

# YALE LAW JOURNAL

VOL XL.

APRIL, 1931

No. 6

## HEDGING AND WAGERING ON PRODUCE EXCHANGES

EDWIN W. PATTERSON\*

TRADING on produce exchanges has been the subject of numerous public and private investigations.<sup>1</sup> Facts are voluminous. Opinions are divergent. The charge that organized exchanges are parasites on the body politic is met by the counter-charge that they perform useful functions in the marketing of certain agricultural commodities.<sup>2</sup> Most arguments in favor of the present system of trading, especially the trading in "futures" (which is the storm centre of the controversy), revolve around the necessity of having a market available for hedging. Without assuming that this is the only possible justification for the continuance of futures trading,<sup>3</sup> one may safely say that it is the

---

\* Professor of Law, Columbia University; author of *THE INSURANCE COMMISSIONER IN THE UNITED STATES* (1927). The author is indebted to B. B. Hadfield, Jr., L.L.B. Columbia, 1930, for valuable aid in gathering materials for this article.

<sup>1</sup> REPORT OF THE FEDERAL TRADE COMMISSION ON THE GRAIN TRADE (1920-1926) Vols. 1-7 (cited *GRAIN TRADE*); REPORT OF THE FEDERAL TRADE COMMISSION ON METHODS AND OPERATIONS OF GRAIN EXPORTERS (1922-1923) Vols. 1-2 (cited *GRAIN EXPORTERS*); HEARINGS BEFORE THE COMMITTEE ON AGRICULTURE AND FORESTRY ON S. 454 (A Bill to Prevent the Sale of Cotton and Grain in Future Markets, U. S. Senate, 69th Cong. 1st sess. 1926) 1-390 (cited *HEARINGS ON S. 454*), also printed in *HEARINGS OF COMMITTEE ON AGRICULTURE AND FORESTRY* (Gov't Printing Office, 1926) vol. 5, 1-193; GEORGE W. HOFFMAN, *HEDGING BY DEALING IN GRAIN FUTURES* (1925), with bibliography of earlier literature, at 131 *et seq.*; JAMES E. BOYLE, *SPECULATION AND THE CHICAGO BOARD OF TRADE* (1920); H. C. EMERY, *SPECULATION ON THE STOCK AND PRODUCE EXCHANGES* (1896); *THE COST OF TRADING IN WHEAT FUTURES, WHEAT STUDIES OF THE FOOD RESEARCH INSTITUTE OF STANFORD UNIVERSITY* (1926) Vol. 2, No. 3. This list is not exhaustive. Stock exchange trading is here excluded from consideration.

<sup>2</sup> Besides the grain and cotton exchanges, herein discussed, there are organized exchanges in sugar, rice, jute, rubber, etc.

<sup>3</sup> Even apart from hedging, grain exchanges furnish a public register of prices open to all who deal in grain (Grain Futures Act, 42 STAT. 998, 1001 (1922), 7 U. S. C. § 6 (1926); *HEARINGS ON S. 454*, 264, quoting the Stanford study), and probably tend to prevent violent fluctuations in price (*ibid.* 215; BOYLE, *op. cit.*, *supra* note 1, at 219).

chief one. If a way could be found to preserve present hedging facilities and yet abolish wagering or excessive speculation, legislators would probably be glad to enact appropriate legislation.<sup>4</sup> Yet no method has been found, and it is frequently assumed that a practical separation of hedging and wagering is impossible.<sup>5</sup>

The present article deals with a narrow phase of the problem, namely, the possibility of distinguishing wagering from hedging in civil actions where illegality is pleaded as a defense or as the basis of a cause of action. Attempts to supervise and curtail futures trading by federal legislation<sup>6</sup> have not superseded the statutes, found in many states, which prohibit the making of contracts for future delivery where there is no intention to deliver or to accept delivery.<sup>7</sup> Direct penalties are commonly attached to these statutes, but, if one may judge by the reported cases on appeal, indirect penalties, such as denial of

---

<sup>4</sup> Senator Norris, in the hearings on S. 454, asked if such a separation were possible. HEARINGS ON S. 454, 15.

<sup>5</sup> Such was the opinion of two Secretaries of Agriculture, Wallace and Jardine. HEARINGS ON S. 454, 8, 12.

<sup>6</sup> The Grain Futures Act, 42 STAT. 998 (1922), 7 U. S. C. § 1 (1926), is a regulatory measure. Section 6 prohibits futures transactions (in interstate commerce) in grain unless the seller is a grower or actual owner of the grain, or the contract is made by or through a member of a board of trade approved on certain conditions, by the Secretary of Agriculture as a "contract market." The constitutionality of this section was questioned, but not determined, in *Board of Trade v. Olsen*, 262 U. S. 1, 43 Sup. Ct. 470 (1923). United States Cotton Futures Act, 39 STAT. 476 (1916), 26 U. S. C. § 731 (1926), purports to be a revenue measure. It imposes a prohibitive tax (two cents per pound) on futures contracts made on a cotton exchange unless the contract complies with certain requirements, one of which is that the contract must provide that delivery of the cotton shall not be effected by "set-off" or "ring settlement," but only by the actual transfer of the specified cotton mentioned in the contract. § 741 (4).

<sup>7</sup> Typically, state statutes are broad enough to invalidate futures transactions made within the state though carried out by trades made in another state. See *infra* notes 42 and 60. The Cotton Futures Act, as a revenue measure, presumably does not supersede this state legislation. The effect of the Grain Futures Act will depend upon whether Congress intended to assume exclusive control of the regulation of grain exchanges as instrumentalities of interstate commerce. Section 5 contains a broad declaration of the necessity of regulation for the protection of interstate commerce. The Supreme Court of Kansas, in an able opinion by Burch, J., has held that the federal law supersedes the direct penal provisions of the Kansas statute, as applied to a commission merchant taking orders for trades on exchanges approved by the Secretary of Agriculture. *State ex rel. Burnett v. Rosenbaum Grain Co.*, 115 Kan. 40, 222 Pac. 80 (1924). *Cf. Hoyt v. Wickham*, 25 F. (2d) 777 (C. C. A. 8th, 1928). The federal law may even supersede state laws as to trades (on approved grain exchanges) consummated wholly within state lines. The question is too involved for further elaboration here. At all events, the present discussion may throw some light on the meaning and usefulness of the "mutual intention" test.

recovery on the contract, are much more frequently invoked. Whatever may be said of this type of deterrent, as long as these statutes continue to be the subject of civil litigation the problem of their interpretation will continue to be important. Moreover, the present attempt to discover their implications and their applications will, it is hoped, throw some light upon the theory of wagering agreements.

Wagering agreements have long given trouble to courts and legislators. The English courts, while enforcing wagers on trivial events with some reluctance,<sup>8</sup> seized upon slight pretexts as a basis for denying recovery on wagers tending to promote crime or immorality.<sup>9</sup> Yet they were unwilling to mount the "unruly horse" of public policy<sup>10</sup> and declare all wagering agreements unenforceable. The legislature was equally cautious. Until 1845 Parliament prohibited, with varying degrees of legal sanction, certain specific types of wagering institutions;<sup>11</sup> then a sweeping prohibition against wagering transactions was enacted.<sup>12</sup> Certainly the earlier legislation, aimed at specific undesirable institutions, was much easier to apply than the abstract prohibition of wagering, which leaves for judicial determination basic questions of social and economic policy. It may be noted also, for future reference, that the sanctions of English legislation were never so severe nor so broad in scope as to indicate a determined purpose to stamp out wagering agreements.

<sup>8</sup> *E. g.*, *March v. Pigot*, 5 Burr. 2802 (1771) (wager on survivorship of fathers of the wagerers); *Hussey v. Crickitt*, 3 Camp. 168 (1811) (wager on who was older). But see Lord Ellenborough's indignant refusal to settle a wager between two attorneys on a question of law. *Henkin v. Gerss*, 2 Camp. 408 (1810).

<sup>9</sup> *E. g.*, *Gilbert v. Sykes*, 16 East 150 (1812) (wager on life of Napoleon I); *Da Costa v. Jones*, 2 Cowp. 729 (1778) (wager on the sex of a certain individual).

<sup>10</sup> "I, for one, protest, as my Lord has done, against arguing too strongly upon public policy;—it is a very unruly horse, and when once you get astride it you never know where it will carry you." Burrough, J., in *Richardson v. Mellish*, 2 Bing. 229, 252 (1824). See also HOLLAND, *JURISPRUDENCE* (10th ed. 1906) 268; 2 ELY, *PROPERTY AND CONTRACT IN THEIR RELATION TO THE DISTRIBUTION OF WEALTH* (1914) 570; 3 WILLISTON, *CONTRACTS* (1920) §1667.

<sup>11</sup> *E. g.*, 33 HEN. VIII, c. 9 (1541-2) (prohibiting gaming houses at which certain games were played); 16 CAR. II, c. 7 (1664) (winning of more than £100 at play unlawful; treble forfeiture); 10 WM. III, c. 23 (1698) (lotteries declared public nuisances).

<sup>12</sup> The Gaming Act, 8 and 9 VICR., c. 109 (1845), superseding nearly all prior legislation, declared contracts "by way of gaming or wagering" void. Subscriptions to prizes for the winners of games, sports, etc., however, were declared lawful. The loser was not allowed to recover his stake. Gaming Act, 1922, 12 and 13 GEO. V, c. 19, repealing an earlier provision (Gaming Act, 1835, 5 and 6 WM. IV, c. 41) which has numerous counterparts in American legislation.

Throughout most of the United States no legislation was needed to make wagering agreements unenforceable. Judges, inspired (one may conjecture) by Puritan ideas of vice and by pioneer notions of useful industry, declared wagering transactions, *in general*, contrary to public policy. Legislation has filled in portions of this broad outline of social policy by prohibiting, with varying penalties, more clearly defined institutional practices (various types of games or gambling apparatus, lotteries, book-making at horseraces, etc.); and enforcement officials have further discriminated between different ways of satisfying the gambling appetite. One should not be surprised, then, if the law in action turns out to be a compromise with the devil.

In order to determine the possibility of separating hedging from wagering in civil litigation one must investigate first, the institutional practices embraced under the term hedging, and their social utility; secondly, the implications of the legal conception of wagering, especially the relation of the "intention" test to institutional behavior; finally, methods of proving a "wager." Judicial decisions directly involving hedging are too few, too divergent, and too obscurely reasoned, to furnish adequate criteria.

#### I. CHARACTERISTICS OF THE HEDGING TRANSACTION

For convenience discussion will be confined chiefly to the grain trade, since the thorough investigation made by the Federal Trade Commission in 1919-1920 renders available a large amount of impartially collected data. The definition of hedging as given by the Commission is:

"Hedging in grain-trade practice may be defined as a combination of transactions in cash grain, and in futures such that a purchase of the former is accompanied by the sale of the latter in corresponding quantity, and *vice versa*. Hedging ordinarily involves fourfold transactions—an initial purchase and an initial sale, one of the cash grain, and the other of the futures, and the opposite closing transactions in each. By means of hedging, a loss on the cash grain will presumably be offset by a gain on the futures and *vice versa*."<sup>13</sup>

"Cash grain" does not refer to the time of payment (hence is not used in contradistinction to "credit grain") but to specific grain actually in the seller's possession, or to a designated quan-

<sup>13</sup> (1926) 7 GRAIN TRADE 33. For greater clarity, the process may be described as follows: (1) Initial purchase of cash grain, (2) initial sale of "futures," (3) subsequent sale of cash grain, closing out the cash transaction, (4) purchases of futures, closing out the futures transaction. The term "hedging" is here used to describe a hedge against a "legitimate" interest, and not a hedge against a wager.

tity and grade "to arrive" in the near future.<sup>14</sup> On the other hand, a sale of "futures" is an agreement to sell grain to be delivered on any day during a designated month the seller may choose. Certain months are commonly so designated by custom of the grain exchanges—*e. g.*, on the Chicago Board of Trade, September, December, May and July.

To illustrate: *A*, the proprietor of a grain elevator at a small town in North Dakota, on October 1 purchases 1,000 bushels of wheat from farmers and has it in his bins. He then contracts through an exchange member to sell to *B* 1,000 bushels of wheat for delivery in December on the Minneapolis exchange at a named price conforming to the "December wheat" price current on the day of sale. *A*'s purpose in making this futures contract is to indemnify himself against a decline in the price of wheat, by reason whereof he will receive less for his "cash" grain, which he sells later, than he would have received by selling it at once. *A*'s assumption is that his loss on his cash grain, due to price decline, will be offset by his gain on his futures sale, due to price decline. Instead of holding his "cash" grain until December and then delivering it to *B* in performance of his futures sale, before December *A* sells his "cash" wheat to others, either directly to a miller, exporter, or other dealer, or indirectly through a broker or commission firm.<sup>15</sup> At the same time *A* orders his broker to "buy" a like quantity of December wheat for the purpose of closing out his futures sale. This order is executed on the exchange, possibly with *B* as seller, but almost certainly with *C*, another person, as seller. If the price of December wheat, on the exchange, has declined, *A*'s futures purchase is made at a lower price than was his earlier futures sale, and this difference, it is assumed, will compensate him for the loss incurred in selling his "cash" wheat at a lower price than he paid for it.

Now *A* might wait until the end of December, take delivery on his wheat from *C*, and make delivery on his wheat to *B*. But *A* knows this would be a wasteful process if the grain were actually hauled about, and a tedious one even if only warehouse receipts were exchanged. The organized exchange has a more economical and sophisticated method of "settling" these transactions. This method involves merely the brokers who nego-

---

<sup>14</sup> (1920) 2 *Ibid.* 329. The "to-arrive" purchase is classed with "cash grain" rather than with "futures." RULES OF THE CHICAGO BOARD OF TRADE (1930) 7; (1923) 2 GRAIN EXPORTERS 8.

<sup>15</sup> While the terms "commission house," "broker" and "member of an exchange" are by no means synonymous, the term "broker" will be used in this article to refer to all three, that is, to an agent in futures trading who is a member of, or deals through a member of, an organized exchange. See (1920) 2 GRAIN TRADE 331. Strictly speaking, a broker is one who reveals the name of his principal. ENCYCLOPEDIA OF THE SOCIAL SCIENCES (1930) tit. Broker.

tiated for *A*, *B* and *C*. Either by direct set-off between brokers, or by "ringing-out" (a process of substituting *B* for *A* in the *A-C* contract) or by a clearing-house which is substituted as buyer to the seller and as seller to the buyer, sales and purchases will be cancelled off with payments of differences in price,<sup>16</sup> and *A*'s broker will pay him the net profit (or collect the loss) on the two "futures" contracts. This net profit or loss will, theoretically, partly offset the loss or profit on the "cash" transactions, and leave *A* his "buyer's margin," or "merchandising profit," *i.e.*, the difference between the local and the Minneapolis price, less expenses of operation, including the cost of hedging.<sup>17</sup>

"Hedging" is (or was) used by ninety per cent of the local elevators in North Dakota, and in a lesser degree by local elevators in other states.<sup>18</sup> The larger flour mills use "hedging" transactions in two ways. Sometimes the miller *sells* futures in order to hedge cash grain which he has on hand for manufacture into flour. More frequently he contracts to deliver flour in the future, on the basis of the present price of wheat futures, and then *buys* wheat futures; as he buys in his "cash" wheat for milling, he sells a corresponding quantity of futures. An increase in the price of wheat will make his flour contract less profitable but will make his futures contract more profitable, so that, if the plan works well, he will come out with his manufacturing profit on the flour.<sup>19</sup> Hedging is also used by grain exporters to cover their commitments to foreign purchasers.

Hedgers rarely, if ever, "expect" to make or take delivery on their futures contracts.<sup>20</sup> Millers, in particular, are unwilling

<sup>16</sup> This statement is to be qualified by the fact that actual delivery of grain takes place on a small percentage of futures transactions which are "open," *i. e.*, cannot be closed out because there are no counter-transactions to cancel them. It is estimated that only a small fraction of one per cent of the transactions on the Chicago Board of Trade are consummated by actual delivery. (1923) 2 GRAIN EXPORTERS 8.

<sup>17</sup> The way in which "hedging" works to *A*'s advantage is shown by a theoretical illustration in (1920) 1 GRAIN TRADE 208 *et. seq.* See also HEARINGS ON S. 454, 19.

<sup>18</sup> (1926) 7 GRAIN TRADE 52. About 50 per cent of the country elevators reporting to the Commission customarily hedged their grain purchases. (1920) 1 *ibid.* 213.

<sup>19</sup> (1926) 7 *ibid.* 43.

<sup>20</sup> "Hedging as such does not involve an expectation to deliver the grain on the future contract, though the hedger of purchased grain is presumably in a better position to make actual delivery than the mere speculator, and delivery on hedges does at times occur." (1926) 7 *ibid.* 34. "The theory of hedging does not involve actual delivery, and in practice the per cent of deliveries is small. Hedges are placed for the purpose of offsetting losses from fluctuations in the price of grain between the time of purchase and sale. If the cash grain is not sold [by the dealer who has sold futures] . . . the hedge is usually transferred to a more remote future. Hedging may be done where it would be impossible or impracticable, because of the loca-

to take delivery because of the uncertainty of getting the kind of grain they want for manufacture into flour.<sup>21</sup> The whole purpose and usefulness of hedging depends upon the fact that it affords, under favorable conditions of the market, an indemnity in money for losses which the "cash grain" dealer or the miller suffers by reason of the swing in market prices. If a dealer sells futures with the expectation of making delivery of the grain, he is not hedging in the accepted sense of that term.<sup>22</sup>

But do not the rules of organized exchanges provide that all contracts are made in "contemplation" of actual delivery, and that mere "trading in differences" is prohibited? Does not one who orders a member of such an exchange to sell futures on the exchange "intend" to conform to those rules, if called upon, hence "intend" to make delivery if necessary, even though he confidently expects that this will rarely happen?<sup>23</sup> Without stopping now over this subtle distinction, one may point out that the exchange rules (as to delivery) apply only to transactions between members of the exchange.<sup>24</sup> After the process of settle-

---

tion of the grain or because of its quality, to deliver on the future contract the actual grain hedged." *Ibid.* 35. See also (1920) 5 *ibid.* 174. Terminal elevators in the Chicago market, however, make delivery under their hedging sales of futures if no satisfactory "cash" buyer can be found. (1920) 5 *ibid.* 185.

<sup>21</sup> (1920) 5 *ibid.* 185. The Commission expected, however, that the establishment of Federal grades of grain would make quality more uniform and thus make millers feel more sure of getting sound milling wheat on a futures delivery.

<sup>22</sup> The dealer who has purchased "cash" grain may at once sell "to arrive" and thus protect himself against a market decline during the interval between his purchase and his delivery to his purchaser; but this is regarded as a "substitute for hedging." (1926) 7 *ibid.* 61.

<sup>23</sup> Here we anticipate the distinction drawn by Mr. Justice Holmes in *Board of Trade of Chicago v. Kinsey Co.*, 198 U. S. 236, 25 Sup. Ct. 637 (1905), discussed *infra* note 85. Default by a member of the exchange entails severer consequences than are imposed by the judicial rules of damages, ranging from a liquidated damage, to expulsion and forfeiture of membership for wilful default in the performance of an exchange contract. RULES OF THE CHICAGO BOARD OF TRADE (1930) §§ 130, 141, 573. The Chicago Board of Trade rule once required the seller to pay not less than five per cent of the value of the commodity as liquidated damages. The St. Louis rules impose a penalty of five cents per bushel (of wheat) upon the buyer who refuses to take delivery. (1920) 2 GRAIN TRADE 260-264.

<sup>24</sup> While some grain exchanges purport to "blacklist" non-members who have "failed to comply with any contract, verbal or written, in relation to a transaction had through or with any member of this association," there is no evidence that these rules are effective sanctions, or that they are applicable to compel actual delivery. (1920) 2 GRAIN TRADE 216-218. "*The Customer Not Necessarily Involved in Delivery.* ... The broker in these matters is not an agent of his principal in any sense that permits the shifting of responsibility but is completely substituted for him as regards obligations to other members under future contracts." 5 *ibid.* 182. The "legal rights" of members against each other are rarely the subject

ment between member and member has been completed, some "open" (uncancelled by clearing-house, set-off or ringing out) trades will be left on the books. In settlement of these, warehouse receipts will be tendered by member (or by the clearing house) to member. The member who tenders a receipt practically always gets it (eventually by endorsement, if not immediately) from a terminal elevator.<sup>25</sup> The customer who sells "short" does not expect to and cannot be compelled to make delivery; he is charged with the price differential. As to the buying end, the member who "stops" a delivery (*i.e.*, who is long, receives a delivery notice, and cannot pass it on) ordinarily makes delivery to the customer whose purchase is oldest among the uncanceled trades on his books, except that a customer who *wants* actual delivery may, if the others do not, be preferred.<sup>26</sup> The customer is practically never "compelled" or "required" to take delivery. Hence, it is difficult to see in what sense a customer-hedger ever "intends" to make or take delivery. This conclusion will be connected further on with the legal rulings on wagering contracts.

One further aspect of hedging practice should be mentioned. The illustrations given above are examples of "strict rule" hedging, *i.e.*, the hedging transactions are made and closed simultaneously with the making, and closing, of the cash transactions. Allowing for a few hours delay as negligible, one may say that "strict hedging" is common among many line and terminal elevators of the Northwest.<sup>27</sup> Yet most hedgers do not keep their interests strictly hedged. The hedger may wait, after buying cash grain, for a better futures market; or he may carry his futures sale, *i.e.*, not "close it out" by a corresponding purchase, after the cash grain has been sold. In this way a futures contract held for thirty or forty days—which is apparently the average length of time during which such a contract is left "open"<sup>28</sup>—may serve as a hedge against several purchases of cash grain if the latter are quickly sold.

---

of litigation; the important relations so far as litigation is concerned are those between the broker (member) and his customer. Practically all the reported cases involve these relations.

<sup>25</sup> "As a matter of fact, however, an ordinary customer would never think of obtaining possession of a warehouse receipt and turning it in to his broker in satisfaction of a futures contract. As indicated above, practically all sales upon which delivery is made originate with elevators." 5 *ibid.* 182.

<sup>26</sup> *Ibid.* 183. A hedger may occasionally want to deliver on his futures sale, however, because of a squeeze in the market, since a purchase to close out would boost the price and thus enhance his loss. (1926) 7 *ibid.* 66.

<sup>27</sup> (1926) 7 *ibid.* 56.

<sup>28</sup> *Ibid.* 39. A table here shows that the "average life" of futures trades of selected elevators and millers for the years 1914-1917 varied from 22 to 40 days, with an average of 30.



Departure from strict rule hedging makes it difficult to draw the line between "hedging" and "speculation." From a legal point of view two observations may be made. First, it is legally immaterial that the hedger postpones making his hedge, just so he has an interest to be protected at the time when the hedge is made; and it seems likewise immaterial that he carries the hedge after his legitimate interest has ceased. Secondly, whether a hedger has "over-hedged" and gone in for "speculation" cannot be determined with reference to any individual futures transaction without taking account of his other trades; it can be determined only by comparing his cash transactions with his *net* short or long commitments at the same moment.<sup>29</sup> A legal rule framed in terms of an individual contract must either take account of such complicated facts or furnish an arbitrary criterion.

## II. "INTENTION" AS THE LEGAL TEST OF VALIDITY

In decisions which turn upon the enforceability of contracts for the future sale of commodities, the standard test laid down is the "intention" or "intentions" of the parties, at the time of contracting, that actual delivery will or will not be made.<sup>30</sup> Why is "intention," in any sense, significant for the purpose of determining the validity of such agreements?

A series of type cases will answer:

*Case No. 1:* In December, 1930, *A* promises to pay *B* \$1,000 if Grade X wheat for May delivery (seller's option) is sold on the Chicago Board of Trade at more than \$1.10 during March, 1931, in exchange for which *B* promises to pay *A* \$1,000 if such wheat is not thus sold. (*Assumption:* Neither *A* nor *B* has any "interest" in the price of such wheat during March, 1931, other than the interest, if any, created by this agreement.)

On these facts neither *A* nor *B* could, in most jurisdictions in the United States, successfully maintain an action for breach of contract. Because of the implicit assumption that neither *A* nor *B* has an extraneous interest in the price of wheat, the agreement is *prima facie* a wager and hence unenforceable. But only *prima facie* or *presumptively*; the addition of facts showing that *A* (or *B*) has an extraneous interest which would be injured to

<sup>29</sup> The net "short" or "long" position of the Washburn-Crosby Co. on November 30 in each of the years 1913-1921 inclusive is shown in (1926) 7 GRAIN TRADE 55. The positions varied from 30% short to 5.78% long, the figures being percentages of the total net commitments on both cash wheat and futures transactions. This gives some idea of the variations from strict hedging of a prudent large-scale hedger.

<sup>30</sup> See cases cited *infra* notes 43, 47, 67, 69 etc.; WILLISTON, *op. cit. supra* note 10, at §§ 1670, 1673. Statutes commonly adopt the "intention" test, the varieties of which are discussed further on.

the extent of at least \$1,000 by the happening of the contingency upon which *B* was to pay would lead to the conclusion that the agreement is an enforceable contract of indemnity. The existence of such additional facts is so highly improbable<sup>31</sup> that an inference, if not a rebuttable presumption, of their non-existence is proper in judicial proceedings. If, then, the agreement above recited is "on its face" a wagering agreement, this is only because, on the basis of experience, a court readily infers that no such extraneous "interest" exists. Without such an inference the agreement "on its face" would be equivocal; in short, one cannot identify an agreement as "wagering" without giving heed to the situation of the parties extraneous to the conduct which makes the agreement.

The necessity of looking beyond the terms of the agreement to its institutional setting is apparent when one considers the reasons why wagering agreements are condemned as against public policy. While judges and legal text-writers rarely give any indication of it, one may conjecture that there are two types of reasoning which account for judicial and legislative hostility toward wagering agreements. One is found in the moral sentiments of the community, or of an important part of it. The Puritan condemns wagering because it is commonly associated with such sinful pastimes as card-playing, horse-racing and cock-fighting. The pioneer, earning his bread by the sweat

---

<sup>31</sup> *Improbable*, because if the price of wheat exceeds \$1.10 by the smallest fraction, *B* wins \$1,000; hence it is unlikely that any "legitimate" interest is protected by such an agreement. Yet not *impossible*, for quotations on the Chicago Board of Trade are usually made in no smaller fractions than eighths of a cent; hence, if *B* had previously "sold" 800,000 bushels of grade *X* wheat for May delivery, *buyer's* option as to time, *B* would stand to lose \$1,000 on the futures contract if wheat went to \$1.10 $\frac{1}{8}$  at any time during May and if *B's* buyer called for delivery at that time. These possibilities show that even such a crass wager as Case No. 1 appears on its face to be, cannot be conclusively labeled as "contrary to public policy" merely by looking at the words of the agreement.

In this article the term "wager" is used to designate an aleatory agreement which does not serve the purpose of indemnifying either party against injury to an extraneous interest. One type of case which would not fall strictly within this definition, but which may properly be designated as a "wagering agreement," would be this: Suppose *B*, before making the agreement in Case No. 1, had made a wagering agreement to pay *C* \$1,000 if grade *X* wheat was sold at more than \$1.10 during March, 1931. Here the agreement in Case No. 1 would serve to protect *B* against loss on the *B-C* agreement; but since *B's* interest under the *B-C* agreement is not protected by the usual legal sanctions, it would not be legally recognized as an extraneous interest sufficient to take the *A-B* agreement out of the class of wagers. *Nash-Wright Co. v. Wright*, 156 Ill. App. 243 (1910), contains a valuable discussion of this type of case. The "indemnity contracts" formerly authorized by the rules of the Chicago Board of Trade, (1920) 2 GRAIN TRADE 119, are now no longer authorized. RULES OF THE CHICAGO BOARD OF TRADE (1930) § 42.

of his brow, is hostile toward one who can gain a living without toil. In the old-fashioned novel or play, the villain was often a gambler and the gambler was always a villain. Accepting this moral sentiment as a sufficient justification for official condemnation, one can see that a particular agreement cannot be identified as coming under the ban, without having regard to other facts than the agreement itself, *i.e.*, the particular individual's *habit* or *practice* of gaining a livelihood by such transactions, and the institutional setting.

The second type of reasoning has to do with "anti-social" consequences. To devote capital and human energy to activity which is not *productive*, is socially wasteful.<sup>32</sup> Under a marginal utility theory of value, the gain of the winner of a wager is of less value than the loss of the loser (assuming equal wealth at the outset), and there is thus a net economic loss without any gain to society.<sup>33</sup> The judicial (or legislative-judicial) conception of wagering has sprung, it would seem, from a narrow conception of productive activity; only those who store, transport or convert wheat, for instance, are regarded as useful in the production process. It fits the conditions of a simple economic society where the farmer and the local miller are easily differentiated from the professional gambler. To these theoretical postulates may be added the observed consequences of various types of wagering when carried on by a considerable portion of the population. Idleness, improvident extravagance, impoverishment of losers and their dependents, dissipation, fraud, fighting and suicide are some of the horrors which have been, with a fair degree of truth, depicted as following in the wake

---

<sup>32</sup> KOHLER, *PHILOSOPHY OF LAW* (Albrecht's trans. 1914) 61; "If two merchants agree that, according to the state of the prices in the exchange, the one must pay the other, this is simply a game that brings about no actual movement of wares." CURTIS, *ECONOMICS: PRINCIPLES AND INTERPRETATION* (1928) 46: "Gamblers, likewise, at great effort and waste of time, accomplish the transfer of the ownership of goods without increasing the adaptation of the goods to human use. It is often the case, also, that those who pretend to speculate by purchasing goods for later sale only acquire for themselves the gains which have been produced by others." Cf. Senator Caraway: "Of course he [the speculator] does not produce anything." HEARINGS ON S. 454, 20. Adam Smith's distinction between productive and non-productive labor must have exercised a powerful influence in shaping the judicial attitude toward wagering. He restricted productive labor to that involved in the physical handling of goods. Hence physicians, lawyers, clergymen and governmental officials were non-productive laborers. 1 ADAM SMITH, *THE WEALTH OF NATION* (Everyman's ed.) 295. The distinction is criticized by Prof. Seligman. *Ibid.* Introduction, xiii.

<sup>33</sup> WILLETT, *THE ECONOMIC THEORY OF RISK AND INSURANCE* (1901) 54, 61.

of wagering.<sup>34</sup> Again, wagering on some events tends to create an incentive to bring about the event, as in cases where heavy speculators try to manipulate the market. In all these cases the agreement itself will not tell whether or not it falls within the class of condemned transactions, because the legal invalidity of the agreement rests, in the last analysis, upon the *consequences* of the type of conduct with which it is identified.

The agreement in Case No. 1 would thus be denied enforcement because of the tendencies of agreements of that type, as ascertained more or less accurately on the basis of experience. Is the "intention" of *A* and *B* of any significance in this connection? While a moral sentimentalist might impute to *A* and *B* intentions to do wrong, it seems clear that the only "intention" which need be inferred is the intention to make this agreement; and that is inferred from the facts above given.<sup>35</sup>

Now modify Case No. 1:

*Case No. 2:* In consideration of \$1,000 paid by *B*, *A* promises to pay *B* \$1,000 for each cent per bushel over \$1.10 which Grade *X* wheat (May delivery) sells for on the Chicago Board of Trade in May, 1931.

Here the assumption that *B* has no "interest" which is indemnified by *A*'s promise is not as clear as in the preceding case; yet such indemnity agreements are rare. Probably the agreement is *prima facie* a wagering contract.<sup>36</sup> Certainly it is unenforceable if neither party has an extraneous interest in the event; and this result follows regardless of any "intention" of the parties except the intention to make such an agreement as is inferred from their utterances.

*Case No. 3:* In December, 1930, *A* promises to sell and *B* to buy Grade *X* wheat, 10,000 bushels, at \$1.10 per bushel, delivery at seller's option any time during May, 1931.

This agreement, "on its face," is a valid contract to sell unspecified goods. It fits neatly into the abstract categories of the Uniform Sales Act. To a person innocent of the iniquitous practices of bucket shops *A* is an honest farmer selling the fruits of his toil to *B*, an honest miller who will make the wheat into flour for the body politic. Courts more or less uniformly take

---

<sup>34</sup> See HARDY, RISK AND RISK-BEARING (1923) 369-372; READINGS IN RISK AND RISK-BEARING (1924) 363.

<sup>35</sup> Like most mentalistic legal terms, "intention" is difficult to define. For the purpose of legal reasoning, "intention to make the agreement" means just the inference drawn from the conduct described in Case No. 1. Yet additional facts would destroy the inference, *e. g.*, if it were proved that both *A* and *B* spoke obviously in jest.

<sup>36</sup> Case No. 2 resembles the "ups" and "downs" litigated in *Nash-Wright Co. v. Wright*, *supra* note 31, which held such agreements to be wagers where the only interest indemnified was based on another wagering agreement. There words of "purchase" and "sale" were used.

this innocent attitude toward such agreements, and there are good reasons of procedural convenience, if not of economic policy, for doing so.<sup>37</sup> Hence the agreement in Case No. 3 would *presumptively* be enforceable. That is, if *B* refuses to take and pay for the grain tendered by *A* during May, 1931, *A* may successfully maintain an action for damages; for *A*'s refusal to deliver the grain by June 1st, 1931, *B* may successfully maintain an action. In either case, the measure of damages is standardized at the difference between contract price and market value at the time and place of delivery.

Now suppose that, in addition to the facts of Case No. 3, *A* and *B* at the same time said:

*Case No. 4*: "Agreed that no actual delivery of wheat is to be made, but we will settle by payment in money of the difference between contract price and market price on the Chicago Board of Trade at the time when delivery is to be made." Is not this case the same as Case No. 3, with the addition of a clause specifying the measure of damages for breach of the agreement, a measure identical with that which the court will apply in the absence of any agreement? Does not every promisor have the power to break his promise and pay the legally assessable damages,<sup>38</sup> and what is the harm in allowing the parties to stipulate frankly that payment rather than performance shall be the consequence of the agreement?

On the contrary, is not Case No. 4 substantially the same as Case No. 1 or Case No. 2? *A* and *B* use the words "buy" and "sell" in peculiar senses, defined by their mutual code, and when with the aid of this code their utterances are translated into the community code<sup>39</sup> one finds that they have in effect exchanged promises to pay money on the happening of a future uncertain event, namely, the quoted price of Grade X May wheat. Presumptively (but only presumptively) such an agreement is unenforceable. It is one thing to stipulate for the payment of damages *if* a breach of the promise shall, *perchance*, occur; it is

---

<sup>37</sup> The procedural inconvenience of investigating the social and economic desirability of every agreement presented for judicial sanction, would impose an intolerable burden on the courts. Moreover, *laissez faire* is still a "brooding omnipresence" of economic policy, or business-man's *mores*. "The measure [Caraway Bill] seeks to strike at freedom of trade or barter, which has been the root of the prosperity of the country..." F. B. Haynes, President of the New Orleans Cotton Exchange, in January, 1926. HEARINGS ON S. 454, 44.

<sup>38</sup> HOLMES, THE COMMON LAW (1881) 301: "The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass. In every case it leaves him free from interference until the time for fulfillment has gone by, and therefore free to break his contract if he chooses."

<sup>39</sup> WIGMORE, EVIDENCE (2d ed. 1923) § 2466.

quite another to stipulate that the payment of money shall be substituted for some other performance ostensibly promised. The difference cannot be explained in terms of legal remedies, but only in terms of the extra-legal consequences of the two types of transactions.

If "intention not to make delivery" means merely that the parties to a futures contract have simultaneously made an additional agreement like that set forth above, the significance of "intention not to deliver" is clear. The communicated intention of both parties not to deliver makes the futures contract into a *prima facie* wager. It is only a "pseudo-sale" contract. In searching for "intention not to deliver" the courts are striving to strip off the disguise of a trade terminology.

The parol evidence rule does not exclude evidence which shows that the agreement was illegal, and hence unenforceable. Even if the effect of such evidence is to prove that a different agreement, outside the writing, was the "real" agreement, and that this "real" agreement is illegal, the rule does not exclude it.<sup>40</sup>

The evidence from which "intention not to deliver" is inferred rarely shows an agreement to settle in cash as explicit as that recited in Case No. 4. Usually the evidence is circumstantial. Judicial rulings on relevancy and permissible inferences become decisive of the litigation. These rulings will be guided, to a considerable degree (lessened by judicial deference to legislative policy), by the judicial attitude toward produce exchanges. Still, making due allowance for variations on close cases, it seems scarcely controvertible that futures contracts entered into for the purpose of "hedging" will come under the ban of the "pseudo-sale" test. They will not (or, at least, strict hedging will not) come under the ban of social and economic policy.<sup>41</sup> The accuracy of this analysis may be tested by examining the varieties of the intention test, and the evidence used in testing the legality of futures contracts.

### III. VARIETIES OF "INTENTION" TEST

#### A. *Undisclosed Intention of One Party*

The statutes of a few states are so worded as to invalidate an

<sup>40</sup> *Ibid* §§ 2406, 2414; *Wheeler v. Metropolitan Stock Exchange*, 72 N. H. 315, 56 Atl. 754 (1903); *Maybank v. Rogers*, 98 S. C. 279, 82 S. E. 422 (1914); WILLISTON, *op. cit. supra* note 10, at § 1753.

<sup>41</sup> The Caraway Bill declared it to be unlawful for any person to send a message offering future delivery of cotton or grain across state lines, "without intending that such cotton or grain shall be actually delivered or received." HEARINGS ON S. 454, 2. Two Secretaries of Agriculture advised the Senate Committee that the enactment of the bill would "substantially impair, if not actually destroy, the valuable hedging facility..." *Supra* note 5. (Significant, but not conclusive support of the text).

agreement for the sale of futures where only one party to the agreement has no "intention" to take (or make) delivery.<sup>42</sup> These statutes have been construed to apply even where the intention of the one party was not communicated to the other.<sup>43</sup>

Thus, in *Price v. Barnes*,<sup>44</sup> the plaintiffs, commission merchants in St. Louis, bought and sold grain and cotton for Barnes (the defendant's testator) who operated a general store, a cotton gin and several farms in southeast Missouri. The evidence showed that Barnes had no storage facilities for receiving the large quantities of wheat which he had contracted to "buy," had insufficient means to pay for his purchases, and was not a dealer in such commodities. While there was evidence that the plaintiff, too, never intended to make delivery,<sup>45</sup> the trial court charged that the intention of *either* party to gamble would render the contract "void," "notwithstanding the other party may be ever so innocent and wholly unaware of the intention to gamble or speculate entertained by the other." A judgment for the defendant was affirmed.

A statute of this type will not enable a party to escape a contract whenever he chooses to swear that he had no intention of taking (or making) delivery, for his own testimony as to his intention, while admissible, will be accepted with caution, and may be overcome by other evidence of a different intention at the time the agreement was made.<sup>46</sup> At best, however, the effect of

---

<sup>42</sup> ARK. DIG. STAT. (Crawford & Moses, 1921) § 2653; MICH. COMP. LAWS (Cahill, 1915) § 15091; MO. REV. STAT. (1919) § 3572; S. C. CIVIL CODE (1922) §§ 5165-5166; TENN. ANN CODE (Shannon, 1919) § 3166. The statutes declaring bucket-shops unlawful frequently declare that the intention of the bucket-shop proprietor alone suffices to make the transaction illegal. N. Y. PENAL LAW § 390; MINN. STAT. (Mason, 1927) § 10488; IOWA CODE (1927) § 9898. The Caraway Bill apparently made the intention of one party decisive. HEARINGS ON S. 454, 2, § 2.

<sup>43</sup> *Maybank v. Rogers*, *supra* note 40; *Price v. Barnes*, 300 Mo. 216, 254 S. W. 33 (1923); *cf.* *McGrew v. City Produce Exchange*, 85 Tenn. 572, 577 (1887); *Huff v. State*, 164 Ark. 211, 261 S. W. 654 (1924). But *cf.* *State National Bank v. Anderson*, 198 S. W. 511 (Mo. App. 1917).

<sup>44</sup> *Supra* note 43.

<sup>45</sup> Plaintiff's books showed entries only of the "differences" on transactions which were closed out at a profit or at a loss to deceased. It does not appear, however, that plaintiff merely "bucketed" the orders; presumably Barnes' purchases were executed on an exchange.

<sup>46</sup> *McClure v. Wilson*, 292 Fed. 109 (C. C. A. 4th, 1923), applying the South Carolina statute. A letter written by the defendant's agent at the time cotton was bought went into some detail about delivery; this evidence was held to contradict the defendant's sworn statement of intention to gamble so effectively that the trial court did not err in refusing to submit the question to the jury. Likewise, in *Parker v. Moore*, 115 Fed. 799 (C. C. A. 4th, 1902), the defendant's testimony that he intended to gamble was held not to require a directed verdict in his favor. In this case, however, the court, obviously disapproving of a defense based upon the defendant's undisclosed intent, construed the South Carolina statute as

such a statute is to invalidate hedging agreements by legitimate dealers or manufacturers.

In most jurisdictions the undisclosed intention of the *defendant* to settle in cash is no defense to an action based on a futures contract.<sup>47</sup> These holdings are consistent with the "pseudo-sale" theory. They are also consistent, however, with a theory that the *plaintiff's* intention to wager, when he entered into the futures agreement, bars his recovery against the innocent defendant.<sup>48</sup> Apparently the only holdings which require the latter explanation, however, are two cases<sup>49</sup> in which the court denied the customer recovery of money paid in reliance on a contract with the defendant broker where there was proof of the plaintiff's intention to gamble but no proof that the broker was aware of such an intention. The action was for money had and received (quasi-contract), a proceeding often said to be "equitable" in nature. The "clean hands" maxim of equity thus becomes applicable. In other words, the plaintiff may be denied recovery if he has wickedly intended or attempted to gamble, even though the agreement made was not a wagering agreement when tested by the "pseudo-sale" analysis. The "clean hands" theory seems broad enough to justify an inquiry into the social desirability of the plaintiff's conduct in each particular case. The legitimate hedger should, therefore, not be denied

---

not authorizing such a defense. The Federal courts adhered to this interpretation until *Maybank v. Rogers*, *supra* note 40, settled the validity of such a defense. In *McLure v. Wilson*, *supra*, the court reluctantly paid lip-service to the rule of the South Carolina court, yet managed to affirm a directed verdict for the plaintiff, a *bona fide* dealer in cotton. These decisions under the South Carolina statute illustrate how conflicting drives of social policy work their way through the legal concepts employed in analyzing a set of facts.

<sup>47</sup> *Browne v. Thorn*, 260 U. S. 137, 43 Sup. Ct. 36 (1922); *Claiborne Commission Co. v. Stirlen*, 262 S. W. 387 (Mo. App. 1924) (applying Illinois law); *Lamson v. Turner*, 277 Fed. 680 (C. C. A. 8th, 1921) (Illinois law); *Pixley v. Boynton*, 79 Ill. 351 (1875); *Nash-Wright Co. v. Wright*, *supra* note 31; *Miller Co. v. Klovstad*, 14 N. D. 435, 105 N. W. 164 (1905); *Hoyt v. Wickham*, *supra* note 7; *cf. Springs v. James*, 137 App. Div. 110, 121 N. Y. Supp. 1054 (1st Dep't 1910), *aff'd*, 202 N. Y. 603, 96 N. E. 1131 (1911); *Cohen v. Rothschild*, 182 App. Div. 408, 169 N. Y. Supp. 659 (1st Dep't 1918); *Solomon v. Newburger*, 35 F. (2d) 328 (C. C. A. 8th 1929). Cases in which the one who intended a gambling transaction is denied recovery against the innocent party, are discussed *infra*.

<sup>48</sup> WILLISTON, *op. cit.*, *supra* note 10, at § 1670.

<sup>49</sup> *Higgins v. McCrea*, 116 U. S. 671, 6 Sup. Ct. 557 (1886); *White v. Barber*, 123 U. S. 392, 8 Sup. Ct. 238 (1887) (explainable on other grounds). See *Parker v. Moore*, *supra* note 46, at 804; *Nash-Wright Co. v. Wright*, *supra* note 31, at 250. It may be questioned whether or not the plaintiff's *delictum* is not outweighed by the defendant's disloyalty to his principal, the plaintiff. WOODWARD, QUASI-CONTRACTS (1913) § 148.



recovery against a defaulting broker.<sup>50</sup> This boon to the hedger is likely to remain academic, however, since, due to the extra-legal sanctions of produce exchange by-laws, members of recognized exchanges seldom default on their obligations. In the vast majority of litigated cases the plaintiff is the broker (or commission merchant).

### B. Disclosed Intention of One Party

It is a logical possibility that *A* intends to settle in cash, discloses this intention to *B*, and yet *B* intends to deliver (or take delivery). But it is not a plausible situation. It often occurs, however, that there is evidence that *A* had no intention of taking delivery and that *B* knew this; there is no *direct* evidence to show that *B* had any "intention" either way, other than that manifested by making the "futures" agreement. Under these facts courts have frequently upheld verdicts to the effect that the agreement was a wager.<sup>51</sup> This test does not differ substantially from the "pseudo-sale" test. If *B* knows that *A* has no intention of taking delivery, the inference is strong, if not conclusive, that *B* had no intention of making a futile tender of delivery, especially since by so doing he would get no more damages than *A* was willing to pay anyhow. Hence the "real agreement" was to settle in cash. Such an inference has been drawn in a jurisdiction which requires "mutual intention" to settle in cash.<sup>52</sup>

Usually brokers studiously avoid inquiry as to the "intentions" of their customers.<sup>53</sup> The occupation of the customer and his financial standing may furnish the basis for an inference that the broker knew his intention not to deliver;<sup>54</sup> yet where the customer is a dealer or manufacturer, who regularly makes *some* contracts with intention to deliver (or to take delivery), the inference that the particular agreement in litigation was

---

<sup>50</sup> The question cannot arise in this form unless the broker is in default. If the customer alleges the illegality of the transaction, he will be treated in *pari delicto*, unless a statute expressly authorizes recovery by the "customer", as in *McGrew v. City Produce Exchange*, *supra* note 43.

<sup>51</sup> *Kilpatrick v. Richter*, 146 Ga. 277, 91 S. E. 51 (1916); *Hyman & Co. v. Hay*, 277 Fed. 898 (C. C. A. 5th, 1922) (Louisiana law); *James v. Clement*, 223 Fed. 385 (C. C. A. 5th, 1915) (Georgia law), *cf. Jacobs v. Hyman*, 286 Fed. 346 (C. C. A. 5th, 1923).

<sup>52</sup> *Ohlendorf v. Bennett*, 241 Ill. App. 537 (1926); *Jamieson v. Wallace*, 167 Ill. 388, 47 N. E. 762 (1897). The *Jamieson* case is practically indistinguishable, on its facts, from the cases cited *supra* note 51. See *Botts v. Mercantile Bank*, 170 App. Div. 879, 881, 156 N. Y. Supp. 700, 702 (1st Dep't 1915).

<sup>53</sup> (1923) 2 GRAIN EXPORTERS 9.

<sup>54</sup> *Cf. Jamieson v. Wallace*, *supra* note 52 (stock purchase by woman of limited means); *Hartwig v. Booth*, 217 Ill. App. 70 (1920) (small druggist bought 10,000 bushels of wheat).

made with a contrary intention, must be supported by the clearest kind of evidence.<sup>55</sup> The "disclosed intention" test undoubtedly gives a court considerable latitude in interpreting such evidence. A court which is hostile to speculation in futures will draw the introspective inference that *B* was aware, when he made the agreement, of *A*'s intent to gamble;<sup>56</sup> while a court friendly to the produce exchanges will, on facts scarcely distinguishable, decline to draw such an inference.<sup>57</sup> This is not the first time that introspective terminology has been used as camouflage for unarticulated theories of policy.<sup>58</sup>

C. "Bilateral" or "Mutual" Intention Not to Deliver

The paper formula in judicial opinions is that, to sustain a defense of illegality to a "futures" contract, the defendant must prove that both parties had no intention that delivery should be made.<sup>59</sup> The same formula is indicated, more or less clearly, by the language of numerous statutes.<sup>60</sup> Does it mean that where the evidence shows that each party, separately, never intended that delivery should be made ("bilateral intention"), or that only where the intention of each is revealed to the other ("mutual intention"), the contract is unenforceable? The latter meaning is consistent with the "pseudo-sale" analysis given above; the former is not. The latter meaning makes it easier to uphold a "hedging" agreement by one who is known to the broker as a legitimate dealer; the former meaning would make it easier to invalidate such an agreement.

The decisions do not give a clear-cut answer to the question. While proof of an "explicit agreement" to gamble is sufficient,<sup>61</sup>

<sup>55</sup> Cf. *Lamson v. Turner*, *supra* note 47 (Illinois law; dealings by corporation, engaged in buying selling, and shipping grain); *Pixley v. Boynton*, *supra* note 47 (purchase of grain by one "extensively engaged in shipping grain"); *Miller Co. v. Klovstad*, *supra* note 47; *McCarthy Bros. Co. v. Equity Co-op. Ass'n*, 286 Fed. 171 (D. Mont. 1923) (strict interpretation of broker's knowledge about particular contract).

<sup>56</sup> *James v. Clement*, *Kilpatrick v. Richter*, both *supra* note 51.

<sup>57</sup> Cf. *Cohen v. Rothschild*, *supra* note 47 (note the court's assumption that no "reputable broker" would make a wagering contract).

<sup>58</sup> Cf. WIGMORE, *op. cit. supra* note 39, at § 242.

<sup>59</sup> *Pixley v. Boynton*, *supra* note 47; *Hooper v. Nuckles*, 39 So. 711 (Ala. 1905); *Springs v. James*, *supra* note 47; *Kilpatrick v. Richter*, *supra* note 51; *Edgeley Co-op. Grain Co. v. Spitzer*, 48 N. D. 406, 184 N. W. 880 (1921); *Lamson v. Turner*, *supra* note 47.

<sup>60</sup> *E.g.*, ALA. CIV. CODE (1923) § 6816; ILL. REV. STAT. (Cahill, 1927) c. 38, § 308; KAN. REV. STAT. (1923) §§ 50-122; MASS. GEN. LAWS (1921) c. 137, § 6; MINN. STAT. (Mason, 1927) § 10223-1; OHIO GEN. CODE (Page, 1926) § 13070; TEX. PENAL CODE (1928) art. 657. Cf. GA. CODE (1914), as amended by Acts, 1929, p. 245, § 4264 (2): "where parties do not contemplate delivery."

<sup>61</sup> *Harvey v. Merrill*, 150 Mass. 1 (1889); *James v. Clement*, *supra* note 51;

such proof is rarely presented. In most cases the evidence is circumstantial, and after making inferences as to the intention of each party, the court is likely to slide over the inference of disclosure.

The case of *Counselman v. Reichart*,<sup>62</sup> a decision from the great agricultural state of Iowa, illustrates this propensity. A Chicago broker sued an Iowa grain dealer for grain actually shipped, and for the loss on a contract to buy May oats which the plaintiff had made on the defendant's telegraphic order. This contract was closed out by the plaintiff in January because of the defendant's failure to put up margins. The plaintiff appealed from a judgment allowing him only the price of the grain actually delivered. In affirming this judgment, the court relied upon the defendant's sworn testimony that he had not intended to take delivery of the May oats. This evidence was deemed sufficient to establish the defendant's intention.<sup>63</sup> Despite the plaintiff's testimony that he intended to make delivery—a statement buttressed by the circumstance that the defendant had taken delivery on one of his orders—the jury was allowed to infer the plaintiff's intention to gamble from the fact that he failed to produce written memoranda showing actual purchases made on the defendant's behalf.<sup>64</sup> Here was "bilateral" intention. For communication, the court found that the apparently innocent telegrams to buy on margins were to be read in the light of the "generally known fact that business on the board of trade is conducted on a plan of non-delivery of the produce." The formula laid down by the court was:

"To make the contract void as between these parties, the intention to make a gambling contract must have been mutual. . . . There was no purpose to make defendant's uncommunicated intentions a part of the contract, except in so far as they were understood, and, together with plaintiff's intentions, completed an understanding."<sup>65</sup>

Yet the court did say, in the course of its opinion,

"If both had that intention [that no delivery should be made], it made a meeting of minds upon that fact, and that is what made the contract."<sup>66</sup>

In other cases which have purported to apply the "mutual in-

---

State v. Clayton, 138 N. C. 732, 50 S. E. 866 (1905) (jury found agreement to settle in cash).

<sup>62</sup> 103 Iowa 430, 72 N. W. 490 (1897).

<sup>63</sup> But cf. *McLure v. Wilson*, *supra* note 46.

<sup>64</sup> The Iowa statute required such proof, apparently in order to require the broker to prove that he was not "bucketing" the orders. The decision might, but does not, rest on this ground.

<sup>65</sup> 103 Iowa at 432, 434, 72 N. W. at 491, citing Iowa statutes.

<sup>66</sup> *Ibid.* 433, 72 N. W. at 491.

tention" test the evidence of a "pseudo-sale" has been stronger, and it seems safe to say that the decided preponderance of judicial authority (in many cases based on statutory provisions) supports the "mutual intention" test.<sup>67</sup> While proof that the broker "bucketed" the orders makes the inference of a "pseudo-sale" practically conclusive,<sup>68</sup> denial of recovery is not confined to the "bucket shop" cases. Conversely, in decisions allowing the broker recovery on orders for futures trades, in grain or in cotton, the reason given is failure to prove mutual intention not to deliver.<sup>69</sup> While no case has been found in which each party, unknown to the other, had an intent not to deliver, it seems that these facts would fall short of maintaining the defense of illegality.<sup>70</sup> At the least the intent of one party not to deliver must be *palpable*, and the inference of palpability becomes crucial in the decision of particular controversies, as one may see by carefully comparing the cases reaching opposite conclusions.

The test of wagering as formulated in most statutes and judicial decisions thus makes no distinction between hedging agreements and other futures transactions made with mutual intention that no delivery shall occur in performance of the transaction. The "mutual intention" test is too narrow to satisfy the requirements of social and economic policy. A candid acceptance of this conclusion would lead to legislative modification of the test in such a way as to define wagering in terms of particular institutions, or rather to except socially desirable institutions from the operation of the formula. Such legislation

---

<sup>67</sup> Cases in which the futures agreement was held unenforceable at the suit of one who "intended" no delivery: *James v. Clement*, *supra* note 51; *Ohlendorf v. Bennett*, *supra* note 52; *Benson-Stabeck Co. v. Reservation Farmers' Grain Co.*, 62 Mont. 254, 205 Pac. 651 (1922); *Lamson v. West*, 201 Ill. App. 251 (1916); *Lane v. Logan Grain Co.*, 105 Mo. App. 215, 79 S. W. 722 (1904); *Board of Trade v. O'Dell Commission Co.*, 115 Fed. 574 (C. C. S. D. Ohio 1902); *Hartwig v. Booth*, *supra* note 54; *Sprague v. Warren*, 26 Neb. 326, 41 N. W. 1113 (1889).

<sup>68</sup> *Carey v. Myers*, 92 Kan. 493, 141 Pac. 602 (1914); *Barnes v. State*, 77 Ark. 124, 91 S. W. 10 (1905). While a "bucket shop" proprietor, to save expenses, ordinarily does not execute trades on a recognized exchange to carry out his customers' orders, he may on rare occasions be obliged to make an actual trade. *ENCYCLOPEDIA OF THE SOCIAL SCIENCES* (1930) tit. Bucket Shops.

<sup>69</sup> *McCarthy Bros. v. Equity Co-op. Ass'n*, *supra* note 55; *Miller Co. v. Klovstad*, *supra* note 47; *Sampson v. Camperdown Mills*, 82 Fed. 833 (C. C. S. C. 1897) (but *cf.* *McLure v. Wilson*, *supra* note 46); *Springs v. James*, *supra* note 47; *Hooper v. Nuckles*, *supra* note 59; *Dillon v. McCrea*, 59 Ill. App. 505 (1895); *Jacobs v. Hyman*, *supra* note 51; *Cohen v. Rothschild*, *supra* note 47; *Botts v. Mercantile Bank*, *supra* note 52; *Bell Co. v. Emberson*, 182 Wis. 433, 196 N. W. 861 (1924); *Lamson v. Mensen*, 187 Iowa 972, 174 N. W. 688 (1919).

<sup>70</sup> *Cf.* *Flowers v. Bush & Witherspoon Co.*, 254 Fed. 519 (C. C. A. 5th, 1918).

might expressly legitimize only hedging trades, in which case a method of distinguishing hedging from pure speculation would be indispensable; or it might except all futures trading on recognized exchanges. Without such legislation, some courts have attained one or the other of these modifications under the guise of applying the mutual intention test. Judicial attitudes toward organized exchanges frequently seem decisive.

#### IV. JUDICIAL ATTITUDES TOWARD ORGANIZED EXCHANGES

Hedging is carried on through organized exchanges.<sup>71</sup> Consequently to the extent that courts enforce all orders for exchange trades they will uphold the validity of hedging transactions. Hence an account of the legality of hedging must include a description of the way some courts have interpreted the mutual intention test so as to legalize not only trades between members of the exchange (which are rarely litigated) but also agreements between non-members and brokers (members or non-members) which are carried out in accordance with exchange practices.

Purporting to apply the mutual intention test of wagering, many courts have been guided, in drawing an inference of intent not to deliver, by their attitude toward futures trading on organized exchanges. In New York, for instance, it seems practically impossible to prove that a transaction with a reputable broker on the New York Cotton Exchange is a wagering agreement.<sup>72</sup> A retired fur dealer, who trusted an exchange member to trade at the latter's discretion, was denied recovery of money so paid because the rules of the Exchange sternly forbade the making of contracts with an agreement that no delivery should take place<sup>73</sup> and because it was "improbable" that the defendants, "reputable brokers," would have made such an agreement. In another case the Appellate Division refused to apply an invalidating statute of benighted Tennessee on the ground that the statute was penal legislation, opposed to the public policy of the state of New York with its busy cotton exchange.<sup>74</sup>

This tendency to uphold the legality of exchange transactions is not confined to the money centers where speculation is rife. In recent years one finds a marked tendency elsewhere to deny that futures transactions are wagers. Thus the Supreme Court of Wisconsin bestowed a qualified blessing upon the Milwaukee

---

<sup>71</sup> Cf. § 6 of the Grain Futures Act, *supra* note 6.

<sup>72</sup> *Springs v. James*, *Cohen v. Rothschild*, both *supra* note 47; *Botts v. Mercantile Bank*, *supra* note 52.

<sup>73</sup> *Cohen v. Rothschild*, *supra* note 47. Suits by the customer to recover money paid for margins appear to be extremely rare.

<sup>74</sup> *Botts v. Mercantile Bank*, *supra* note 52.

Chamber of Commerce.<sup>75</sup> The evidence in the case seems indistinguishable from that in *Counselman v. Reichart*,<sup>76</sup> i.e., a series of transactions in which purchases of "cash grain" were mingled with "playing the market." In reversing a judgment for defendant (the customer), the court said:

"It is undoubtedly true that the great majority of contracts made through the agency of boards of trade are gambling contracts; that thousands of persons every year enter into such contracts fancying that they can foresee the trend of the world's markets better than their fellows, and have their awakening when compelled to pay their losses.

"On the other hand, a vast amount of important and legitimate business is carried on every day through the agency of boards of trade. Speculation is not necessarily gambling, and contracts to be consummated on boards of trade, if intended to be carried out in good faith, are as legitimate as the innumerable other contracts made in the business world in which gains or losses may depend on changes in market values."<sup>77</sup>

A recent Iowa decision<sup>78</sup> is irreconcilable, both on its facts and on its reasoning, with the earlier Iowa decision in *Counselman v. Reichart*. An Iowa farmer ordered a broker to "buy" corn on the Chicago Board of Trade, cautioning the broker's agent (who took his order) not to let the local banker know that he was "speculating." The court upheld a verdict and judgment for the broker, saying:

"Nothing was said about delivery; but this would naturally be implied from the purchase; nor was anything said about speculating on the rise or fall of the market or gambling on the board of trade."<sup>79</sup>

Since exchange trades, and agreements for the making of such trades, are customarily framed in the language of buying and selling, it is possible for courts to indulge a presumption of intention to deliver which makes proof of a contrary intention practically impossible. Moreover, the letter-heads of brokers and commission merchants frequently contain the following admonition to their customers:

---

<sup>75</sup> Bell Co. v. Emberson, *supra* note 69. The Milwaukee Chamber of Commerce is more extensively used as a cash grain market than is, for example, the Chicago Board of Trade.

<sup>76</sup> *Supra* note 62.

<sup>77</sup> *Ibid.* 446, 196 N. W. at 866. Note the confusion of "speculation" by those who handle goods with speculation by those who at best help others to handle goods.

<sup>78</sup> Lamson v. Mensen, *supra* note 69.

<sup>79</sup> *Ibid.* 977, 174 N. W. at 690. A very similar conversation between the customer and the broker's agent has been held to show wagering so conclusively that a verdict for the broker could not stand. James v. Clement, *supra* note. 51.

"All transactions made by us for your account contemplate the actual receipt and delivery of the property and payment therefor."<sup>80</sup>

If the language of the overt bargain is treated as conclusive, the "pseudo-sale" theory is practically repudiated. Likewise, if one treats the exchange rule, forbidding agreements that no delivery shall be made, as conclusive proof that delivery is always intended, the "pseudo-sale" test is discarded and futures trading on or through exchanges having such a rule is unqualifiedly approved. If such a rule means that exchange trades, or agreements therefor, are always made with intention of delivery it is difficult to understand the opposition of the organized exchanges to statutes which prohibit the making of agreements without intent to deliver.<sup>81</sup>

It is sometimes said that if either party can "compel" delivery (or acceptance), the agreement is valid.<sup>82</sup> This begs the question.<sup>83</sup> A more sophisticated inference is that "mutual intention" to set-off other contracts or to make "ring settlements" under the rules of the exchange, is not equivalent to the "mutual intention to settle in cash" of the paper formula.<sup>84</sup> This distinction is apparently approved by Mr. Justice Holmes in *Board of Trade v.*

<sup>80</sup> See *Bell Co. v. Emberson*, *supra* note 69, at 438, 196 N. W. at 863; *Hoyt v. Wickham*, *supra* note 7; *Clark v. McNeill*, 25 F. (2d) 247 (C. C. A. 6th, 1928). In the last case the court found that actions spoke louder than words.

<sup>81</sup> The Caraway Bill (*supra* note 1) prohibited the sending of messages offering to make a contract "without intending that such cotton or grain shall be actually delivered or received..." In expressing his opposition to this bill, Mr. Frank B. Hayne, president of the New Orleans Cotton Exchange, read into the record a rule of the exchange prohibiting the making of contracts "with any stipulation or understanding between the parties, at the time of making such contract, that the terms of such contract are not to be fulfilled and the cotton received and delivered." Yet he stated unequivocally that the enactment of the bill "would so restrict trading in future contracts as to ultimately abolish future trading in the American exchanges." "As president of an exchange," he declared, "I positively state that if the selling of cotton was confined only to those who possess that cotton or who intended to possess cotton, the exchanges would immediately have to close their doors." HEARINGS ON S. 454, 44, 47. Either the exchange rules do not apply to dealings with non-members, or they are to be taken in a Pickwickian sense.

<sup>82</sup> *Sampson v. Camperdown Cotton Mills*, *supra* note 69.

<sup>83</sup> Similarly, *EMERY*, *op. cit. supra* note 1, at 100, n. 1, says: "A bucket-shop 'contract' reads in terms of a sale and purchase, but is gambling because it cannot be enforced." (Italics ours).

<sup>84</sup> "Intention to deliver" and "intention to settle by payment of differences" are often put as the two alternatives. *WILLISTON op. cit. supra* note 10, at § 1670. But the institutional practices have blurred this simple distinction. Sometimes "contemplation" of delivery is used in place of "intention." A trader may "contemplate" delivery as a melancholy possibility without having any "intention" of delivery.

*Kinsey Co.*,<sup>85</sup> in which the Chicago Board of Trade sought to enjoin the purloining of its market quotations. The defendant alleged that the plaintiff's hands were soiled with gambling. In decreeing an injunction, the court (with three justices dissenting) declared the defense irrelevant, if true.<sup>86</sup> Mr. Justice Holmes went further, however, and approved the exchange practice of settling contracts by set-off or "ring settlement," saying:

"Purchases made with the understanding that the contract will be settled by paying the difference between the contract and the market price at a certain time<sup>87</sup> . . . stand on different ground from purchases made merely with the expectation that they will be satisfied by set-off."<sup>88</sup>

Is this distinction a logical application of the mutual intention test, or is it based upon a broader premise of social and economic policy? First, is the difference between an "understanding" (cash settlement) and an "expectation" (set-off settlement) merely verbal? Now "understanding" may mean "mutual" (communicated) intention, whereas "expectation" may mean "bilateral" (uncommunicated) intention. But surely this is another distinction than the one aimed at here, and surely the learned justice means us to take "understanding" and "expectation" in the same sense.<sup>89</sup> With this assumption the "under-

<sup>85</sup> *Supra* note 23.

<sup>86</sup> "If, then, the plaintiff's collection of information is otherwise entitled to protection, it does not cease to be so, even if it is information concerning illegal acts. The statistics of crime are property to the same extent as any other statistics, even if collected by a criminal who furnishes some of the data." *Ibid.* 251, 25 Sup. Ct. at 640.

<sup>87</sup> Here the learned justice cites two cases: *Embrey v. Jemison*, 131 U. S. 336, 9 Sup. Ct. 776 (1889) in which a brokerage firm a member of the New York Cotton Exchange, was held not entitled to recover from a customer for losses on "futures" transactions on the Exchange, if defendant proved his allegation that "delivery of actual cotton was never contemplated," and "it was understood between them that the settlement was to be made between said parties by one party paying to the other the difference between the contract price and the market price;" *Weare Commission Co. v. People*, 209 Ill. 528, 70 N. E. 1076 (1904), in which a member of the Chicago Board of Trade was found guilty of violating the Illinois statute against "bucket-shops and wagering," because he executed, on the Board of Trade, orders for the purchase of grain futures, knowing that the customers intended to "sell" before delivery and settle in cash for the price difference though the rules of the Board of Trade sternly forbade pseudo-sales. In neither case did it appear that the broker settled by the set-off method with other members of the exchange, but very probably such proof would not have altered the result.

<sup>88</sup> 198 U. S. at 249, 25 Sup. Ct. at 639. See also WILLISTON, *op. cit. supra* note 10, at § 1672.

<sup>89</sup> In the paragraph preceding the sentence quoted he says: "The fact that contracts are satisfied in this way by set-off and the payment of differences detracts in no degree from the good faith of the parties, and if



standing" that settlement be made by payment of differences is analytically equivalent to the "understanding" that settlement will be made by set-off or "ringing out." For the latter merely adds a bookkeeping device to the former; the final result is the same—payment of cash differences, not as an afterthought, but in performance of the original expectation to that effect. Under the "mutual intention" test, this is a wagering agreement.<sup>99</sup>

The real basis of Mr. Justice Holmes' distinction can be stated only in terms of institutions and the policy of the government in dealing with them. Produce exchanges, in which the "set-off" settlement is used, *are* different from "bucket shops," in which a direct payment or collection of price differences is employed. A small fraction of exchange contracts, while virtually none of the bucket shop contracts, are settled by delivery of grain. What is more important, the exchange is an important and useful business institution; and not the least of its usefulness is in the machinery which it provides for legitimate hedging. That Mr. Justice Holmes is going back of the "mutual intention" test to the "social desire" which produced it, is apparent from the following excerpts:

"There is no doubt, from the rules of the board of trade or the evidence, that the contracts made between the members are intended and supposed to be binding in manner and form as they are made. There is no doubt that a large part of those contracts is made for serious business purposes. Hedging, for instance, as it is called, is a means by which collectors and exporters of grain or other products, and manufacturers who make contracts in advance for the sale of their goods, secure themselves against the fluctuations of the market by counter contracts for the purchase or sale, as the case may be, of an equal quantity of the product, or of the material of manufacture. It is none the less a serious business contract for a legitimate and useful purpose that it may be offset before the time of delivery

the parties know when they make such contracts that they are *very likely to have a chance to satisfy* them in that way, and *intend to make use of it*, that fact is perfectly consistent with a serious business purpose, and an intent that the contract shall mean what it says." 198 U. S. at 248, 25 Sup. Ct. at 639. Here the distinction suggested in the first italicized phrase is of a different kind: knowing that I may be able to settle in cash without legal penalties or loss of membership in the exchange, I nevertheless intend to deliver the wheat which I have contracted to sell. The distinction is subtle and difficult to apply to the circumstantial evidence of "intention" of the parties to a particular contract; it is a *different* distinction, however, from the one between intention to settle by payment of differences and intention to settle by set-off.

<sup>99</sup> In support of this conclusion, it should be noted that the United States Cotton Futures Act treats settlement by set-off or "ring" settlement as quite different from "actual transfer." 39 STAT. 479 (1916), 26 U. S. C. § 741(4) (1926).

in case delivery should not be needed or desired."<sup>91</sup>

Again,

"It seems to us an extraordinary and unlikely proposition that the dealings which give its character to the great market for future sales in this country are to be regarded as mere wagers or as 'pretended' buying and selling, without any intention of receiving and paying for the property bought, or of delivering the property sold, within the meaning of the Illinois Act. Such a view seems to us hardly consistent with the admitted fact that the quotations of prices from the market are of the utmost importance to the business world, and not least to the farmers."<sup>92</sup>

Mr. Justice Holmes' opinion thus shifts the focus of attention from "mutual intention" to the evaluation of institutional practices. In his *dictum*, however, the learned justice was evaluating the institution as a whole, not particular abuses of it. He expressly limited his discussion to transactions between members of the exchange.<sup>93</sup> It does not follow that every agreement between a member of the exchange and his customer is enforceable merely because the member contracts with another member under the rules of the exchange, which require delivery on "open" (uncancelled) contracts. Transactions between members of the exchange are sanctioned by exchange penalties, extending even to forfeiture of membership, which do not apply to the customer, an outsider. Moreover, since a small fraction of all future transactions are eventually settled by delivery of wheat, every member of the exchange must always "contemplate" delivery as an ugly possibility even though he does not desire or expect it in most instances. Even if this can be called an "intention" to make (or take) delivery, the same cannot be said of every customer. If for instance, the latter makes a "sale" with intention to close-out by "buying" before the delivery day, he can feel practically certain that he will not be called upon to make delivery and quite certain that the penalty for failure to make delivery will be no more than the difference between contract and market price.

---

<sup>91</sup> 198 U. S. at 248, 25 Sup. Ct. at 639. "Serious business purpose" suggests that wagering is, by contrast, a frivolous pastime. The emphasis on policy is unmistakable. Note also that "equal quantity" suggests "strict rule" hedging, and "may be offset" greatly overestimates the probability that a hedging contract will be performed by actual delivery.

<sup>92</sup> *Ibid.* 249, 25 Sup. Ct. at 639. A little further on, the learned justice says: "A set-off is, in legal effect, a delivery." A bucket-shop proprietor may set-off his "long" customers against his "shorts," or he may himself buy to offset his "short" customers, and *vice versa*; but he does not "deliver." ENCYCLOPEDIA OF THE SOCIAL SCIENCES (1930) tit. Bucket Shops. Does not "in legal effect" imply a value judgment of the particular institution?

<sup>93</sup> 198 U. S. at 250, 25 Sup. Ct. at 639.

Yet some lower federal courts have seized upon Mr. Justice Holmes' distinction between cash settlement and set-off as a means of validating agreements between customer and broker dealing through a reputable produce exchange.<sup>94</sup> The latter transaction is approved on the fallacious assumption that because *settling* by set-off is "legitimate," it follows that agreeing when the "sale" is made to settle thus is "legitimate."<sup>95</sup> Under this reasoning it would be virtually impossible to prove that an agreement between an exchange broker and his customer is a wager. The rules and practices of the exchange do not permit the broker to contract (with another member) for a simple settlement in cash without the intervention of a set-off or ring settlement, or a transfer to a clearing house.<sup>96</sup> The effect of these decisions is to validate all futures transactions made through a member of an organized exchange, and hence to validate all "hedging" transactions.

#### V. JUDICIAL ATTITUDES TOWARD HEDGERS

Without going so far as to approve all exchange transactions, some courts have found devious ways of upholding futures agree-

---

<sup>94</sup> *Gettys v. Newburger*, 272 Fed. 209 (C. C. A. 8th, 1921); *Mullinix v. Hubbard*, 6 F. (2d) 109 (C. C. A. 8th, 1925); *Hoyt v. Wickham*, *supra* note 7; *Lamson v. Turner*, *supra*, note 47; *Medlin Milling Co. v. Moffat Commission Co.*, 218 Fed. 686 (W. D. Mo. 1915). Also, *Mackay Telegraph-Cable Co. v. Bain*, 163 S. W. 98 (Tex. Civ. App. 1914). *Contra*: *Birmingham Trust & Savings Co. v. Currey*, 175 Ala. 373, 57 So. 962 (1911). *Cf. Andrews v. Shutt Co.*, 44 F. (2d) 337 (C. C. A. 5th, 1930).

<sup>95</sup> *Sanborn, J.*, in *Gettys v. Newburger*, *supra* note 94, at 219: "Where such contracts are closed out before such times of delivery, the legal presumption is, in the absence of substantial evidence to the contrary, that at the time the parties made the contracts they intended to close them out by these legal methods, and not by the illegal method of paying the difference between the contract prices and the market prices at the times of delivery, so that there would be no liability to deliver and no delivery of the property at such times for deliveries; and this intention is a lawful intention which does not detract from the good faith of the parties or the validity of the contracts." See also the statement of *Lewis, J.*, in *Mullinix v. Hubbard*, *supra* note 94, at 114. Just the opposite reasoning was adopted by the Illinois court in *Weare Commission Co. v. People*, *supra* note 87, at 541, 70 N. E. at 1080. "When Kruse [the customer] gave the order for the purchase of grain, and made his deposit, and then, as soon as there was a rise in the market price, sold out the grain, the presumption is that he intended, when he first made the purchase, to sell out as soon as there was a rise. And when the plaintiff in error [the broker], or its agent, aided him in the transaction, and helped him to carry it out in this illegal way, it is idle to say that the plaintiff in error did not know what the intention of Kruse was."

<sup>96</sup> See RULES OF THE CHICAGO BOARD OF TRADE (1930) §§ 288, 288A.

ments which appear to be hedges.<sup>97</sup> A picturesque statement of the distinction is given by Borquin, J.:

"It must be noted that this is not the ordinary case of marginal transactions between a more or less fugitive customer, not in the grain trade, and brokers. Whenever the latter appears, the presumption of validity virtually disappears, and if a counter presumption does not arise, as in principle it might, proof of invalidity is practically made, at least unless successfully rebutted by the broker. For it is known of all men that the overwhelming majority of the transactions last aforesaid intend no deliveries, unless therein one can squeeze or break another, is gambling pure and simple, and of most pernicious character, victimizing the world, commonly increasing and rarely decreasing the price of bread, plundering non-participants and rich and poor alike for the profit of modern forestallers, engrossers and regraters, in comparison with which all Monte Carlos pale to insignificance. On the contrary, the instant case and its transactions are those usual and valid between a country elevator association, storing or buying grain at the point of production and selling it at distant terminal markets, and brokerage or commission houses, more or less necessarily employed to dispose of the grain at the latter places."<sup>98</sup>

Here the exchange transactions are righteously tarred, and the whitewash is reserved only for hedging transactions. Without rejecting the mutual intention test, the court finds a way to separate the tar from the whitewash. The method is not to concede that the mutual intention test is only a *prima facie* inference which may be rebutted by proof of an "insurable interest" (the interest hedged), but to infer that, since *some* of the defendant's sales were followed by shipment of wheat, the plaintiff (broker) *did not know* that others were made with no intention of fulfillment. This is a legitimate use of the inference of palpability.

Other courts, however, feeling bound by statutes which make the mutual intention test conclusive, have held hedging agreements to be illegal.<sup>99</sup> Thus the Mississippi Supreme Court has felt itself precluded, by the statutory test, from taking into consideration the social utility of hedging:

"It may be true, and for the purpose of this discussion it will be assumed, that the contracts made in New Orleans for the

<sup>97</sup> Lamson v. Turner, *supra* note 47; McCarthy Bros. v. Equity Co-op. Ass'n, *supra* note 55; Edgely Co-op. Grain Co. v. Spitzer, *supra* note 59; Miller Co. v. Klovstad, *supra* note 47; Browne v. Thorn, *supra* note 47, where an instruction that hedging is lawful was approved on appeal, with the comment: "*Prima facie* such transactions are lawful." Query, why the "*prima facie*?" Cf. Medlin Milling Co. v. Moffat Commission Co., *supra* note 94.

<sup>98</sup> McCarthy Bros. v. Equity Co-op. Ass'n, *supra* note 55, at 174.

<sup>99</sup> Falk v. Alexander Mercantile Co., 138 Miss. 21, 102 So. 843 (1925); State v. Clayton, *supra* note 61.

sale of four hundred bales of cotton were made for the purpose of hedging against any loss which the appellant might have sustained by a decline in the price of cotton before he could sell that which he had purchased from the appellee, and it may be, as counsel for the appellant seem to contend, that such a contract is not a wagering contract, and consequently is valid at common law, although it was the intention of the parties that the commodity therein sold was not to be delivered, but that the settlement to be made under the contract was the payment of the difference in price of the commodity arising out of the rise and fall of the market price above or below the contract price therefor, but with the common law we have here no concern, for the case is controlled and must be decided by the statute hereinbefore set out."<sup>100</sup>

The result reached, a logical application of the mutual intention test to futures agreements avowedly made as hedges, shows that the adoption of this test as a *conclusive* one invalidates hedging agreements openly arrived at. If hedging agreements are to be avowedly separated from illegitimate wagers, and not merely protected sporadically by means of introspective inference, the mutual intention test must be treated as merely *prima facie* or presumptive, and must be supplemented by the principle that a futures agreement entered into for the purpose of protecting a legitimate "long" or "short" interest, is valid. Unfortunately, only one statute has been found which creates such an exception. Minnesota expressly validates "hedging agreements."<sup>101</sup> Legislation aimed at gambling in futures has usu-

---

<sup>100</sup> *Falk v. Alexander Mercantile Co.*, *supra* note 99, at 27, 102 So. at 814. The defendant, a merchant engaged in buying and selling cotton, sold the plaintiff 400 bales of "spot" cotton (cotton actually on hand). Because of a foreseeable delay in transporting the cotton to the New Orleans market, the defendant agreed that the plaintiff should "sell" through the New Orleans Cotton Exchange, 400 bales for future delivery and that the defendant would "protect" him against any loss he might sustain on account thereof. The plaintiff made the "sale" as agreed, and later closed it out, by payment of the cash difference, at a loss, which he now seeks to recover from defendant. The court inferred that this settlement was "in accord with the parties' original intention relative thereto," and affirmed a judgment for defendant. The statute read, in part: "A contract for the purchase or sale of a commodity of any kind, to be delivered at a future date, the parties not intending that the commodity is to be actually delivered in kind and the price paid, shall not be enforced by any court..." *MISS. ANN. CODE* (Hemingway, 1927) § 2034. See also *Mackay Telegraph Cable Co. v. Bain*, *supra* note 94, where the court said that the Texas Penal Code (art. 536 and 539) prohibited hedging agreements, but held that the Texas law did not govern this transaction, which was valid apart from statute.

<sup>101</sup> *MINN. STAT.* (Mason, 1927) § 10223-3, declares that it is not illegal for producer or dealer to enter into a contract for "future delivery on any grain exchange, according to the customary method of making such contract on such grain exchange; and if either party . . . enters into such contract in good faith as a protection against loss . . . such contract is lawful, and

ally, as in Mississippi, failed to discriminate between pure wagering and the hedging of an extraneous interest.

Once the distinction between hedging and wagering is recognized in legislative or judicial doctrine, the question will arise, how can the courts discriminate between hedges and pure wagers? What brands or earmarks can be used to separate the sheep from the goats?

## VI. THE INDICIA OF HEDGING AGREEMENTS

### A. *Burden of Proof and Judicial Notice*

Except where a statute imposes the burden of proving the legality of a futures agreement upon the party seeking to enforce it,<sup>102</sup> the party who asserts the illegality of the agreement—in most cases the customer of a broker—ordinarily has the burden of pleading and of proof.<sup>103</sup> The weight of this burden varies with judicial assumptions of fact and notions of relevancy. Occasionally a court virtually takes judicial notice that futures agreements on commodity exchanges are wagers unless the contrary be shown.<sup>104</sup> Fortunately such cases are rare; even proof that the vast majority of exchange transactions are made with no intention of delivery, is generally inadmissible to prove that the litigated transaction falls within this class.<sup>105</sup> As a matter of persuasiveness such proof seems strictly relevant;<sup>106</sup> its rejection must therefore be ascribed to considera-

---

may be carried out by delivery . . . or may be settled by novation or by payment of the difference between contract price and market price. . . ." This legislation frankly recognizes that a speculator (rather than another hedger) is usually on the other end of a hedger's agreement, and that hedgers do not intend, as a rule, to make (or take) delivery. It seems strange, however, that the statute of a great milling state does not clearly apply to millers.

<sup>102</sup> *Pate v. Wilson Bros. Mercantile Co.*, 208 S. W. 235 (Tex. Civ. App. 1919); *Sprague v. Warren*, *supra* note 51. The present Texas statute omits this provision. TEXAS PENAL CODE (1928) art. 657-663.

<sup>103</sup> *Hooper v. Nuckles*, *supra* note 59; *Hyman & Co. v. Hay*, *Kilpatrick v. Richter*, both *supra* note 51; *McCarthy Bros. Co. v. Equity Co-op. Ass'n* *supra* note 55; *Browne v. Thorn*, *supra* note 47. This rule is tacitly assumed in many other cases. Where the contract is in terms of numbers rather than quantities of a commodity, however, the presumption of legality virtually disappears. *Carey v. Myers*, *supra* note 68.

<sup>104</sup> *Counselman v. Reichart*, *supra* note 62; *Lane v. Logan Grain Co.*, *supra* note 67 (common understanding that no delivery is intended on "puts" and "calls"); *cf. McCarthy Bros. v. Equity Co-op. Ass'n*, *supra* note 55.

<sup>105</sup> *Lamson v. Turner*, *supra* note 47; *Roundtree v. Smith*, 108 U. S. 276, 2 Sup. Ct. 630 (1883) (evidence insufficient to go to the jury); *Gettys v. Newburger*, 272 Fed. 209 (C. C. A. 8th, 1921), *certiorari* denied, 257 U. S. 649, 42 Sup. Ct. 56 (1921), writ of error dismissed, 260 U. S. 693, 43 Sup. Ct. 11 (1922).

<sup>106</sup> Proof that less than one per cent of the transactions on the Chicago Board of Trade are consummated by delivery *tends* to show (a) that this

tions of policy. A similar explanation accounts for the inference, sometimes made, that this contract was entered into with intent to deliver because the rules of the exchange forbid the making of agreements with a contrary intent.<sup>107</sup> A "bucket-shop" proprietor could not take advantage of such an inference.<sup>108</sup>

Evidence that other persons have made "futures" agreements with the plaintiff with no intention of delivery would seem to have some probative value; but it is perhaps too slight to justify its admission.<sup>109</sup> Proof that previous similar agreements have been consummated between the plaintiff and the defendant without actual delivery seems clearly of the requisite probative value; but it is not always admitted.<sup>110</sup> Such proof could frequently be made by a "hedger" who used a particular broker solely for hedges and sold his cash grain elsewhere. On the other hand, proof that the customer had delivered grain (or taken delivery) under previous futures transactions would clearly be admissible to show that the broker was ignorant of the defendant's intention as to the litigated transaction.<sup>111</sup>

#### B. Occupation of Customer and His Ability to Make (or Take) Delivery

The occupation of the customer and the disclosure of this fact to the broker has been treated as an important fact in many cases. Futures agreements have been held illegal where, to the knowledge of the broker, the customer was a bank cashier of

---

transaction will not be consummated by delivery; (b) that the broker and the customer, knowing this fact, did not "intend" to make delivery. Cf. *Russo v. Slawsby*, 146 Atl. 508 (N. H. 1929); *WIGMORE, op. cit. supra* note 39, at 389.

<sup>107</sup> *Springs v. James, supra* note 47 (rules of New York Cotton Exchange); *Bell Co. v. Emberson, supra* note 69 (rules of Milwaukee Chamber of Commerce); *Sampson v. Camperdown Mills, supra* note 69; *Jacobs v. Hyman, supra* note 51; *Cohen v. Rothschild, supra* note 47. But cf. *Hyman & Co. v. Hay, supra* note 51; *Price v. Barnes, supra* note 43.

<sup>108</sup> *Carey v. Myers, supra* note 68 (bucket-shop proprietor posted notice that "in buying, actual delivery is contemplated").

<sup>109</sup> *Browne v. Thorn*, 272 Fed. 950, 953 (C. C. A. 8th, 1921), *aff'd*, 260 U. S. 137, 43 Sup. Ct. 36 (1922).

<sup>110</sup> *Admitted: Carey v. Myers, supra* note 68; *Ohlendorf v. Bennett, supra* note 52; *Lamson v. West, supra* note 67; *Hartwig v. Booth, supra* note 54; *Fraser v. Farmer's Cooperative Co.*, 167 Minn. 369, 209 N. W. 33 (1926). *Excluded, or Held Insufficient to Raise an Issue of Fact: Lamson v. Turner, Solomon v. Newberger, both supra* note 47; *Flowers v. Bush and Witherspoon Co., supra* note 70. See *Dillon v. McCrea*, 59 Ill. App. 505 (1895) (proper to charge jury that previous settlement in cash was not "conclusive").

<sup>111</sup> *Lamson v. West, supra* note 67; *Hartwig v. Booth, supra* note 54.

limited means,<sup>112</sup> or a druggist of small capital,<sup>113</sup> or a farmer having no need for the commodity which he "purchased."<sup>114</sup> Farmers do not customarily hedge;<sup>115</sup> yet the farmer may on occasion use the futures market for this purpose. Thus, in *Edgeley Co-operative Grain Co. v. Spitzer*,<sup>116</sup> a luckless farmer who expected a rye crop of 12,000 bushels sold 10,000 bushels for future delivery. His crop was less than expected, and the price of rye mounted to the point where he closed out at a loss of \$4,000 on his futures. The court gave judgment against him, saying that this was a hedging contract which protected him against price decline on his expected crop, but adding inconsistently that the fact he expected 12,000 bushels from his crop showed an intention to deliver under the futures contract. If the futures contract was a hedge, he did not expect to make delivery under that contract.

Where the customer is a dealer in grain, buying and shipping it, he has frequently been held liable on his futures contracts.<sup>117</sup> In the cases cited the court expressed its approval of hedging agreements, and assumed that the litigated transactions were of this character. In none of them, however, was it clearly shown that the counter-interest of the customer was at least equal to the amount of the hedge. These cases may, therefore, be taken to show that the appropriate agreements of the typical hedger will be enforced. In one case the court went somewhat further, holding that a *purchase* of futures by a local elevator association, though not a typical hedge, was enforceable because it *might* have been made to close out a *sale* (a proper hedge, in this case) assumed to have been previously made through another broker.<sup>118</sup>

But in several cases a grain dealer has successfully evaded performance of his futures contracts.<sup>119</sup> Two of these cases are

<sup>112</sup> *Ohlendorf v. Bennett*, *supra* note 52 (suit by bank receiver against broker).

<sup>113</sup> *Hartwig v. Booth*, *supra* note 54.

<sup>114</sup> *Carey v. Myers*, *supra* note 68 (farmer "bought" 1,000 barrels of pork); *Price v. Barnes*, *supra* note 43; *Hyman & Co. v. Hay*, *supra* note 51.

<sup>115</sup> HEARINGS ON S. 454, 26, 28.

<sup>116</sup> *Supra* note 59. But in *Kilpatrick v. Richter*, *supra* note 51, a farmer who sold cotton by a memorandum stating that it represented a part of his crop was allowed, on his own testimony that it was a wager, to defeat recovery for breach of his contract.

<sup>117</sup> *Bell v. Emberson*, *supra* note 69; *Miller Co. v. Klovstad*, *Lamson v. Turner*, both *supra* note 47; *McCarthy Bros. v. Equity Co-op. Ass'n*, *supra* note 55; *cf. Mackay Telegraph-Cable Co. v. Bain*, *supra* note 94; *Pixley v. Boynton*, *supra* note 47 (plaintiff a grain shipper); *Sampson v. Camperdown Cotton Mills*, *supra* note 69 (defendant a cotton manufacturer).

<sup>118</sup> *McCarthy Bros. v. Equity Co-op. Ass'n*, *supra* note 55.

<sup>119</sup> *Falk v. Alexander Mercantile Co.*, *supra* note 99; *State v. Clayton*, *supra* note 61; *Lamson v. West*, *supra* note 67; *Fraser v. Farmer's Co-oper-*



to be explained on the ground that a statute made the mutual intention test conclusive and hence hedging was irrelevant.<sup>120</sup> The Illinois case<sup>121</sup> reveals a suspicious disproportion between the futures transactions and the legitimate interests to be protected. A small-town farmer and grain dealer, owning two elevators having a joint capacity of 35,000 bushels (as the broker's agent knew), during a period of nine months engaged in 157 futures transactions aggregating 1,700,000 bushels. The particular transaction in litigation was a "sale" of 100,000 bushels, on which a loss of \$7,000 was sustained. While the opinion does not mention hedging as a possible explanation, and in fact treats the mutual intention test as conclusive under the Illinois statute, the decision is compatible with the legality of proper hedging agreements. For even if due allowance be made for a rapid turnover of "cash" grain, it seems highly improbable that the operation of this small elevator would entail such extensive futures commitments as a protection of legitimate interests. The case is illustrative of the factors to be considered in drawing the line between hedging and wagering by small grain dealers.

The two Minnesota cases draw a closer line around legitimate hedging. In one case<sup>122</sup> the defendant, a local elevator company, bought 20,000 bushels of May oats in October, though there was no substantial evidence that it had any stored oats at the time. The court thought it suspicious that this transaction, if it were a hedge, was not closed out until the following April, long after the "returns would have been made or the stored oats shipped out." If this indicates that a transaction, originally a hedge to cover a legitimate interest, becomes a wager as soon as the legitimate interest is disposed of, a very strict rule indeed is laid down, and one which makes hedging by present methods impracticable. As soon as this transaction was closed in April, the defendant, having 9,406 bushels of stored oats "in transit," "bought" 12,000 bushels of July oats through the plaintiff. Apparently the effect of shipping the oats of its depositors as its own was to make the defendant liable for the price prevailing

---

ative Co., *supra* note 110; *Bolting v. Schoener*, 144 Minn. 425, 175 N. W. 901 (1920); *Benson-Stabeck Co. v. Reservation Farmers' Grain Co.*, *supra* note 67.

<sup>120</sup> *Falk v. Alexander Mercantile Co.*, *supra* note 99; *State v. Clayton*, *supra* note 61. In the latter case a dealer in pork, to protect his interest in contracts whereby he contracted to sell pork to various customers for actual delivery, purchased pork futures on margin. The jury found specially that there was to be no actual delivery under the futures agreement, and the dealer was convicted of violating a penal statute which made "intention to deliver" the conclusive test. The court assumed a liberal attitude toward hedging but felt concluded by the jury's verdict.

<sup>121</sup> *Lamson v. West*, *supra* note 67.

<sup>122</sup> *Fraser v. Farmer's Cooperative Co.*, *supra* note 110.

when the depositors demanded their grain; hence a purchase of futures was made as a hedge against this fluctuating liability.<sup>123</sup> The court remarked that "no explanation is made as to why the future trade should involve an excess of 3,500 [2,500] bushels." On this evidence the court, "with some reluctance," upheld a verdict for the defendant. The opinion indicates a failure to understand that the hedging transaction is not, in purpose or practical use, a transaction for the actual transfer of grain:

"Hedging is a legitimate transaction. . . . But contracts in form for future delivery, not intended to represent actual transactions, but merely to pay and receive the differences between the agreed price and the market price at a future day, are in the nature of wagers on the future price of the commodity, and are void. Dun. Dig. § 10133."<sup>124</sup>

A clearer understanding of the hedging transaction is manifested in the earlier Minnesota case of *Bolfing v. Schoener*,<sup>125</sup> a suit by the personal representative of a deceased customer to cancel a mortgage given to a broker for losses on futures transactions. The judgment of the trial court, that the mortgage be cancelled, was affirmed. The appellate court recognized that hedging transactions, entered into with no intention of delivery, are legitimate:

"There is no pretense that the passing of actual grain was ever contemplated in any of these option deals. They were to be settled by paying or receiving the amount of the rise or fall in the market price of the grain and were clearly illegal unless justifiable as 'hedges.'"<sup>126</sup>

But the court found, on the following evidence, that some, at least, of these transactions were not hedges: (1) Some transactions originated in a purchase rather than a sale of futures; (2) six transactions were closed out in July and August, 1916, when the customer, a small elevator proprietor, had bought little, if any, grain, and hence had no interest to protect; (3) even if the customer bought September (1917) wheat to close out a previous unprofitable sale of July (1917) wheat, he was speculating rather than hedging; (4) the sale of July wheat was made in January, 1917, while the purchase of September wheat was not made until the end of March, 1917, "long after any legitimate hedge made in January ought to have been closed out;"

<sup>123</sup> This type of hedging, used by Northwestern elevators of small capacity, is described in (1920) 1 GRAIN TRADE 226.

<sup>124</sup> 167 Minn. at 377, 209 N. W. at 37.

<sup>125</sup> *Supra* note 119.

<sup>126</sup> 144 Minn. at 426, 175 N. W. at 901 (italics ours). A similar statement is made *ibid.* 430, 175 N. W. at 903. Yet elsewhere the opinion reads: "For present purposes we shall assume without deciding that 'hedging' transactions are lawful. . . ." *Ibid.* 427, 175 N. W. at 902.

(5) in January, February, March and April, 1917, the customer shipped only about 8,400 bushels of grain, yet he closed out options for 39,000 bushels; (6) the customer gave "stop-loss orders"<sup>127</sup> on some transactions.

The decision can be sustained on the fifth point, since the disproportion between the futures and cash transactions indicates that the bounds of legitimate hedging were overstepped; yet one is troubled somewhat by the absence of evidence showing that this disproportion was known to the broker. The other points are highly doubtful. The first is valid only if the purchases were not made to close out hedging sales; it is here assumed they were not.<sup>128</sup> The court recognizes that there may be situations in which a local elevator will legitimately hedge by purchasing,<sup>129</sup> but says there is no evidence of such a situation here. As to the second point, if the customer sold and then closed out before he had any cash interest to protect, it was not hedging. But the question may be raised, would it not be legitimate hedging for an elevator to sell in advance of receipt of grain actually anticipated? The analogy of insurance law, that one may insure property which one actually expects to acquire in the future,<sup>130</sup> would seem pertinent here. The third point seems to put a needless limitation on hedging since the September purchase was, in effect, a hedge against the July sale, which was a legitimate hedge and therefore a legitimate interest to be protected. The fourth point is clearly unsound, not only because the average life of hedging transactions is thirty to forty days, but also because the practice of using one sale to cover several successive purchases and shipments of cash grain cuts down the cost of hedging and is, therefore, to be encouraged.<sup>131</sup>

In contrast with the United States District Court for Montana, which presumed that futures transactions of a vocational hedger were legitimate,<sup>132</sup> the Supreme Court of the same state adopted a "strict hedging" test in *Benson Stabbeck Co. v. Reservation Farmers' Grain Co.*<sup>133</sup> A member of the Minneapolis Chamber of Commerce, a well-established grain exchange, sued a Montana elevator company on notes given for losses on futures trans-

---

<sup>127</sup> ". . . gave an order for the purchase or sale of an option, and at the same time directed that it should be closed out whenever the market rose or fell a certain amount." *Ibid.* 430, 175 N. W. at 903.

<sup>128</sup> Contrast *McCarthy Bros. v. Equity Co-op Ass'n*, *supra* note 55, where the opposite assumption was made. The court said the broker might have thought the purchase was made to close out a sale ("hedge") made through another broker.

<sup>129</sup> See *supra* note 123.

<sup>130</sup> VANCE, INSURANCE (2d ed. 1930) 143.

<sup>131</sup> (1926) 7 GRAIN TRADE 63.

<sup>132</sup> See *supra* note 128.

<sup>133</sup> *Supra* note 67.

actions which the defendant claimed to have been illegal. A verdict and judgment for the defendant were affirmed. The court found sufficient evidence (for the jury) of a disclosed intention not to deliver, in three bits of evidence: (1) Of ninety-nine sales, made in August, of May futures, three were made on "stop-loss" orders, contrary to the rules of the Chamber of Commerce. A "stop-loss" order is inconsistent with strict hedging, since the strict hedger should close out his futures transaction when he delivers his cash grain, rather than when the market price reaches a certain point. (2) The plaintiff obligingly "scalped" for the defendant in order to save a loss on a sale of futures. "Scalping" is purchasing and selling on the same day, and is rarely, if ever, compatible with strict hedging. (3) The plaintiff advised the defendant to sell out a purchase of December wheat in order to avoid having to take delivery. Just why the defendant was "long" on wheat is not clear, but if the elevator company were selling stored grain a purchase of futures would be a proper hedge, and the fact that the defendant was reluctant to take delivery on such a transaction would not be incompatible with strict hedging. The court approves hedging transactions but by adopting the mutual intention test it practically outlaws genuine hedging, even strict hedging. The case shows the difficulty of separating the strict hedging transactions of a vocational hedger from his speculative transactions; it also shows the harsh results of the rule that a few illegal transactions will vitiate an entire cause of action, including many legitimate transactions.

In endeavoring to distinguish hedging from wagering, the courts are between the devil and the deep sea. On the one hand, the grain broker who, even though he actually executed the orders on recognized exchanges, participates in, or encourages, reckless wagering by the manager or directors of a local elevator company on the company's credit, may properly be denied recovery of losses thus incurred. On the other hand, either the mutual intention test or the strict hedging test, when applied to a series of complicated transactions, will penalize a broker who furnishes a useful service.

A *via media* can be found by using the "vocational hedging" test, limited by a "disproportion" test. That is, all futures transactions by persons (including corporations) whose business involves actual handling of cash grain should be treated as presumptively valid, even though made with a mutual intention not to deliver. This presumption would be overcome by proof that, to the knowledge of the broker, the hedger had engaged in futures transactions far in excess of his normal requirements for hedging purposes.<sup>134</sup> The degree of permissible disproportion

<sup>134</sup> *E.g.*, Lamson v. West, *supra* note 67. For example, the by-laws of a

can be marked out by a series of concrete decisions.

On the other hand, to wield the bludgeon of nullity whenever the limits of strict hedging are passed would be to outlaw many, perhaps most, transactions actually used for hedging purposes. We are confronted with an institution, not a theory. Many factors make strict hedging difficult if not unworkable. For example, "on most of the exchanges trading in futures is in 1,000 bushel lots as a minimum."<sup>135</sup> Hedging transactions are often made in anticipation of cash grain which will be delivered later.<sup>136</sup> Frequently one hedging transaction is allowed to stand as protection on several cash purchases. Cash wheat of a certain grade may be hedged in wheat of one or of many other grades, and barley and rye, with limited futures markets, are often hedged in wheat.<sup>137</sup> Moreover, successful hedging requires the exercise of business judgment as to favorable market conditions. Once a hedge is made the hedger is likely to exercise his judgment as to the best time to close it out, just as an ordinary speculator would do. Hence "spreading," "stop-loss" orders and even "scalping" should not *per se* be regarded as incompatible with vocational hedging. If, as is essential, hedging enables the small operator or miller to protect himself against ruin, and to finance his dealings in cash grain on a small capital,<sup>138</sup> the *actual* practice of hedging should be given judicial sanction.

#### VII. SOME UNANSWERED QUESTIONS

In order to make clear the implications of the foregoing discussion, it must be noted that the following questions are avowedly left unanswered:

(1) The extent to which organized exchanges are socially useful institutions apart from their use by hedgers. They are public registers of grain prices, and there is considerable evidence that fluctuations in prices have become less violent since they came into being. That they also help in the movement from soil to consumer seems plausible.

(2) The extent to which a beneficent government may properly allow its citizens respectable methods of gratifying their appetites for gambling. The organized exchanges, as super-

---

St. Louis flour mill gave the manager a leeway of 35,000 bushels, the extent to which the mill may be "long" or "short" at any one time. (1926) 7 GRAIN TRADE 56.

<sup>135</sup> (1920) 1 GRAIN TRADE (Country Grain Marketing) 212. On the Chicago Board of Trade, the minimum is 5,000 bushels, except in job lots.

<sup>136</sup> *Ibid.* Or, in the case of exporters, in anticipation of cash grain to be sold. (1926) 7 *ibid.* 49.

<sup>137</sup> *Ibid.* 213.

<sup>138</sup> (1926) 7 GRAIN TRADE 279.

vised under recent federal legislation, seem to afford honest machinery for speculation.<sup>139</sup>

(3) The extent to which speculation by the uninitiated, as distinguished from the professional operator, is indispensable to the maintenance of a broad market. Off-hand it would seem that the inexperienced speculators tend to upset the market rather than stabilize it.

(4) The legal machinery by which speculation on produce exchanges is to be kept within limits. The civil penalty (denial of recovery on the contract) is a blunderbuss remedy, yet it has the advantage of not requiring a host of administrative officials for its enforcement. While there is a distinct tendency to throw over the mutual intention test, for the present that test is "a political necessity though an economic impossibility." Some brake upon futures trading by the lunatic fringe seems needed, and the broker who solicits the uninitiated to take a "flyer in the market" is hit hardest by the mutual intention test.<sup>140</sup>

(5) The way in which the mutual intention test can be so shaped as to legitimize trades by or for the professional operator, who seems to be an indispensable factor in the maintenance of a broad and stable market. Logically, there is no way. Practically, the professional operator, one may conjecture from the reported cases, is not the man to contest his legal liability. Custom conquers the law.<sup>141</sup>

---

<sup>139</sup> *Ibid.* 291: "The distinction between the gambler and the speculator is principally a matter of degree of knowledge." "There is another very important qualification for speculation. This point is emphasized—over-emphasized, in fact—in the view that all that is necessary is that the speculator be financially responsible. . . . Responsibility, however, is not a matter of the size of the customer, but of the ratio of the trades carried by a speculator to his available resources." Prof. Irving Fisher emphasizes the element of expertness. HARDY, READINGS IN RISK AND RISK-BEARING (1924) 347.

<sup>140</sup> "The simplest and best rule is that speculative trade should in no case be really solicited." (1926) 7 GRAIN TRADE 299. In an earlier volume of the report, however, the criticism of *James v. Clement*, *supra* note 51, fails to note that the order in that case was solicited. In *Clark v. McNeil*, testimony was given that the broker's branch office in Hickman, Ky., "was all the time trying to get people to give John F. Clark & Co. their business. . . . Men, women, and children and babies dealt in cotton over there and in all transactions that they had there was not an actual delivery of any commodity." 25 F. (2d) at 249. In fairness it must be pointed out that the Chicago Board of Trade is trying to curb solicitation, *e.g.*, by limitations on radio broadcasting (RULES (1930) § 1044) and by requiring solicitors (for members) to work on a fixed salary (*ibid.* § 1600).

<sup>141</sup> This statement must, however, be accepted with caution, since the reports do not always disclose the vocation of the customer, much less his expertness in market operations. Though the occupation of the customer is treated as significant in judicial opinions, no case has been found in which a "typical" professional speculator has raised the defense of illegality.

(6) The way in which the speculator on the other end of a hedging transaction may be treated as a legitimate indemnitor—a socially useful risk-bearer—rather than a wagerer. Practically, there seems to be no way, since the exchange member lumps orders together in trading on the exchange, and a trade by one non-member through the exchange cannot be allocated to a non-member at the other end of the chain.

#### VIII. HEDGING AS PRICE INSURANCE

The statement that hedging is "price insurance" is frequently made as a justification of the existence of organized exchanges and of trading in futures, especially the much denounced "short" sale.<sup>142</sup> The accuracy of this statement may be examined, first because of its bearing upon the problem of "strict" or "loose" hedging, and secondly, because of the possibility of devising an adequate form of insurance to serve the same purpose as hedging without the evils of exchange gambling.

The Federal Trade Commission report distinguishes hedging from insurance:

"The future contract used in hedging is not an insurance contract in any proper sense, even if it serves a somewhat similar purpose. There is no specific premium paid for specified protection. The hedger gives up gains as well as avoids losses. Insurance avails itself of the theory of probabilities, in its practical application to averages, with the result of broadly distributing nearly certain aggregate losses, but the direct effect of the hedge is merely to transfer a loss or a gain, and such losses or gains are often markedly concentrated."<sup>143</sup>

The distinction is not made as clear as one might wish. The

---

The Federal Trade Commission's study of the occupations of 5,000 customers of eight Chicago "wire" houses (commission houses executing exchange transactions on telegraphic orders) indicated that sixty-three per cent of the customers were in the "trade" group; but the inquiry was unable to separate "hedgers" from speculators, nor did it reveal the "expertness" of the speculators, though the conclusion is reached: "Such a tendency . . . indicates that attraction to trading in futures depends partly upon experience in mercantile matters, such as would to some degree, though not very directly, prepare a person for speculation." (1926) 7 GRAIN TRADE 199.

<sup>142</sup> ". . . hedging is a manufacturer's or merchant's insurance against price fluctuation of materials, and no more damnatory than insurances of property and life, which in one sense are wagers that the property will not be destroyed during the term, and that the life will not fail in less than the expectancy in the actuaries' tables." Baker, J., in Board of Trade v. Kinsey Co., 130 Fed. 507, 512 (C. C. A. 7th, 1904). Most "hedges" are "sales" of futures, because the volume of hedging by elevators is larger than that by millers. For a discussion of hedging as insurance, see the colloquy in HEARINGS ON S. 454, 29.

<sup>143</sup> (1926) 7 GRAIN TRADE 65.

losses by fire, for instance, are "markedly concentrated," since only a small proportion of those insured against fire suffer loss by fire at all. Apparently "concentrated" means "concentrated in time" rather than concentrated upon a small number of those exposed to the risk at any one time. A sudden and violent downward turn of the market will cause heavy losses to all unhedged holders of cash grain, just as a sudden upward turn will bring them unforeseen profits. If such sudden and violent downward turns occur, let us say, once every two years, then the "insurer" who assumes such a risk is in the position of a fire insurer who insures all the buildings in a town where a general conflagration is bound to occur every two years and cause serious loss to all his insured.<sup>144</sup> The cash premium for such insurance would be so high that no hedger would be willing to pay it in cash. A genuine insurance scheme works successfully only if the risk assumed is such that only a few of those exposed to it will actually suffer the loss.<sup>145</sup>

Since the hedger will not pay his "premium" in cash, he pays it by foregoing his gains on a rising market (to continue the illustration of the elevator-hedger). This brings the "insurer" in as a participator in the enterprise, a situation which is incompatible with the analogy of insurance. To deduct a fixed premium from gross profit (as the insured does in shifting his fire risk) is quite a different matter from turning over to the risk-taker an undetermined portion of the possible profits of the enterprise. Hence hedging does not fit the Procrustean bed.

As has already been pointed out, the successful operation of "hedging" in grain requires a stable relation between the price of cash grain and of futures.<sup>146</sup> Such conditions frequently do not exist.<sup>147</sup> The holder of cash grain who wishes protection

---

<sup>144</sup> The hedger may seek protection against minor fluctuations in the market, which also cause loss to all exposed to the risk. On the principle of averages, downward fluctuations occur about half the time. Hence it has been suggested that hedging is unnecessary for minor fluctuations, which will average out. Hedging has relation primarily to *extended* price trends.

<sup>145</sup> RICHARDS, INSURANCE LAW (3d ed. 1909) 2.

<sup>146</sup> (1926) 7 GRAIN TRADE 64.

<sup>147</sup> After a thorough study of the results of "hedging" on the New York Cotton Exchange, Mr. Reaviss Cox, Market Editor of The Journal of Commerce (New York), concluded that spot cotton and futures do not move up and down concurrently, that "the individual's risk when he is hedged is from one-eighth to two-thirds as great as it would have been had he not been hedged," that hedging "involves dangers peculiar to itself, so that it is an instrument to be used with all possible skill and care," and that the cotton merchant's only benefit from hedging is that he can operate on a smaller capital. Reavis Cox, *Hedging Cotton*, The Journal of Commerce, May, June and July, 1929. See also HARDY, RISK AND RISK-BEARING (1923) 225.



against decline cannot get a contract of indemnity from a responsible risk-bearer; he must utilize a device which at times affords very imperfect indemnity; and he must use his business judgment in deciding when to hedge and when not to hedge. In so doing he becomes again, a speculator, and should not be held too strictly to a theory of pure indemnity. The hedging agreement is more nearly analogous to life insurance than to fire insurance; and in applying the law of wagering to the former, the courts do not exact strict indemnity but administer a "rough working rule" which tends to minimize frenzied wagering.<sup>148</sup> A similar working rule is that advocated above for hedging agreements.

The foregoing considerations indicate that the substitution of price insurance for hedging on produce exchanges could not be accomplished simply by transferring to an insurance company the hedging agreements now made by speculators. A wholly new type of insurance would have to be devised. Since one primary object of those who favor such a substitution is the abolition of futures trading (or at least, "short selling") on organized exchanges, the insurance plan must be worked out on the assumption that trading in futures on organized exchanges does not exist. To estimate the premium, and to devise a contractual definition of the risk assumed, in the absence of a market for futures at least as continuous and stable as the present exchanges offer, would call for a degree of sagacity and skill not exhibited by any heretofore successful insurance enterprise. If, to obviate some of these difficulties, the price insurer should agree to take over the insured's unprofitable contracts (a plan analogous to that once embodied in credit insurance contracts<sup>149</sup>) or should agree to buy the produce from the insured (or sell to him, in the case of a miller), the insurer could hardly avoid becoming a grain dealer on a large scale. If, on the other hand, it be assumed that organized exchanges are to continue in operation, price insurance would probably be more costly than, and hence unable to compete with, the hedging facilities offered by those exchanges. To supplant the hedging agreement by a private insurance contract seems highly impracticable.

---

<sup>148</sup> See Patterson, *Insurable Interest in Life* (1918) 18 COL. L. REV. 381.

<sup>149</sup> Credit insurance contracts were formerly made in the form of an agreement by the insurer to purchase at their face amount all uncollectible debts over a named percentage of the insured's total annual credit transactions. HARDY, *RISK AND RISK-BEARING* (1923) 324; WOLFE, *PRINCIPLES OF PROPERTY INSURANCE* (1930) c. XXI. This form of credit insurance, however, has been supplanted by one in which the risk is defined in terms of specific facts indicating insolvency. Hanna, *Credit Insurance* (1931) 79 U. of PA. L. REV. 521, 527. While the credit insurer still collects the insured's bad credits, this salvage service is hardly comparable to the buying and selling of produce.

Hedging agreements will continue to be used. Courts and legislatures should seek to make them feasible. The following suggestions are offered with this end in view:

(1) "Mutual intention to deliver" as a test of wagering in futures should be a *prima facie* rather than a conclusive test of illegality. Statutes which make it a conclusive test should be modified by some such provision as that adopted in Minnesota.

(2) The legality of hedging agreements made with no intention that delivery of the commodity shall actually occur, should be avowedly recognized.

(3) The inevitability of a limited amount of speculation by those engaged in hedging legitimate interests should be recognized and futures transactions by vocational hedgers on reputable produce exchanges should be presumptively valid.

(4) The responsibility of preventing obviously excessive speculation by vocational hedgers may, in view of present legislative policy, be placed on the shoulders of the broker or commission firm in so far as the denial of civil liability of the hedger will accomplish this end.