Negotiable Instruments Pledged As Collateral Security for Loans

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Banks and other institutions lending money require the utmost safety in protecting their loans. Generally more than original security is required, and the term applied to that security other than the original is "collateral security" which is legally defined in the case of Schützler v. Wichita Fourth Nat. Bank, I Kan. A 674 as "that security for the payment of money besides the original security." "The etymology of 'Collateral security' indicates that it is something running along with, and, as it were, parallel to, something else of a similar character. It is collateral to the original indebtedness." 158 Fed. 858 (quot. 14 Col. 104.) The general and the most common form of this type of security is negotiable instruments. Negotiable paper is valuable for pledge not because of the value of the paper itself, but because it is either a promise or order to pay money, and will ultimately be converted into money.

When banks lending money require collateral security for their safety they become the pledgee of such property and have certain duties to perform and acquire certain liabilities for failure to perform. A pledge is defined in 31 Cyc. 785 as a transfer of personal property as security for a debt or other obligation. "It is a bailment to secure the payment of a debt, or a performance of an engagement, accompanied by a power of sale in case of default," Dobie on Bailments. The rights and duties of the pledgor and pledgee in most cases are governed by the contract of pledgment. But a great many interesting questions of law arise because of the failure to stipulate for all of the conditions that might arise. It would be next to impossible to make a contract of bailment which would govern all of the rights and duties of the parties. It is the purpose of this article to treat of a few of the circumstances that may arise when negotiable instruments are pledged as collateral security for loans, which are not governed by the contract of pledgment.

A in order to secure a loan at the X Bank gives his...
note for the amount of the loan to the bank and also places
with the bank as collateral security two negotiable notes
which he owns. There being no express agreement regulat-
ing the contract of pledgment the bank retains the original
note of A and separates the collateral notes and sells one
to C and the other to D. The questions then arise as to the
rights of A and the liabilities of the bank and as to the rights
acquired by C and D, the innocent purchasers of the Col-
lateral notes.

The general rule in regard to the pledgee’s right to sell
commercial paper pledged is stated in 31 Cyc. 839, “In the
absence of special authority or agreement permitting him
to do so, a pledgee has no right to sell commercial paper
held as pledge, either at public or private sale, and an un-
authorized sale by him constitutes a conversion of the instru-
ment.” The right to sell commercial paper may be given by
express agreement. 39 Pa. St. 243. But in the absence of
authority to sell it has been held in the following cases that
the pledgee of commercial paper may not sell the same.
Hall, 47 N. Y. Sup. 1054; Joliet Iron and Steel Co. v.
Scioto Fire Brick Co.; 82 Ill. 548; Fletcher v. Dickinson, 7
Allen 23; Lasser v. Long, 96 So. 841; Aulwes v. Farmers
Bank of Humboldt, 182 N. W. 528. By becoming the
pledgee of the collateral note the bank has assumed the
duties of ownership, and it must protect not only its interest
but also the interest of the pledgor, who because of the
changed relationship is unable to do so. By selling the notes
the bank has put the control of the notes beyond its power
and is not able to protect its interest and the interests of the
pledgor. Thus we see that this case will fall within the
rule announced in Wheeler v. Newbould, 16 N. Y. 392, af-
firmed in 5 Duer 29, which is the most frequently cited and
the leading authority on this subject. In that case promis-
sory notes were pledged as collateral security for the pay-
ment of a loan. There was no agreement in the contract per-
mitting the pledgee to sell the collateral. The main note and
loan became due and upon failure of the pledgor to pay the
note the pledgee sold the notes held as security. The court
held that in such a case the pledgee has no right to sell such
notes at the maturity of the loan which is not paid. “In the
absence of any agreement to the contrary between the parties it is the duties of the pledgee, if he resorts to hypothecated securities, to hold the notes and collect the same when they become due, and apply the proceeds in payment of the loan, and return the surplus, if any, to the borrower."

The court in this case showed the distinction between a pledge of a chose in action such as negotiable instruments and goods and merchandise. When the subject of the pledge is goods and merchandise the general rule of pledges is that they may be sold to satisfy the debt because there is no other way in which they can be applied to the payment of the debt, unless they are converted into money, which can only be done by sale. But a different rule is applied to negotiable securities because of the nature of the subject. The reason negotiable securities are excepted from the general rule of sale of pledged property on default of payment of the main debt is well stated in Wheeler v. Newbould, supra, "Creditors holding such property in trust, for the use of the debtor and offering it for sale in satisfaction of his debt, can hardly fail to sacrifice it; for unless the solvency and circumstances of the makers of the note are well known and placed beyond doubt, few will purchase, and those only for the purpose of speculation, and at ruinously low prices. Unless the stipulations of the contract are expressly to that effect, the law will not require the debtor to subject his property to an ordeal which must be, in a great measure, destructive of the value." Thus we see in the present case the X Bank has violated a duty to hold the collateral security and is therefore liable for conversion at the option of the pledgor. 124 Mass. 500; 25 My. 424. It has been held, however, that if the sale is not inconsistent to any extent with the rights of the pledger or is such a transfer as does not injure the rights of the pledgor, and could be delivered to him any time he may demand it there is no conversion and no liability. Heath v. Griswold, 5 Fed. Rep. 573. In Cleghorn v. Minn. Title & Trust Co., 57 Minn. 441, it was held that although a pledgee of commercial paper pledged as collateral security may not sell it, a court of equity may order a judicial sale. And in Donohoe v. Gamble, 38 Cal. 341, it was held that foreclosure and sale of negotiable instrument held as pledge is authorized, when
the maker resides in a remote country or a different state, and it does not appear that he has any property within the jurisdiction subject to seizure and sale. In the present case the question of the amount of damages would probably arise and if the general rule of damages for such a conversion were followed X would be able to recover for the actual value of the securities and not merely the price the bank received. 123 S. E. 165 (Ga.) 207 Mo. App. 302.

Any previous equities which might have been set up against the pledgor or other prior parties are cut off as against the pledgee in regard to the collateral notes after the notes have been accepted by the pledgee without notice of any defences to such paper. The pledgee of commercial paper is considered a bona fide holder for value by all of the authorities. Dobie on Bailments; Stephenson v. Perry, 199 N. W. 499, 112 Neb., 294; First National Bank of Iowa City v. John McGrath & Sons Co., 111 Miss. 872; Peoples State Bank of Texarkana v. Birmingham 266 S. W. 766. Thus we see that the pledgee of negotiable instruments gets a better title than the pledgor had. This is true even though the pledgee violated the rights of the pledgor in sealing the note. 51 N. E. 453 Mass. Justice Holmes in delivering the opinion stated “that the law of the case is settled by numerous decisions. If a thief gives stolen money, or negotiable securities before their maturity, in payment of his debt, or as a security for it, to one who in good faith receives the money or securities as belonging to him, the creditor can hold the property as against the true owner.” Therefore, following the law in the above cases the X Bank in the present case, being a holder for value, it could transfer a good title to the purchasers of the collateral and C and D, the purchasers from the bank, would get a title better than that of the pledgor. However, some states forbid by statute the separation of the collateral from the main debt. In a case from Ga. (102 So. 110) it was held that securities pledged as collateral can not be transferred without transfer of debt nor otherwise than provided by code.