76.1936

In the Privy Council

No. 5 of 1936.

ON APPEAL FROM THE COURT OF APPEAL OF ONTARIO

BETWEEN:

J. A. ALLEN, Trustee in Bankruptcy of the Estate of L. S. Clarke (since deceased) and WILLIAM M. FLANNERY and BENJAMIN F. NOTT Executors of the Will of L. S. Clarke (Plaintiffs) *Appellants*

— AND —

F. O'HEARN and COMPANY (Defendants) *Respondents.*

CASE FOR THE APPELLANT

Record

1. This is an appeal by the plaintiffs from the judgment of the Court of Appeal for Ontario delivered on the 16th day of April, 1935, dismissing the action with costs and setting aside the judgment of Kingstone, J., dated December 1, 1934. p. 248, l. 10. p. 229, l. 1.

2. The plaintiff L. S. Clarke was a contractor who resided in the City of North Bay in the Province of Ontario. In January, 1931, he engaged in a general brokerage business with two offices, one at North Bay and the other at Sudbury. He did not personally supervise these offices, and the supervision was left in the hands of L. J. Bayne, manager of the North Bay office, and J. F. Woods, manager of the Sudbury office.

The defendant, F. O'Hearn & Company, operated a general brokerage business in the City of Toronto, and had a seat on the Standard Stock and Mining Exchange in Toronto and upon other exchanges. The members of the firm were A. Gardner, T. A. Richardson and E. Marks.

3. L. S. Clarke did not own a seat upon any stock exchange and it was necessary for him to make some arrangement with a broker who did own a seat upon an exchange or exchanges to execute orders coming through him. In January 1931 he entered into negotiations with members

APPELLANT'S CASE

Record.

P. 46, L. 15 to P. 47, L. 41. 4. At the request of Clarke, after receiving from him statements as to the standing and business history of Clarke and his employees and a very favourable financial statement of Clarke himself, the respondents agreed with Clarke to act as his "correspondents" in executing orders on the Exchanges. The respondents also for a consideration arranged to have Clarke's offices connected with their private wire for the purpose of taking orders and supplying market information. The respondents gave some assistance to Clarke in setting up his business by supplying him with standard customers' contract forms, information as to margin requirements, etc., for his guidance.

Ex. 19, P. 251 to P. 253. P. 86, L. 34. P. 72, L. 41. P. 87, L. 5 to L. 18. Ex. 26, P. 250.

5. Clarke established his business under the name of L. S. Clarke, broker, and opened offices in North Bay and Sudbury. The capital for the business was supplied entirely by Clarke. He appointed one, Woods, as manager of the Sudbury office, and the said L. J. Bayne as Manager in North Bay. On all transactions to be executed on the Toronto Stock and Mining Exchange Clarke and the respondents were to divide commissions equally. On all other business the respondents charged the full commissions. The respondents were not in any way interested in the losses or profits made by Clarke.

P. 47, L. 6. P. 48, L. 19. P. 50, L. 20 to L. 29. P. 50, L. 38. P. 150, L. 6.

6. On the commencement of business, Clarke entered into an agreement with the respondents to govern their transactions on a printed form which the respondents ordinarily had signed by their customers. It was the basis upon which the respondents executed orders and carried shares for L. S. Clarke throughout their dealings. It gave the respondents the right to pledge and sell securities carried by the respondents for the account of L. S. Clarke.

Ex. 8, P. 256. P. 50, L. 11. P. 190, L. 32. to L. 39.

7. Bayne, as Manager of the North Bay office, was given full authority to deal with the respondents. He was given a power of attorney to sign cheques. Bayne settled and prepared the contract forms to be used in the transactions with the customers of Clarke, and all details were left in his hands, with no supervision or control by the respondents.

P. 48, L. 19 to L. 35.

8. During 1931 and 1932 the account of Clarke with the respondents was fairly active, and until November, 1932, no difficulties arose. Margin calls made by the respondents were met promptly. In September, 1931, when there was a sudden break in the market, margin calls were met with the usual promptness. Even through this time of general depression Clarke led the respondents to believe that his financial position was sound.

P. 133, L. 44. to P. 134, L. 43. P. 152, L. 30. to L. 39.

9. The respondents had no knowledge of how Clarke's capital was apportioned between the Sudbury and North Bay offices. Payments were made to the respondents from North Bay to be applied to both branch accounts.

P. 150, L. 46. P. 47, L. 3 to L. 27. Exs. 20 and 21. P. 258 and P. 260.

P. 151, L. 3. P. 185, L. 36. P. 87, L. 15.

10. When orders were given to the respondents, the names of Clarke's customers were never disclosed. The respondents were not told upon what terms Clarke was dealing with his customers.

P. 17, L. 18. to P. 18, L. 20.

11. The respondents for convenience carried eight ledger accounts for

L. S. Clarke: North Bay Canadian Account; North Bay American Account; North Bay Canadian Grain Account; North Bay American Grain Account; Sudbury Canadian Account; Sudbury American Account; Sudbury Canadian Grain Account; Sudbury American Grain Account. His account was treated exactly as the accounts of other customers. Transactions, classified as above, were recorded in their chronological order. Each transaction was confirmed to Clarke by bought and sold notes. Clarke confirmed them to his Customers in similar manner.

Record.
P. 151. L. 5 to L. 18.
P. 150, L. 22. P. 151, L. 48 to P. 152, L. 18.
P. 161, L. 30.
Ex. 46, P. 263.
P. 73, L. 19 to L. 29.

12. In September, 1932, unknown to the respondents, Bayne entered into certain transactions with one, Barkell, a person unknown to the respondents. Barkell spoke highly of low-priced oil shares in a company known as Peninsular Petroleum, referred to in the evidence as "Pen Pete," and he induced Clarke and several others to join a "pool" for the purchase of these shares, with the result that about 150,000 shares were purchased. The respondents had no interest of any kind in this stock, owned no shares of that company, and knew little about the company. Bayne delivered to Barkell certificates for 150,000 shares apparently held for the "pool." Barkell then sold these shares through Toronto brokers, and Bayne, on behalf of Clarke, purchased them through the respondents, and carried them on Clarke's books in two fictitious accounts under the names of Smith and Greenwood. Upon receipt of the certificates for shares purchased he would deliver them again to Barkell, who would repeat the process, as a result of which the market price of the shares rose with the volume of transactions.

P. 158, L. 36 to P. 159, L. 15.
P. 195, L. 32.
P. 97, L. 11.
P. 139, L. 17 to L. 28.
P. 195, L. 17.
P. 89, L. 24 to P. 97, L. 13.
P. 346 and P. 350. Ex. 35.

13. Pen Pete shares, selling on the exchange for less than one dollar a share, were shares which, according to By-laws Nos. 38 and 41 of the Standard Stock and Mining Exchange, should not be carried on margin—that is, a broker carrying them for a customer, in calculating the margin requirements of the customer should not place any value on them.

P. 354, Ex. 11
P. 152, L. 3.
P. 180, L. 10 to L. 14.
P. 181, L. 18 to P. 184, L. 38.
P. 188, L. 34 to P. 189, L. 11.

14. Bayne was able to carry out these transactions with the respondents because Clarke's account with them was always well margined.

P. 94, L. 3.

15. During September and October, Clarke frequently visited the respondent's offices in Toronto, spoke highly of Pen Pete, was aware of the increasing volume of transactions in these shares, and at no time gave the impression that there was any irregularity in the dealings in it. In September, 447,000 shares were purchased on Clarke's account, and in October 75,350 shares, the prices ranging from 7c to 17½c. During heavy purchases in September the respondents sent a message to Clarke: "Watch your step on Pen Pete."

P. 134, L. 44 to P. 136, L. 10.
P. 152, L. 46 to P. 153, L. 5.
P. 325, to P. 345. Ex. 22
P. 264, Ex. 36
P. 97, L. 13.

16. In November, 1932, the purchases of Pen Pete became heavy. On November 4, a cheque from Clarke for $7500 was not met, and Gardner, a partner of the respondents, telephoned to Bayne, who assured him that it would be met in the morning, and it was honoured the next day.

P. 153, L. 23 to L. 34.

17. In this telephone conversation, Bayne asked Gardner to send him some envelopes, bearing a printed form of draft on the exterior, in which brokers

P. 266. Ex. 2

of the respondent firm. Arrangements were made with them for the maintenance of a private telegraph system between L. S. Clarke's offices in North Bay and Sudbury and the respondents' office in the City of Toronto. It was agreed that the regular commissions on orders executed by the respondents at L. S. Clarke's request on the Standard Stock and Mining Exchange should be equally divided.

p. 250, l. 1. The respondents by letter dated the 21st of January, Exhibit 26, advised L. J. Bayne, the North Bay manager for L. S. Clarke who was in charge of setting up the office there, that the law required a written confirmation of all transactions by a broker for a customer to be sent to the customer, and copies of confirmation forms used by the respondents were sent with the letter so that Clarke might adapt their form to his own use in his brokerage business. Exhibit 45, is a sample of the confirmation notes sent by L. S. Clarke's offices to his customers. Exhibit 46 is a sample of the confirmation notes sent to L. S. Clarke by the respondents upon executing orders on behalf of L. S. Clarke's customers on advice from his offices.

p. 262, l. 1; p. 263, l. 1.

The form sent by the respondents to Clarke and adopted by him contains the following clause:

"Purchases or Sales are made subject in all respects to the Rules, Bylaws and Customs existing at the time at the Exchange where executed; and also with the distinct understanding that actual delivery is contemplated, and that the party giving the orders agrees to these terms. It is agreed between broker and customer, that all securities from time to time carried in the customer's marginal account, or deposited to protect the same may be loaned by the broker, or may be pledged by him either separately or together with other securities, either for the sum due thereon or for a greater sum, all without further notice to the customer. It is further understood that on marginal business the right is reserved to close the transactions without further notice when margins are unsatisfactory."

On the 29th of January 1931, L. S. Clarke executed a standard printed card prepared for the respondents to be signed by ordinary clients (Exhibit 8.)

p. 256, l. 15.

The respondents however recognized at all times that L. S. Clarke was not a customer dealing on his own account, but a broker entering into transactions with them on account of his clients. The relationship between the respondents and L. S. Clarke is described as that of correspondents, and the letterhead employed by L. S. Clarke, the signs set outside his offices and the confirmation notes used by him, all with the knowledge of the respondents, describe F. O'Hearn & Co. as the "correspondent" of "L. S. Clarke, Broker."

After L. S. Clarke's offices had begun to do business, orders of his clients were sent to the respondents on the private wires and were of two sorts, "cash" or "margin". The cash transactions were transactions in which immediate delivery by the respondents to L. S. Clarke of shares purchased for his clients and immediate payment by L. S. Clarke for such shares on behalf of his clients were contemplated. Marginal transactions

were transactions sometimes described as "open" or "speculative" transactions.

Each order of L. S. Clarke's clients was telegraphed separately to the respondents, but the name of the customer was not disclosed, although the respondents were occasionally aware of the names of individual customers of L. S. Clarke. All transactions executed by the respondents on the various exchanges of which they were members, on the order of L. S. Clarke, were recorded in one of eight accounts entitled respectively: "L. S. Clarke North Bay general account; L. S. Clarke North Bay American grain account; L. S. Clarke North Bay Canadian grain account; L. S. Clarke North Bay New York account; L. S. Clarke Sudbury general account; L. S. Clarke Sudbury American grain account; L. S. Clarke Sudbury Canadian grain account; L. S. Clarke Sudbury New York account." When shares were ordered by L. S. Clarke to be purchased on behalf of his clients on margin, the shares would be retained by the respondents and credited to the account of L. S. Clarke. From time to time as the value of these shares held as security for the balance owing on the margin accounts of L. S. Clarke declined, requests for the deposit of further shares or monies as collateral were made by the respondents to the Sudbury office or the North Bay office and further shares or monies would be sent down from the North Bay office or Sudbury office and credited to the respective margin accounts. For the purpose of estimating the amount of margin required, and of making requests for further margin, the North Bay and Sudbury accounts were treated separately.

The relationship between L. S. Clarke and the respondents was similar, if not identical, to that of the Frontier Company and Solloway Mills & Company discussed by the Judicial Committee in Johnson v. Solloway Mills 1934 A.C. 193. In that case apparently no card similar to Exhibit 8 was signed by the out-of-town broker at the time of entering into arrangements with the correspondent broker on the exchange. In the present case, confirmations of sales and purchases for the clients of the out-of-town broker in the form of Exhibit 45 were sent out to customers of the out-of-town broker in addition to the monthly statements mentioned in the Johnson v. Solloway Mills case. p. 256, l. 15. p. 262, l. 1.

4. The course of dealing between L. S. Clarke and the respondents went on without material incident until September 1932. At that time the respondents held in the various accounts mentioned above, large quantities of shares purchased for or deposited by L. S. Clarke on behalf of his clients, as margin for the balance owing on these accounts.

In September 1932 one Barkell interested in the stock of a highly speculative oil company named Peninsular Petroleum Limited induced L. J. Bayne, Clarke's North Bay manager, to enter into a series of fraudulent transactions designed to enhance the price of the Peninsular Petroleum stock. This stock was described in the evidence as a "cash" stock or "penny" stock, that is a stock selling for less than $1.00 per share, and referred to in By-law No. 38 of the Standard Stock and Mining Exchange as a stock p. 354, l. 8.

which no member or firm or company represented by a member should purchase on a marginal basis for the account of a client.

The course of dealing between Barkell and L. J. Bayne was described by the learned trial judge as a "merry-go-round" and involved the purchase of quantities of Peninsular Petroleum stock at intervals during the months of September, October and the first part of November, by orders telegraphed from the North Bay office of L. S. Clarke to the respondents. These purchases were recorded in the books of L. S. Clarke as being made on behalf of Smith and Greenwood. These names were the names of fictitious characters used to describe transactions made at the instance of Barkell. Full payment was not made for these stocks although they were "penny" stocks as described above, and stocks delivered to L. S. Clarke in pursuance of these purchases were delivered out by Bayne to Barkell although not paid for, for delivery once more on sales through the respondents on further purchasing orders of L. S. Clarke's North Bay office for these fictitious accounts.

5. On the 4th of November 1932 a circumstance occurred which showed that the North Bay office of L. S. Clarke was becoming financially embarrassed. A cheque for $7500.00 in payment of the purchase price of some of the Peninsular Petroleum stock payable to the respondents and drawn by L. J. Bayne in the name of L. S. Clarke under a power of attorney from him was not accepted by the bank. A. Gardner then communicated with L. J. Bayne by long distance telephone, and in the course of discussion about the unaccepted cheque an arrangement was made to "draft out" Peninsular Petroleum stock.

pp. 78, ll. 5-45; 79, ll. 1-30; 165, ll. 32-45; 166, ll. 1-15.

The nature of this "drafting out" arrangement appears in the evidence and is briefly as follows: large orders for the purchase of this Peninsular Petroleum stock were said to be expected by Bayne to be sent in through Barkell. The orders for these stocks were to be given by L. J. Bayne to the respondents through the private telegraph system described above.

p. 266, l. 12.

Draft envelopes in blank, of which Exhibit 2 is a sample, were to be sent to L. J. Bayne in North Bay. The names of the purchasers and the amount of shares purchased by each, were to be filled in by L. J. Bayne in North Bay, and the envelopes returned to the respondents, who would sign and send them to their bankers in New York with the shares of the Peninsular Petroleum stock attached to be delivered to the purchasers on acceptance of the drafts in New York. The evidence differed between L. J. Bayne and members of the defendant firm as to whether this drafting out arrangement was limited with respect to the amount of stock to be "drafted out" and as to whether the drafting arrangement was to be used in financing the purchase of shares already purchased on the 4th of November at the time the arrangement was made.

p. 162, ll. 30-44

The evidence of A. Gardner however indicated that no limit had been set upon the amount of the shares which were to be drafted out. The trial

Record

judge has apparently accepted the evidence of L. J. Bayne on these points, which is indeed consistent with admissions made from time to time by A. Gardner and Elly Marks. The purpose of this drafting out arrangement was apparently to finance large purchases of penny stock, which should in the ordinary course have been settled for in cash shortly after the purchase, and which could not under the rules of the exchange be carried on margin. It also indicated that L. J. Bayne or the North Bay office of L. S. Clarke had not obtained from prospective customers or had not enough capital to pay for these purchases in the ordinary way. The drafting out arrangement was described by the learned trial judge and in several passages in the evidence by members of the respondent firm as an exceptional, extraordinary and unusual transaction and unprecedented in the brokerage business.

p. 22, ll. 13-14; p. 162, ll. 30-41; p. 220, ll. 37-47; p. 221, ll. 1-6; p. 228, ll. 3-5.

In pursuance of this arrangement fifty-two draft envelopes in blank in the same form as Exhibit 2 were sent by the respondents to the North Bay office of L. S. Clarke shortly after the telephone conversation between A. Gardner and L. J. Bayne on the 4th of November. No further discussion took place with regard to the drafting arrangement until late in the afternoon of November 9th.

Meanwhile on the 8th of November 1932 orders for the purchase of 78,000 shares of the Peninsular Petroleum stock had been sent through the private telegraph system on L. J. Bayne's direction to the respondents and further orders for the purchase of 247,000 shares on the 9th of November. These orders were duly executed by the respondents on the Standard Stock and Mining Exchange. L. J. Bayne stated that the proposed purchasers were a group in New York who were to accept the drafts to be sent down to New York by the respondents in pursuance of the "drafting out" arrangement referred to. In fact the arrangement for the purchase of these shares was made by Barkell with Bayne, and Bayne at no time had the names of any purchasers, if such existed.

After the orders for these 325,000 shares had all been executed on the Exchange by the respondents, with the exception of 50,000 shares, E. Marks, a member of the respondent firm, being informed of the unusually large amount of speculative stock ordered by L. S. Clarke's North Bay office, made inquiries and was informed by Gardner that some arrangement for drafting out this stock had been made. He caused Gardner to telephone to L. J. Bayne and repudiate any drafting out arrangements. At the same time an examination of the marginal accounts of L. S. Clarke was made to see if there was an ample surplus of value in the stocks held in the accounts (which were stocks held for Clarke's clients) over and above the balance then owing on the accounts. This examination proved that a substantial surplus or equity existed and apparently relying upon a supposed right to resort to this surplus or equity in case the purchases of the Peninsular Petroleum stock were not paid for, the respondents permitted the final order for 50,000 shares of stock to be executed.

A doubt at this time also apparently suggested itself to the minds of

the respondents as to L. S. Clarke's knowledge or approval of the transactions entered into by Bayne and an effort was made, without success, to communicate with L. S. Clarke by long distance telephone. The fact is that L. S. Clarke had nothing to do with the Peninsular Petroleum transactions of the 8th and 9th of November and was not aware of them until after the orders had been executed. Whether or not there were any bona fide purchasers of this 325,000 shares of Peninsular Petroleum stock, or whether the refusal of the respondents to carry out the "drafting out" arrangement prevented L. J. Bayne from obtaining purchasers, none in fact materialized to admit responsibility for or to pay for the shares. The respondents therefore looked to L. S. Clarke to pay the purchase price for these shares, which amounted to approximately $49,000.00. The respondents also claimed to be entitled to enter the amount due for the purchase price of these shares as a debit in the marginal account of L. S. Clarke with them and they claimed to have the right to sell Clarke's clients' stocks held as security in all of the marginal accounts in satisfaction of this claim for $49,000 for the purchase price of the Peninsular Petroleum stock bought on November 8th and 9th.

As stated above although these accounts were in the name of L. S. Clarke, they were in reality accounts for L. S. Clarke's customers and a considerable equity or surplus value existed after deducting from the value of the securities held for the accounts, the debit balance owing on the accounts and the customary percentage of the value required as marginal security. L. S. Clarke denied the right of the respondents to resort to the equity in these stocks to cover the deficiency in the purchase price of the Peninsular Petroleum transaction of November 8th and 9th and it is this question which is the main issue involved in this case.

6. Efforts were made by L. S. Clarke to obtain money from the proposed purchasers of the Peninsular Petroleum stock, but these efforts were unavailing, and on the 19th November, as the price of the Peninsular Petroleum stock was rapidly falling and the respondents were threatening to sell some part or all of the 325,000 shares and so further to depress the price, L. S. Clarke arranged for the deposit of 500,000 additional shares of Peninsular Petroleum by one Kaatz as a further security for the repayment of the purchase price of the Peninsular Petroleum stock bought on the 8th and 9th November. A written agreement between Kaatz and the respondents was drawn up and executed. (Exhibit 3).

p. 281, l. 1.

L. S. Clarke gave evidence that in the presence of all of the members of the respondent firm an oral agreement was entered into with him that the respondents would segregate the Peninsular Petroleum transactions of November 8th and 9th and keep them separate from the marginal accounts where his customers' securities were carried, and that therefore the purchase price of these stocks would not appear in the general debit balance of the marginal accounts, nor would the securities in this general account be available for sale to make up what was owing on the Peninsular Petroleum transaction. In fact a separate account for the Peninsular Pet-

roleum transactions of November 8th and 9th was set up and maintained by the respondents until the end of January, 1933.

7. The agreement of November 19th did not prove satisfactory to the respondents as the price of the Peninsular Petroleum stock fell very rapidly. Accordingly the balance due for the purchase price of the stocks bought on the 8th and 9th of November remaining unpaid, after the exchange of correspondence in January, 1933 in which the position of the parties was set out (Exhibits 4, 6), the respondents proceeded on the 7th of February, 1933, despite Clarke's protest, to sell some of the securities held in the marginal accounts of L. S. Clarke, and applied the proceeds in satisfaction of the claim for the balance due on the Peninsular Petroleum transactions of the 8th and 9th of November. pp. 304; 313.

The stocks sold included stocks deposited as collateral by and stocks purchased for the Sudbury clients of L. S. Clarke in his name, as well as stocks deposited by or purchased for the North Bay clients.

On the 28th day of February, 1933, L. S. Clarke made an authorized assignment under the provisions of the Bankruptcy Act, R.S.C. 1927, c. 11, and the appellant J. A. Allen was appointed his trustee. Further sales of securities held in the marginal accounts of L. S. Clarke were made on the 28th of February and on 6th and 11th of March and the proceeds again applied by the respondents to the indebtedness arising out of the Peninsular Petroleum transactions of November 8th and 9th.

On the 27th of September, 1933, the appellant J. A. Allen issued the writ of summons and commenced this action in which he claimed inter alia, a declaration that the respondents were not entitled to charge the ordinary accounts of L. S. Clarke for his customers with the purchase price of the Peninsular Petroleum stock bought on November 8th and 9th, and for damages for the wrongful sale of the shares held in these accounts and sold in the exercise of a supposed right to hold them as security for the unpaid balance due on these transactions.

The appellant L. S. Clarke was added as a party plaintiff as trustee of such rights of action as remained vested in him and did not pass to his trustee upon bankruptcy.

8. The action came on for trial in North Bay before Kingstone, J., on the 5th and 6th days of April, and the 30th and 31st days of May, 1934, and on the 1st day of December, 1934, he gave judgment for the appellants declaring that the respondents had no right to charge the securities held by them in the L. S. Clarke accounts and later sold by them, with the purchase price of the 300,000 shares of Peninsular Petroleum stock, and that the plaintiffs were entitled to damages for wrongful sale of the same, with a reference to the Local Master to determine the amount of the damages. p. 229, l. 1.

Kingstone, J., in his Reasons for Judgment found as a fact that the "drafting out arrangement" alleged by L. J. Bayne had in fact been made, and that this "drafting out arrangement" was of an exceptional, extraordinary and unusual nature, and that one of the partners of the defendant firm had said that they never had an experience similar to this one be- p. 221

fore in the brokerage business. He further found as a fact that there was no complaint that the accounts of L. S. Clarke, if the unpaid purchase price
p. 221, l. 29. of the Peninsular Petroleum transactions of November 8th and 9th be omitted from consideration, were not safely and fully margined and protected. He found as a fact that the respondents entered into an agreement with L. S. Clarke to "segregate" the Peninsular Petroleum account from the other accounts "as a further protection" for the clients of L. S. Clarke whose securities were in jeopardy owing to the claim of the respondents that they were entitled to sell them to satisfy the indebtedness arising out of the Peninsular Petroleum transaction.

The appellants contended that the respondents, under the rules of the Standard Exchange, subject to which all transactions were entered into between L. S. Clarke and the respondents, were not entitled to enter in the debit balances of the marginal accounts any sums owed for "penny stocks" (stocks selling for less than $1.00, and including Peninsular Petroleum stock). In support of this contention they referred to Exhibit 11,
p. 354
p. 256, ll. 33-4 By-law No. 38 of the Standard Stock and Mining Exchange, and Exhibit 8.

The learned trial judge upheld this contention and found that the customers and clients of L. S. Clarke had a right to insist that their equity in the marginal account was not to be affected or prejudiced by the purchase
p. 227, l. 7 by Clarke from the respondents of a penny stock, under the circumstances.

The learned trial judge further found that the respondents were put upon their inquiry as to the authority of L. S. Clarke to bind his customers by a pledge of the securities held in the marginal accounts, that might be implied from the purchases of the Peninsular Petroleum stock on the 8th and 9th November through the North Bay office of L. S. Clarke. He found that the members of the respondent firm were aware of the extremely hazardous nature of the Peninsular Petroleum stock, and of the financial embarrassment of the North Bay office of L. S. Clarke, and of the exceptional and unusual "drafting out arrangement". He found that the respondents actually considered whether they were entitled to resort to the securities held on behalf of L. S. Clarke's clients, and having decided that they were
p. 228, l. 5 so entitled, completed the Peninsular Petroleum transactions notwithstanding their hazardous nature, in reliance upon such supposed right. He held that the whole Peninsular Petroleum transaction permitted by, if not assisted by, members of the respondent firm, was of such an unusual nature,
p. 228, l. 9 and in many respects fraudulent in character, as one would have thought would have aroused and excited the suspicion of even less experienced brokers than the respondent firm.

On appeal to the Court of Appeal of Ontario, consisting of Riddell, J.A., Fisher, J.A., and Macdonnell, J.A., the judgment of Mr. Justice Kingstone was reversed and the action dismissed with costs.

9. Riddell, J.A., held that the relationship between the parties was exactly the same as if L. S. Clarke had been dealing throughout on his own

account alone. The learned justice in appeal distinguished the Johnson v. Solloway Mills case on the ground that evidence that L. S. Clarke was acting for clients as the undisclosed principal in the transactions, was excluded by the terms of Exhibit 8. Accordingly the learned justice in appeal could not see why the respondents should not be entitled to have resort to the securities held in the marginal accounts to pay for the unpaid purchase price of the Peninsular Petroleum transactions of November 8th and 9th in the same way as they would have been entitled if all the transactions entered into were admittedly transactions entered into on L. S. Clarke's personal account.

10. Fisher, J.A., disagreed with the conclusion of the learned trial judge that the respondents were put upon their inquiry as to Bayne's authority or Clarke's authority to pledge by implication the securities held in the marginal accounts for the purchase price of the Peninsular Petroleum transaction. The learned justice in appeal thought that the surrounding circumstances were not such as to indicate to the respondents that there was anything different in the transactions of November 8th and 9th from ordinary transactions entered into between the parties. The learned justice in appeal also refused to accept the finding of the learned trial judge that there was an agreement on the 19th November, 1932 to relieve the margined accounts from liability for the Peninsular Petroleum transaction.

The learned justice in appeal also found that there was no right of action vested in the plaintiff Allen as trustee-in-bankruptcy, or in L. S. Clarke as trustee on behalf of his customers.

11. Macdonnell, J.A., found that there was no obligation upon the respondents not to introduce into the debit balances in the marginal accounts the purchase price of "penny stocks" such as Peninsular Petroleum, and that no objection on that account could be taken to the sale of the securities held in the marginal accounts by the respondents to satisfy the balance due on the Peninsular Petroleum transactions.

The learned justice in appeal stated that the Peninsular Petroleum transaction of November 8th was in no way exceptional, and that of November 9th exceptional only in point of volume. It is respectfully submitted that the learned justice in appeal has overlooked the "drafting out" arrangement found to have been entered into at the time of these transactions and described by the respondents themselves as extraordinary, exceptional and unprecedented.

The learned justice in appeal also states that this case is different from one in which a broker has notice that two accounts are different in character and that the case is not comparable to the case of O'Hearn & Company carrying one account for Clarke's customers and another account for Clarke personally, the one impressed with a trust and the other not.

It is respectfully submitted that the two accounts were of an essentially different character. The debit balance in the marginal account was made up of an amount owing by L. S. Clarke's customers for stocks and

shares purchased by L. S. Clarke, broker, in the course of ordinary brokerage business and in accordance with the rules of the exchange. The Peninsular Petroleum transactions of November 8th and 9th, on the other hand, were transactions entered into by L. J. Bayne fraudulently contrary to the ordinary practice of the brokerage business and the rules of the exchange and in circumstances of such an unusual, extraordinary and unprecedented nature as to have put the respondents upon their inquiry.

12. The appellants humbly submit that the appeal should be allowed and the judgment of Kingstone, J., restored for the following reasons:—

1. Because the respondents were not entitled to hold securities of L. S. Clarke's clients pledged as collateral for the margin accounts for any other indebtedness than the indebtedness incurred by the sale or purchase of securities in accordance with the rules and customs of the exchange where executed, and in the ordinary course of the brokerage business.

2. Because the purchase of 300,000 shares of Peninsular Petroleum stock on November 8th and 9th, 1932, was not in accordance with the rules and customs of the exchange, and was out of the ordinary course of the brokerage business. Therefore the indebtedness arising from the purchase of these shares could not properly be added to an indebtedness for which the securities in the margin account could be sold.

3. Because the Court of Appeal have given to Exhibit 8, the printed contract card, an effect not justified by its terms. The Court have considered that the terms of this exhibit justified the sale of securities held in the marginal accounts to satisfy any debit balance in the accounts however arising, whereas the said exhibit is silent as to the nature of the debit balance for which such securities are to be sold, except for the overriding provision that all transactions are to be subject to the rules, regulations and customs of the Exchange where executed.

4. Because the Peninsular Petroleum transactions of November 8th and 9th were transactions in a stock which, by the terms of By-law No. 38 of the Standard Stock and Mining Exchange, could not be treated as marginal transactions.

5. Because the terms of By-law No. 41 of the Standard Stock and Mining Exchange, which the respondents knew to be introduced into the agreement defining the extent of L. S. Clarke's authority to pledge his clients' shares, expressly prohibited the pledging of shares for more than was fair and reasonable in view of the indebtedness of the customer.

It is submitted that in this case the indebtedness for which it was fair and reasonable that L. S. Clarke should pledge and may be taken to have pledged the shares of his clients, did not include an indebtedness contracted in the manner of the Peninsular Petroleum indebtedness of November 8th and 9th.

6. Because the finding of the learned trial judge that the "drafting out arrangement" was extraordinary, unusual and unprecedented in the respondents' experience, was amply justified by the evidence.

p. 162
p. 21, l. 16

7. Because the making of the "drafting out" agreement took it out

of the class of transaction in which L. S. Clarke or L. J. Bayne would under the agreement with the respondents be presumed to have pledged the securities of their clients or would have had authority to do so.

8. Because the finding of the learned trial judge that the respondents were put upon their inquiry as to the fraudulent nature of the orders for Peninsular Petroleum stock of November 8th and 9th made by Bayne, is amply justified by the evidence, and as a result the respondents were not entitled to claim that Bayne had authority on behalf of L. S. Clarke or his customers to pledge the securities held in the marginal accounts for clients for the purchase price of the Peninsular Petroleum transactions. The principles enunciated in London Joint Stock Bank v. Simmons 1892 A.C. 201 and Lord Sheffields Case 13 A.C. 333 apply.

9. Because L. J. Bayne had no authority from L. S. Clarke as the respondents knew or should have known, to enter into the transactions of November 8th and 9th in such a way as to add the purchase price of the Peninsular Petroleum stock to the debit balance for which the securities in the marginal accounts were held.

10. Because L. S. Clarke did not ratify the action of L. J. Bayne in giving the fraudulent orders for the purchase of the Peninsular Petroleum stock on the 8th and 9th November, except on his own account, and not so as to bind his clients, and in any event he could not ratify the transactions so as to affect the securities of his clients; or in the alternative, if L. S. Clarke purported to ratify the transactions of L. J. Bayne on the 8th and 9th November so as to bind his clients, the ratification is ineffective as it was made in ignorance of the facts, and by reason of the denial of the "drafting out" arrangement made by A. Gardner.

p. 36, ll. 5 to p. 37 l. 45, l. 8.

11. Because the learned Court of Appeal erred in failing to give effect to the finding of the learned trial judge which was supported by the evidence that on November 19th the respondents orally agreed with L. S. Clarke not to have recourse to the marginal accounts to satisfy the indebtedness arising out of the Peninsular Petroleum transactions of November 8th and 9th, and that without consideration of the rights of the parties existing on the 19th of November, after that date any sale of securities in the marginal accounts was wrongful as a breach of the agreement of November 19th.

12. The Court of Appeal erred in seeking to distinguish this case from Johnson v. Solloway Mills Company Limited, and in holding that the implied terms of the agreement between L. S. Clarke and F. O'Hearn & Company were the same as if L.S. Clarke had been acting on his own account, and had not been known by the respondents to be acting as a broker for clients.

13. Because, in any event the Court of Appeal should have held that the respondents were not entitled to sell securities held for the Sudbury clients to pay for the deficiency in the Peninsular Petroleum transaction as the transaction in the Peninsular Petroleum was made through the North Bay office and was recorded in the North Bay office, and the North Bay

and Sudbury accounts were separate and treated as separate at all times by the respondents and should have given judgment declaring the sale of securities held for the Sudbury clients wrongful.

14. Because a right of action herein was properly vested in either one or both of the appellants. The obligation of the respondents was contractual in nature, and their sale of the securities in question was a breach of their implied contract with L. S. Clarke who was acting as agent for undisclosed principals. An agent for an undisclosed principal may sue in his own name on a contract. The transactions were not closed, and the right of action therefore passed to the trustee-in-bankruptcy. If not Clarke was entitled to sue as trustee for his customers under the Rules of Practice in force in Ontario (Rule 74).

J. C. McRUER.

No. 5 of 1936.

In the Privy Council.

ON APPEAL

FROM THE COURT OF APPEAL OF ONTARIO.

BETWEEN :

J. A. ALLEN, Trustee-in-Bankruptcy of the Estate of L. S. Clarke and L. S. CLARKE, (since deceased) in his capacity as a Trustee - (Plaintiffs) *Appellants*

— AND —

F. O'HEARN AND COMPANY (Defendant) *Respondent.*

CASE FOR THE APPELLANTS.

LAWRENCE JONES & Co.,
Lloyd's Building,
Leadenhall Street,
London, E.C.3,
For the Appellants.

[redacted]