's "net equity" is determined by "excluding any specifically identifiable securities reclaimable by the customer and by subtracting the indebtedness of the customer to the stockbroker from the sum which would have been owing by the stockbroker to the customer had the stockbroker liquidated, by sale or purchase on the date of bankruptcy, the remaining securities or security commitments of the customer." If customers cannot satisfy their claims in full from the single and separate fund, they are entitled to share, to the extent of their unpaid balances, in the general estate with general creditors.

PROBLEMS RELATING TO RIGHT OF CUSTOMERS TO RECLAIM SECURITIES

The complex problems of construction, raised by sec. 60e, relate solely to a customer's right to reclaim money. That sec-

between margin customers and include all of them in one class whether they could trace their property into securities which the stockbroker possessed at the date of his bankruptcy or not. If, therefore, a person who had originally deposited securities or for whom securities were purchased by the stockbroker, is entitled to share in the single and separate fund even if he cannot trace any of his property into it, a person, who has deposited cash for the purchase of securities with the stockbroker which he cannot trace at the date of bankruptcy, should have an equal right to participate in that fund.

The acceptance of a contrary interpretation would achieve this ridiculous result: If the stockbroker converted the cash originally deposited by a customer, the latter could not share in the single and separate fund; if the stockbroker utilized the cash so deposited to acquire securities for the customer and then converted the securities, the customer would thereafter be classified with the single and separate group.

The conversion of cash arising from the sale of securities deposited with the broker would clearly bring the customer within the definition of "customer" set forth in 60e(1), since he would be a person who had a claim against the stockbroker "arising out of sales or conversions of such securities."

See discussion at p. 62, supra. The possible constitutional objection to these paragraphs has also been considered at pp. 62-63, supra.

Paragraph (2), pp. 59-60, supra.

Paragraph (1).

Paragraph (2), pp. 59-60, supra.
tion, however, clearly prescribes the right of a customer to re-
capture securities. Consequently the principal question,\textsuperscript{53} relating to this latter right, will be: what constitutes a specific identification of securities within the meaning of paragraph (4). That problem requires a consideration of the extent, and methods, of segregation of customers' securities by stockbrokers.

It has been the practice of brokers, in order to facilitate the reclamation of wholly owned or excess margin securities (which, by the rules of some stock exchanges, can not be repledged by the broker), to segregate such securities in some way. The various methods of setting aside such securities can be generally classified as either specific or bulk segregation.

There are several ways of specifically segregating securities. In the first place, wholly owned securities, such as those deposited by a customer with a broker for safekeeping, may be physically set aside and tagged with the customer's name. Securities purchased by the broker and fully paid for, or securities constituting excess margin, may be identified either by certificate number\textsuperscript{54} or by the broker's physically setting them aside in an envelope or box, bearing the customer's name, or by his tagging the particular certificate.

It is primarily a question of fact whether securities which do not remain in their identical form have been sufficiently allocated to or physically set aside for a customer so that he may reclaim them under paragraph (4). The practices, above described, would seem to meet the requirements of that paragraph so that a cash customer may reclaim his securities so segregated.

In addition to these methods of specific identification for reclamation purposes many brokers have adopted the practice of segregating securities in bulk. Under this practice, shares of stock are regarded as completely fungible. The broker places in a box certificates totaling the amount of all shares of a particular stock which have been fully paid for or which constitute excess margin. Each customer's interest in this fungible mass is represented by a "requisition card" showing how many shares of a particular stock belong to him, although specific certificates are not identified as his. When the margin clerk requires additional margin for a particular customer's account, a "removal card" is

\textsuperscript{53}The question of the constitutionality of section 60e, in this connection, has been considered in footnote 45, supra.

\textsuperscript{54}This is the usual practice where orders are executed for out-of-town brokers; in such cases, telegraphic notification to such brokers of the purchases would list the certificate numbers.
placed in the box, to show that the latter's stock has been removed, and shares to that amount are thereupon taken from the box. This system, which facilitates the substitution and withdrawal of certificates by the broker, makes the customers, dealing in a particular security, tenants in common of the mass of such securities in the box.56

Since securities are put into bulk segregation only when a customer's securities are fully paid for or constitute excess margin, a customer for whom such segregation has been made, should be regarded as a cash customer and entitled to reclaim from the segregated mass of securities if he can meet the requirements of paragraph (4). Yet this conclusion is not free from doubt. It might be argued that segregation must be made only for an individual customer, rather than a group of customers, since paragraph (4) provides that cash or securities are "specifically unidentifiable" only when set aside for "such customer." That construction, however, does not seem meritorious.56

When securities are placed in bulk segregation, whatever right a cash customer may have had to a particular certificate terminates. In exchange therefor, he acquires an undivided interest, pro tanto, in the segregated mass. Consequently, he can not reclaim any portion of that mass on a theory that his original property has remained in its "identical form," within the meaning of paragraph (4). He may only lay claim to that mass as, pro tanto, representing the proceeds of, or substitutes for, his property.

Under the restrictions of paragraph (4), however, such customer is entitled to reclaim his share of the segregated mass only in so far as securities were placed therein for his account four

56 This would clearly be the result under the old New York rule and, moreover, under the old Massachusetts rule it would be regarded as a sufficient appropriation of the securities to pass title to the customer as a tenant in common. See Denton v. Gurnett & Co., (C.C.A. 1st Cir. 1934) 69 F. (2d) 750.

It is well settled that a customer is bound by the rules, regulations, customs and usages of a stock exchange. (See Meyer, Stock Brokers and Stock Exchanges (1931) sec. 27 and cases therein cited.) Therefore, a customer must be deemed to have consented to, and accepted, this right of tenant in common to the segregated mass, wherever bulk segregation is customarily employed.

56 True, paragraph (4) permits reclamation only where the segregation was made "for such customer." That phrase, however, should not prohibit reclamation where the segregation was made for customers as tenants in common. The use of the singular designation, "such customer," is obviously intended to describe the person seeking reclamation, not the character of his interest in the property sought to be recaptured.

57 See footnote 75 infra. Although paragraph (4) permits a customer to reclaim the substitutes for, or proceeds of, his property where such were "allocated to or physically set aside" for him more than four months be-
months before the broker's bankruptcy or at a time when the latter was solvent.\textsuperscript{58} Such customer can not reclaim anything from this mass on account of securities placed therein within four months of the broker's bankruptcy and when the latter was insolvent.\textsuperscript{59} That portion of the mass which represents securities of customers segregated during this latter period, belongs to the single and separate fund.

Where only a part of the segregated securities can be reclaimed by the customers for whom they were set apart, the entire segregated mass constitutes, in essence, a fund held by the broker partly for the benefit of such customers and partly for the single and separate class of customers. It follows, therefore, that any loss to that fund, such as might result from the misappropriations of the broker, should be borne equally by such customers and the single and separate class in proportion to their respective interests therein.\textsuperscript{60}

\textsuperscript{58}To this extent bulk segregation should be valid and effective under section 60e. It can be argued that this practice does not violate the spirit of that section which was primarily designed to prohibit only a tenancy in common in a general mass of securities of a particular kind (1) held by a broker "in the box" and unsegregated or (2) repledged by that broker; that the draftsmen of that statute intended merely to eliminate the old priorities which were based only on the chance existence of certain stock in the possession of the bankrupt or upon wrongful dealing by the broker in such stock, not upon a systematic method of safeguarding the rights of customers in wholly owned or excess margin securities by setting aside certain stock for particular customers. See footnote 29 supra. Certainly it seems desirable to protect these rights of customers.

\textsuperscript{59}In so far as purchased, or excess margin, securities are involved, this result would seem proper, since the customer has relied upon the broker's general credit. Where securities, delivered by a customer for delayed sale, are involved, the broker may be deemed a trustee of such securities under state law. Consequently, in this case there may be a constitutional objection to this paragraph, in so far as it denies such customer the right to reclaim the proceeds of his property. See footnote 45, supra.

\textsuperscript{60}This conclusion is sound under ordinary principles of the law of trusts which hold that where a trustee wrongfully diverts part of a fund representing two trust res, the trusts must bear the loss pro rata. See footnote 78, infra.

Further, a similar result was reached under the prior law relating to reclamation in bankruptcy. See footnote 21, supra.
A customer's right to demand money from his broker's estate may arise in several ways. A person who engages only in cash transactions, as distinguished from margin or running accounts, may deliver cash against a future purchase to his broker who becomes a bankrupt before the order can be executed, or such person may deliver securities for sale to the broker who effects the sale but becomes bankrupt before delivering the proceeds thereof to the customer. A margin customer may deposit money on account or may acquire a credit balance as credits and debits are balanced from time to time. A "free credit balance," as a customer's right to demand cash from a broker is termed, by hypothesis represents a right to cash, not to securities.

All customers who have claims against a bankrupt stockbroker for money, whether it represents the customers' deposits or the proceeds of sales of customers' securities, would seem to be forced into the single and separate class. To hold that paragraph (2) controls to deny a customer a right to reclaim money may achieve a harsh result in some cases. For example, a customer may engage in but one transaction with a broker, whereby the former delivers money to the latter accompanied by an order to buy certain stock at several points below the then market price. Before the order can be executed, the customer's right to demand money from his broker's estate may arise in several ways. A person who engages only in cash transactions, as distinguished from margin or running accounts, may deliver cash against a future purchase to his broker who becomes a bankrupt before the order can be executed, or such person may deliver securities for sale to the broker who effects the sale but becomes bankrupt before delivering the proceeds thereof to the customer. A margin customer may deposit money on account or may acquire a credit balance as credits and debits are balanced from time to time. A "free credit balance," as a customer's right to demand cash from a broker is termed, by hypothesis represents a right to cash, not to securities.

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broker becomes bankrupt. He may have held the customer's money earmarked or may have, immediately upon its receipt, deposited such money in a special account for customers where the proceeds of the money remain at the time of bankruptcy. By the strict language of paragraph (2), this customer, not being a "cash customer," will be unable to reclaim his money and will be only entitled to share pro rata with other customers in the single and separate fund.64

An argument against the foregoing result might conceivably be based upon a construction of the definition of "customers," as set forth in paragraph (1),65 which would hold that the person who deposited the money in the assumed case never became a "customer," is, therefore, not affected by the provisions of paragraph (2), and may consequently rely on his right to trace his property under the old law, unaffected by the limitations contained in Section 60e.66

Such a contention, however, should have little force in light of the proper construction of paragraph (1) which attributes to the word "include" a quality of enlargement, rather than restriction, to embrace persons such as the one described in the assumed case.67 As a matter of fact, a contrary construction would work to the disadvantage of such person in a case where he was unable to trace his money, for then, not being classified as a "creditor," he would be relegated to the status of general creditor and precluded from participation in the single and separate fund.

It might be argued that the draftsmen of sec. 60e intended merely to adopt the Massachusetts rule which only governs margin transactions and which would permit the person in the assumed case to recover his funds.68 All legislative documents, however, indicate that the draftsmen intended to go beyond the Massachusetts doctrine, in this connection, and to put all customers in

64This is similar to the result reached under bulk segregation of securities, already considered. The possible constitutional objections to section 60e in so far as it denies customers the right to reclaim their property has already been considered at pp. 62-63, supra.

65See footnote 46, supra.

66That section was not designed to eliminate the right of the broker's other creditors to trace their funds; and that section bars a customer's right to trace his property only as against other customers, not as against general creditors. See discussion at p. 59, supra.

67See discussion at p. 66, supra.

68It was held by the federal district court in Massachusetts, in In re Smith, (D.C. Mass. 1922) 278 Fed. 844, that where a customer delivered a check to a broker for a purchase of stock which was never consummated, the former could reclaim the proceeds of the check from the bankrupt's general bank account.
the same class irrespective of the circumstances of their dealings with the broker. In effect, sec. 60e would seem to constitute a legislative fiat that all persons who engage in stock transactions with a broker must be deemed to have relied upon his credit and thereby became his creditors, as far as their rights inter se are concerned but not as against general creditors of the broker.

Difficult questions will arise if a broker maintains a special bank account for customers' free credit balances, as is the not uncommon practice. Thus, a broker may deposit in a special account all money received from customers on account of future purchases or he may deposit therein money representing customers' free credit balances arising in other ways. In the latter situation deposits would not be made from money delivered by particular customers to the broker but would be made either from the broker's own funds or from funds arising from sales of securities of customers generally.

If the broker opens an account, and makes deposits therein, for the benefit of customers who have free credit balances, he might thereby create a trust for them if he intends that result.

By depositing money in trust for customers the broker effects a

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60See footnote 29, supra.

70At the present time this is not a general practice among brokers. This is a convenient method of setting aside money with which a broker can meet customers' demands for cash on account of their free credit balances.

71Under stock clearing practices similar to that of the New York Stock Exchange it would be impossible to trace the proceeds of a specific sale of securities. If after a particular day's trading the broker is "long," he may have to pay out money even though he sold securities for a particular customer. In this situation, a particular customer could not trace the proceeds of his securities. Even if the broker is "short" as a result of the day's trading, money received through the clearing could not be shown to be the proceeds of a particular sale of securities.

72No formal declaration is necessary to create a trust in money or personalty. "Any declaration, however informal, evincing the intention with sufficient clearness will have that effect." (Day v. Roth, (1858) 18 N. Y. 448, 453; see also Putnam v. Lincoln Safe Deposit Co., (1908) 191 N. Y. 166, 182, 83 N. E. 789, 793.) Nor need the declaration of trust be communicated to the beneficiaries (Martin v. Funk, (1878) 75 N. Y. 134; Matter of Brown, (1930) 252 N. Y. 366, 169 N. E. 612) or even to other third persons (Restatement of the Law of Trusts, sec. 23 comment c). The mere act of depositing funds in the trust account would sufficiently indicate the broker's intention to hold the chose in action, to-wit, his claim as depositor against the bank, for the benefit of the customer in respect of whose free credit balance the deposit was made (see United National Bank v. Weatherby, (1902) 70 App. Div. 279, 283, 75 N. Y. S. 3, 6.) The requisite identification of beneficiaries could be accomplished by the account books of the broker.

With respect to the effect of paragraph (4) on the rights of tenants in common, see footnote 56, supra.
transfer of such fund to said customers for, the trust being passive, legal title to the bank account vests in such customers.\textsuperscript{73}

Whether the broker deposits customer's or his own funds in the trust account, it would seem that all deposits or transfers, made within four months of his bankruptcy and at a time when he is insolvent, are voidable as preferential transfers under Section 60,\textsuperscript{74} if the customer benefited thereby had, at the time when the deposit was made, reasonable cause to believe that the broker was insolvent.\textsuperscript{75} Preferential and voidable deposits in special account,  

\textsuperscript{73}A true trust must include elements of management. Otherwise the statute of uses immediately executes the trust and vests legal title in the cestui (Matter of Sweeney, (1935) 155 Misc. Rep. 461, 279 N. Y. S. 927; Long Branch Banking Co. v. Winter, (1933), 112 N. J. Eq. 218, 163 Atl. 903; Estate of Edwin Newman, Jr. (Surr. Ct. N.Y.) reported in N. Y. L. J. Dec. 18, 1935, p. 2492); see also Restatement of the Law of Trusts, sec. 69, comment a; 1 Bogert, Trusts and Trustees, sec. 206).

The fact that the deposit is held in trust for customers would not prevent the broker from making withdrawals for purposes consistent with the trust. In other words, he could withdraw money from the account to pay directly to customers or to apply on the purchase price of securities acquired for "trust customers" or to reimburse himself for money which he has advanced for the foregoing purposes.

Nor does the trust character of the deposit entitle trust customers to make withdrawals from the deposit. The depositary bank can properly pay the funds to the trust customers only with the consent of the broker or when compelled to do so by court order (Hemmerich v. Union Dime Savings Institution, (1911) 144 App. Div. 413, 129 N. Y. S. 267; Day v. Old Colony Trust Co., (1919) 232 Mass. 207, 122 N. E. 189).

\textsuperscript{74}Section 60a, b, e (5). But cf. possible constitutional objections mentioned at pp. 62-63, supra. See footnote 56 supra.

\textsuperscript{75}It is not entirely clear that a deposit of cash in a separate account for the benefit of customers constitutes a "transfer" by a broker which must be set aside under the provisions of paragraph (5) rather than nullified solely by the provisions of paragraph (4). It can be said that it is not necessary that the voidable portion of the deposit be "recovered" by the trustee within the meaning of paragraph (5) on the ground that the separate bank account will pass to the possession of the trustee upon the bankruptcy of the broker. It might be urged therefore that the provisions of paragraph (4) are sufficient to "undo" the voidable deposits and to give title therein to the bankruptcy trustee. (It is assumed that paragraphs (4) and (5) permit reclamation of cash; see p., et seq.

The determination of this problem is not solely of academic interest since, if the provisions of paragraph (4) operate to set aside deposits made by a broker within four months of his bankruptcy and at a time when he is insolvent, the knowledge of the broker's insolvency by the customers for whom such deposits were made, is immaterial, whereas if the deposit constitutes a "transfer" which must be set aside under paragraph (5) the trustee can recover only if such customers knew of the insolvency of the broker.

Since "transfer" is not specially defined for the purposes of sec. 60e, it would seem that the definition set forth in sec. 1 (30) should govern. By that definition a declaration of trust of a bank account would constitute a "transfer."

It may be argued that the trust customer's knowledge, or lack thereof, of this fact is important at the time when the deposit was withdrawn
made from customer's money, can be recovered by the bankruptcy trustee for the benefit of the single and separate fund;76 voidable deposits, made from the broker's own funds, can be recovered by the trustee for the general estate.

Where the trust account consists partly of voidable and partly of non-voidable deposits, it is highly important to ascertain the deposits against which subsequent withdrawals will be charged in order to determine the property against which the bankruptcy trustee may proceed, the balance in the trust account or the money, and the proceeds thereof, withdrawn.

The situation where all the voidable deposits in the trust account were made entirely from customers' money will be first considered. Since recovery of such voidable deposits would benefit the single and separate fund, the controversy here will be between the trust customers for whom non-voidable deposits were made, and members of the single and separate class of customers, represented by the bankruptcy trustee. By force of sec. 60e, this trust account really represents two trust funds, the non-voidable deposits constituting a trust fund for such trust customers and the voidable deposits constituting a trust fund for the single and separate class.

If the broker, after making the voidable deposits, wrongfully withdrew funds from the account and dissipated them, one of three rules might conceivably be applied to ascertain the deposits against which the wrongful withdrawals should be charged.

To begin with, the "first-in-first-out rule," established in the famous Clayton's Case,77 might be used to charge withdrawals and paid by the broker to, or for the benefit of, such customer. Yet the transfer to said customer really occurred at the time of the deposit.

As a practical matter it may be exceedingly difficult for a bankruptcy trustee to prove that a trust customer had knowledge of the insolvency of the broker, especially since such customer might not even know that such a deposit had been made for his benefit.

There would seem to be no method by which a trust could be created in respect of customers' free credit balances which could not be avoided, to some extent at least, by the provisions of the Bankruptcy Act. If such trust account be regarded either as payment or as security for the obligation of the broker to the customer on account of such free credit balances, such trust would be subject, as pointed out in the discussion, to the provisions of Section 60. It is extremely doubtful whether such deposit could operate as payment of customers' claims against the broker. See Day v. Roth, (1858) 18 N. Y. 448, 453; Hamer v. Sidway, (1891) 124 N. Y. 538, 549-550, 27 N. E. 256, 258.

76Section 60e(5), footnote 35, supra.
77Devaynes v. Nobel, (1816) 1 Mer. 572.
against deposits in the order in which the latter were made. That principle, being designed to govern controversies between a bank and a depositor, would seem to be wholly inapplicable to this situation, and its arbitrary application in this situation would not rest upon any basis of fairness. However, the courts have uniformly applied the rule of Clayton's Case to similar situations under the former Act and, with but one exception, have failed to appreciate the real problem.

Restatement of the Law of Trusts, sec. 202, comment n, declares:

Where the trustee deposits in a single account funds held by him as trustee under different trusts, and subsequently wrongfully withdraws and dissipates a part of the deposit, the beneficiaries of the trusts are entitled to share the balance of the deposit proportionately, regardless of the order in which the deposits were made.

It has been stated, even with respect to a bank's right to setoff, that the application of the first-in-first-out doctrine is a rule applied by courts of equity and its application must depend upon its justice in a given situation. See Lowden v. Northwestern Nat'l Bank & Trust Co. (C.C.A. 8th Cir. 1936) 84 F. (2d) 847, 851 and Carson v. Federal Reserve Bank, (1930) 254 N. Y. 218, 232, 172 N. E. 475, 480.


In In re Walter J. Schmidt & Co., (S.D. N.Y. 1923) 298 Fed. 314, Judge Hand at first refused to apply the rule in Clayton's Case or the authority of the Empire State Surety Case, (C.C.A. 8th Cir. 1912) 194 Fed. 593, and in a very logical discussion declared that each trust fund should suffer the loss pro rata. Subsequently, however, counsel called his attention to the decision in In re Bolognesi & Co., (C.C.A. 2d Cir. 1918) 254 Fed. 770, which he acknowledged as a binding authority and thereupon he modified his first opinion.

Where a trustee has wrongfully withdrawn funds from a trust account and thereafter deposits his own money therein, it is held that he intends to make restitution. In In re T. A. McIntyre & Co., (C.C.A. 2d Cir. 1910) 181 Fed. 960, the wrongful withdrawals of the trustee from the trust account, which consisted of several trust funds, had exhausted all funds. Subsequently he made deposits therein and the question was whether such deposits, regarded as restitutions, should be considered a general restoration in which all the defrauded cestuis should share ratably or whether it should be treated as making good, in so far as possible, the separate funds in the order in which they were abstracted. The Court held that it must be assumed that the defalcating trustee intended to make a general restitution. This seems unfair in light of the rule charging wrongful withdrawals against first deposits instead of charging them against all deposits pro rata.

To be sure, the application of Clayton's Case to this situation may have certain merit. It would afford the easiest avenue for recovery of preferences by the bankruptcy trustee since he could look solely to the balance of the account if it equalled or exceeded the amount of voidable deposits. It is obvious that under the first-in-first-out rule deposits for trust customers with non-voidable interests would have been first in. Further, by throwing the loss primarily upon trust customers, this rule might be said to carry out an underlying purpose of section 60e to eliminate, as far as possible, priorities among customers inter sese, as indicated in footnote 29, supra.
Second, it might be urged that this problem is governed by the rule of *Knatchbull v. Hallett* which holds that where a wrongdoer mingles, in a bank account, his own funds with those of another person and thereafter makes withdrawals from that account, the wrongdoer is presumed to have first withdrawn his own funds. This rule is inapplicable to the assumed case since, by hypothesis, none of the money in the account belonged to the broker. Hence, irrespective of the purposes for which the broker may have withdrawn money from the trust account, he cannot be deemed to have withdrawn his own money.

A third rule, and the proper one to apply to this situation, would distribute the loss pro rata between trust customers, for whom non-voidable deposits were made, and the single and separate class. As already stated, such trust customers and the single and separate class should be regarded as tenants in common in this trust account. It is equitable, therefore, to require these tenants in common to share pro rata any loss resulting from the dissipation of the account by the broker.

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83 In re Hallett's Estate, (1878) 13 Ch. Div. 696.
84 The rationale often given for that doctrine is that it would have been dishonest for the wrongdoer to withdraw the claimant's or beneficiary's money, hence he must be presumed to have withdrawn the latter's money last. That is, of course, pure fiction. The real reason for that rule is that the wrongdoer, whatever his intent, should not be permitted, by taking away a part of the fund, to deprive the claimant or beneficiary of his lien on, or share of, the rest of the fund.


A claimant or beneficiary is held entitled to a lien for his claim to the extent of the lowest intermediate balance in the account. Subsequent deposits by the wrongdoer may have been intended to operate as a restoration of the funds so withdrawn, in which case the claimant has a lien for the amount of his money originally deposited by the wrongdoer rather than only for the lowest intermediate balance.

85 See footnotes 78 and 81, supra.

Where the broker uses the withdrawals to pay a trust customer in respect of whose credit balance a non-voidable deposit was made, there would be no need to ascertain what rule to apply with respect to the withdrawals since the balance in the trust account would be sufficient for both the other trust customers for whom non-voidable deposits were made and for the single and separate fund.

Even where the broker pays the withdrawals to a trust customer for whom a voidable deposit was made (and who consequently has no vested right to the deposit under section 60e), the sole right of the bankruptcy trustee to recover the voidable transfers for the benefit of the single and separate fund is against the recipient of the withdrawal; he should have
If all the voidable deposits in the trust account were made from the broker's own funds, the controversy would be between trust customers, for whom non-voidable deposits were made, and general creditors, represented by the bankruptcy trustee. Although the voidable deposits were intended by the broker to be in trust for customers, nevertheless, in the contemplation of sec. 60e these deposits, not constituting non-voidable trust funds, remain funds of the broker to which his general creditors are entitled.

In essence, therefore, this situation would seem to present a case of trust funds mingled with the trustee's individual funds in a bank account. Consequently, if the broker, after making the voidable deposits, wrongfully withdraws funds from the account and dissipates them, the rule of Knatchbull v. Hallett would seem to govern and to place the burden of the withdrawals first on the voidable deposits. General creditors, claiming through the broker, cannot object.

Where voidable deposits in the trust account represent funds, no right to proceed against the trust account since it no longer includes property belonging to such fund.

To illustrate the results which would be reached under the foregoing rules, assume that a broker deposited in the trust account $1,000 prior to four months of his bankruptcy; that within four months of his bankruptcy and while insolvent he deposited $400, representing customers' money; that subsequently he withdrew and dissipated $900. Under the rule of Clayton's Case, the trust customers, whose rights to the fund arose prior to four months of bankruptcy, would receive $100 and the single and separate fund would get $500. Under the pro rata rule, such trust customers would receive $400 and the fund $200.


If the broker pays such withdrawals to trust customers for whom non-voidable deposits were made, no problem is created. See footnote 85, supra.

Where the broker pays the withdrawals to or for the benefit of trust customers for whom voidable deposits were made, the bankruptcy trustee's sole right is against the recipients of the withdrawals so that trust customers, whose deposits antedated the preference period, are entitled to be paid in full. The broker must be deemed to have paid the trust customers, first described, from the voidable deposits. Otherwise, he would have converted the non-voidable deposits belonging to trust customers of the latter type, and the rule of Hallett's Case would be applicable.

To illustrate the application of these rules, assume that the broker deposited $1,000 in the trust account prior to four months of his bankruptcy; that within four months of his bankruptcy and at a time while he is insolvent he deposited therein $500 from his own funds; that subsequently he withdrew and dissipated $600. Under the rule of Clayton's Case trust customers would receive $400 and the general estate $500. Under the rule of Knatchbull v. Hallett, trust customers would receive $900 and the general estate nothing.
belonging partly to the broker and partly to customers, the problem becomes more complicated. Claims to this account would then involve controversies between three distinct classes of persons: customers whose interests in the account are vested as far as Section 60e is concerned, members of the single and separate class, and general creditors.

If the broker wrongfully withdrew money from this trust account and dissipated it, it would seem equitable to apply the rule of *Kvatchbull v. Hallett* as between general creditors and all customers so as to place the loss primarily upon the former, and then to regard trust customers for whom non-voidable deposits were made in the account, as tenants in common with members of the single and separate class and to impose the remaining loss upon them pro rata.\(^8\)

If the claims of trust customers are not satisfied in full from the trust account, they would be entitled to participate with other customers in the single and separate fund, and then, if their claims and those of other customers are not satisfied therefrom, all customers may then participate in the general estate, along with general creditors, to the extent of the unpaid balance of their claims.\(^9\)

**CONCLUSION**

On the whole, sec. 60e constitutes a considerable and worthwhile advance over the old law. It has completely destroyed the old classifications* between customers inter se based upon such fortuitous circumstances as (a) whether particular securities remained in the possession of the broker at the date of his bankruptcy\(^8\) and (b) whether the broker, in dealing with his customers' securities, had rightfully or wrongfully disposed of them.\(^9\) The new statute also makes a clean cut distinction be-
between customers and general creditors of a broker and thereby provides for an easy administration of stock brokerage bankruptcies.

Many perplexing problems, however, may still exist in stockbrokers' bankruptcies. As already pointed out in the discussion, section 60e not only contains certain ambiguities but, in addition, may overstep, in some particulars, the bounds of the federal bankruptcy power and may violate the due process clause of the fifth amendment. Undoubtedly, serious controversies may arise as a result of those difficulties. To make unnecessary the trouble and expense of the litigation which might otherwise result, Congress should speedily enact an amendment designed to answer these problems.