

# Enforceability of Contract by Bank to Purchase Stocks

Sidney E. Cohn

Follow this and additional works at: <https://scholarship.law.stjohns.edu/lawreview>

---

### Recommended Citation

Cohn, Sidney E. (1930) "Enforceability of Contract by Bank to Purchase Stocks," *St. John's Law Review*: Vol. 5 : No. 1 , Article 14.  
Available at: <https://scholarship.law.stjohns.edu/lawreview/vol5/iss1/14>

This Note is brought to you for free and open access by the Journals at St. John's Law Scholarship Repository. It has been accepted for inclusion in St. John's Law Review by an authorized editor of St. John's Law Scholarship Repository. For more information, please contact [lasalar@stjohns.edu](mailto:lasalar@stjohns.edu).

## ENFORCEABILITY OF CONTRACT BY BANK TO PURCHASE STOCKS.

"Courts should be zealous to maintain the standards of safety which have been demonstrated to be essential for the continued safety of such institutions (banks). On the other hand, care should be exercised not to cripple them and break down their usefulness by a narrow and unreasonable construction of the statutes which will result in unwisely limiting their usefulness in the transaction of business under modern conditions."<sup>1</sup>

The problem presented to the Court in the recent case of *Block v. The Pennsylvania Exchange Bank*<sup>2</sup> demonstrates the practical difficulties of applying this rule of construction. In that case the bank, acting as the agent for an undisclosed principal, ordered from the plaintiffs, brokers, certain stocks totalling \$15,800. The plaintiffs from time to time tendered delivery of the stocks so purchased to the defendant, but the defendant in each instance requested the plaintiffs to withhold delivery thereof until on or about the 25th day of June, 1928, when the defendant notified the plaintiff that it would not accept delivery of said stocks or make payment therefor. The plaintiffs sold the stock on the 25th of June, 1928 for \$9,125, and now claim a balance due them of the difference between the purchase price of the stocks and the amount realized thereon, plus interest and costs, a total of \$10,375.

The defendant moved to dismiss the complaint on the ground that it was *ultra vires* the power of a bank to enter into such transactions. This motion was denied.<sup>2a</sup> The Appellate Division reversed the decision on the authority of their own opinion in the case of *Dyer et al. v. The Broadway Central Bank*.<sup>3</sup> On appeal the question presented to the Court for determination was whether or not such a contract as that alleged in the complaint was *ultra vires* and illegal, as contended by the respondent.

While an appeal on this case was pending, the Court of Appeals reversed the Appellate Division in the *Dyer* case, and when the instant case came up for review, it was reversed on the basis of their decision in the *Dyer* case.

That we may determine whether or not this decision has either legal precedent or economic necessity let us analyze our problem from both angles.

II. *Legal Aspects.*

Section 106, subdivision 8, of the banking laws, gives banks the power "when specially authorized by the Superintendent of Banks to

---

<sup>1</sup> Cardozo, *Ch. J.*, writing in the *Whiting v. Hudson Trust Company* case, 234 N. Y. 394, 138 N. E. 33 (1923).

<sup>2</sup> 253 N. Y. 227, 170 N. E. 900 (1930).

<sup>2a</sup> 134 Misc. 153, 235 N. Y. Supp. 671 (1929).

<sup>3</sup> 225 App. Div. 366, 233 N. Y. Supp. 96 (1st Dept., 1929).

act as trustee, executor, administrator, transfer agent, or registrar of stocks and bonds, guardian of estates, assignee, or in any other fiduciary capacity in which trust companies are permitted to act. \* \* \*

Section 18 of the Stock Corporation Law expressly excludes banks (as moneyed corporations under the General Corporation Law, sec. 3, subd. 4) from its provision permitting stock corporations to purchase stock of any other corporation. Section 10 of the General Corporation Law provides that no corporation shall possess or exercise any corporate powers not given. These sections, when read together, claims the defendant, make such an agreement as that stated above *ultra vires*, illegal and void. The plaintiffs, on the other hand, claim that the purchase and sale of stocks is an incidental power necessary to carry on the business of banking.<sup>4</sup>

The defense of *ultra vires* has ever been frowned upon. The attitude of the courts generally seems to be that where one has entered into an obligation or contract he should be held to the consequences of his act wherever possible. An examination of the cases where banks have pleaded the defense of *ultra vires* demonstrates this unmistakably. In *Appleton v. The Citizens' National Bank*<sup>5</sup> the bank pleaded the defense of *ultra vires* where they had guaranteed the note of a depositor to another bank, an act clearly with the prohibitions of the statute. The Court went so far as to say that even assuming the contract to be *ultra vires*, since the defendant bank had received an actual benefit from the contract, it must be compelled to return whatever benefits it had received.

Similarly it has been held in New York that if a contract were not immoral *per se*, but unlawful because the corporation is incapable of making it, all benefits received under the *ultra vires* contract must be returned.<sup>6</sup>

<sup>4</sup> Banking Law, sec. 106:

"General powers.—In addition to the powers conferred by the general and stock corporation laws, every bank shall, subject to the restrictions and limitations contained in this article, have the following powers:

1. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion, and by lending money on real or personal security. \* \* \*

<sup>5</sup> 190 N. Y. 417, 83 N. E. 470 (1907). *aff'd* 216 U. S. 196, 30 Sup. Ct. 364 (1909). In his opinion in this case Cullen, *J.*, said: "Yet the defendant, in our opinion, became plainly liable for the amount which it received under the *ultra vires* contract. The law which obtains in this jurisdiction and in several others is that where one party has received the full benefit of an *ultra vires* contract, he cannot plead the invalidity of the contract to defeat an action upon it by the other party."

<sup>6</sup> *American Surety Co. v. The Philippine National Bank*, 245 N. Y. 116, 156 N. E. 634 (1927). Judge Crane says in this case: "A contract being unlawful and void, not because it is in itself immoral, but because the corporation by the law of its creation is incapable of making it, the courts while refusing to main-

Judge Lehman, in a dissenting opinion concurred in by Chief Judge Cardozo, disagreed, not because the agreement was *ultra vires* but because under the *ultra vires* agreement, in his opinion, the bank had received no benefit.<sup>7</sup>

In the case of *The Logan County National Bank v. Townsend*,<sup>8</sup> it was held that a bank cannot retain securities and at the same time refuse to comply with the terms of an *ultra vires* agreement.

In the case of *The Bath Gas Light Co. v. Claffey*<sup>9</sup> Chief Judge Andrews said:

“The courts in this state from an early date, commencing as far back as the Utica Insurance cases, have sought to regulate and restrict the defense of *ultra vires* so as to make it consistent with the obligations of justice.”

The principal case differs from all these, in our opinion, in that the defendant bank here received *no benefit*, either real or illusory, from the transaction. And, with the single exception of the Dyer case, which was decided almost simultaneously, we can find no authority for holding a bank or any other corporation liable on an *ultra vires* contract where no benefit of any sort has been received. Since the facts in the Dyer case are substantially the same as those in the present case, we do not feel that it is necessary at this point to discuss the former case.

### III. *Economic Aspects.*

Since we are at a loss for any legal precedent for this decision, we turn to the economic factors that unquestionably influenced the Court. As far back as *Central National Bank v. White*,<sup>10</sup> decided in 1893, the custom and propriety of banks purchasing stock through brokers for undisclosed principals was recognized, with this very important proviso: *that the risk was on the customer, and not on the bank*. And the bank there was held liable not on the basis of any contract, but because of its negligence.

In 1897 a decision of the Court of Appeals seemed to recognize and sanction the practice of persons, residing outside of New York City, and wishing to purchase or sell securities on the New York

---

tain any action upon the unlawful contract, have always striven to do justice between the parties so far as could be done consistently with adherence to the law, by permitting property or money parted with on the faith of the unlawful contract to be recovered back or compensation to be made for it.”

<sup>7</sup> “The benefit,” said Judge Lehman, in his dissenting opinion, “must be real, and not illusory.”

<sup>8</sup> 139 U. S. 67, 11 Sup. Ct. 496 (1890).

<sup>9</sup> 151 N. Y. 24, 45 N. E. 390 (1896).

<sup>10</sup> 139 N. Y. 631, 34 N. E. 1065 (1894).

Stock Exchange, going to their bankers and dealing through them.<sup>11</sup> But a closer examination of that case clearly shows that although the defendants were called bankers, they were really stockbrokers, and there is nothing in the case to show whether the defendants were *private* bankers or whether they were under the supervision of the State Banking Department.

More recently it has been said that we cannot assume that the banking business of today is the same as it was a decade ago.<sup>12</sup> The *raison d'être* of a commercial bank, says Holdsworth,<sup>13</sup> is that "a bank manufactures credit by accepting the business paper of its customers as security in exchange for its own bank credit in the form of a deposit account." Willis and Edwards<sup>14</sup> write similarly:

"The central function of a commercial bank is to substitute its own credit, which has general acceptance in the business community, for the individual's credit, which has only limited acceptability. \* \* \* It does this by substituting its own credit for that of the borrower or owner of wealth."

Now let us see what the writers say as to the actual entry of banks into the brokerage field. Langston and Whitney<sup>15</sup> state:

"\* \* \* Banks are frequently called upon to make purchases and sales of investment securities for their customers. \* \* \* While all banks, to a greater or lesser extent, make investments in bonds and securities for their own account, many of them also buy and sell securities for their customers. Hence the banks are not only called upon for advice, *but they are frequently asked to make purchases and sales of investment securities for their customers.*"

Fiske, in his book on *The Modern Bank*, says substantially the same thing.<sup>16</sup>

With these eminent economists as authority, we must agree with Judge Hubbs, writing in the *Dyer* case, when he says:<sup>17</sup>

"It is well known that many depositors in banks deal directly with their banks in making purchases of stock on the Stock Exchange. \* \* \*"

<sup>11</sup> *Le Marchant v. Moore*, 150 N. Y. 209, 44 N. E. 770 (1896).

<sup>12</sup> *Supra* Note 6.

<sup>13</sup> Holdsworth, *Money and Banking*, p. 182.

<sup>14</sup> Willis and Edwards, *Banking and Business*, p. 74.

<sup>15</sup> Langston and Whitney, *Banking Practice*, p. 309.

<sup>16</sup> Fiske, *The Modern Bank*, p. 154.

<sup>17</sup> *Supra* Note 3.

But we must disagree with the learned Judge when he proceeds to dismiss the entire argument of *ultra vires* under section 106 by merely saying:

“So far as we are advised, the Superintendent of Banks in this state has never raised any objection to that extensive practice.”

Judge Hubbs, writing further, as his justification for paying no attention to the foregoing argument, lays down the rule that

“in determining this case we should not close our minds to the well-known fact that the banking business in this country has developed rapidly during the last few years to meet the ever-growing demands of business. Banks *ex necessitate* have been required to extend their functions and perform services *formerly foreign to the banking business.*”

The principal case relies entirely on Judge Hubbs' opinion in the Dyer case, and sets up as the test of whether or not a bank involved in a transaction such as that alleged above should be held to the terms of its agreement in spite of the fact that it is *ultra vires* is:

“The test of power in all such cases is not the presence of risk or its absence, unless it be so inordinate as to be a speculative enterprise: the test is the relation of the act to the substitution of credits, which is of the essence of the banking function. Whatever risk is incident to the fulfillment of that function, according to the practice of banking as it has developed in these days, is to be accepted and suffered as one of the perils of the business.”<sup>18</sup>

We must respectfully submit that Chief Judge Cardozo's statements both in the Whiting case referred to above<sup>19</sup> and in the present case do not seem to us to have courageously faced the issue of just how we are going to determine whether or not any transaction is a speculative transaction. We cannot conceive of any venture for which a bank may not now lend funds, other than out-and-out games of chance. The social and economic undesirability of such a course as the banks have been pursuing, and now will continue to pursue with the approval of the courts, seems to us to be demonstrated most sharply and convincingly during our present economic depression. There is no question but that banks have pauperized business in order

---

<sup>18</sup> *Supra* Note 2 at 232, 170 N. E. at 901.

<sup>19</sup> *Supra* Note 1.

to place their funds at higher interest rates on the Stock Exchange. Now they carry their process of pauperization a step further, by making money more easily available when their customers wish to purchase speculative securities. The question will be asked: How can the state prevent such transactions? Frankly, to us it seems possible only by legislation. And we claim that this legislation now exists. We must adopt one of two attitudes: (a) Are we going to encourage stock speculation, or (b) are we going to encourage legitimate business transactions? The court seems to have spoken. The restraint of the statute has been ruled out, and now by judicial legislation a situation has been brought about which, in view particularly of the present financial depression, is economically unsound.

We cannot close our eyes to the unique position which banks occupy in society. That the Legislature never intended to allow banks to deal with other people's moneys as they (the banks) saw fit has hitherto been unquestioned.<sup>20</sup> All the statutes dealing with the banks and banking powers stand in formidable array as authority.

To us it seems that courts should be more wary of throwing overboard the safeguards which sound conservative economics and policies have placed on the statute books, in favor of the radical practices of the school of "new economics" that flamed so brightly during the hectic days of our "bull market," but are visible now, if at all, by a subdued blush.

SIDNEY E. COHN.

---

#### LIABILITIES OF TRUSTEES FOR BONDHOLDERS IN EXCESS OF THEIR EXPRESS UNDERTAKINGS.

The instrument which creates an express trust specifies the powers of the trustee and in the main furnishes the measure of his obligations.<sup>1</sup> A trust deed or trust mortgage is such an instrument.<sup>2</sup> The trustee, with regard both to his powers and duties, is required to act with the utmost good faith and diligence in protecting the interests of both obligor and the bondholders.<sup>3</sup> He may not transcend the

---

<sup>20</sup> As an indication that conservative banks regard this practice with apprehension, see the circular published by the Central Hanover Bank & Trust Company, New York, under the title, "No Securities For Sale."

<sup>1</sup> 3 Pomeroy, *Equity Jurisprudence* (3rd ed.), secs. 1062, 1079, 1080; 39 Cyc. 290-294; *Ainsa v. Mercantile Trust Co.*, 174 Cal. 504, 163 Pac. Rep. 898 (1917). See, however, *Rhinelander v. Farmers Loan & Trust Co.*, 172 N. Y. 512, 65 N. E. 499 (1902), where the Court finds an implied duty arising from the relationship alone.

<sup>2</sup> *Browning v. Fidelity Trust Co.*, 250 Fed. 321 (C. C. A., 3rd, 1918).

<sup>3</sup> *Davenport v. Vaughn*, 193 N. C. 646, 137 S. E. 714 (1927); *Goode v. Comfort*, 39 Mo. 313 (1866); *Sherwood v. Saxton*, 63 Mo. 79 (1876); *Central Trust Co. v. Owsley*, 188 Ill. App. 505 (1914); *Merchants Loan Co. v. Trust Co.*, 250 Ill. 86, 95 N. E. 59 (1911).