

ship of the paper.<sup>42</sup> And when paper money has depreciated, the holder cannot be allowed "revaluation".<sup>43</sup>

#### IV. The Portuguese Bank Note Case

The basic problem of paper money, inconvertibility, was illuminated in a tragi-comic way by the famous English case of *Banco de Portugal v. Waterlow & Sons, Ltd.*<sup>44</sup>

Early in 1925, a swindling ring, by an incredibly ingenious manoeuvre, induced the reputable printing firm of Waterlow & Co. of London, official printers of the notes of the *Banco de Portugal*, to run off on the plates of the bank 200,000 notes of 500 *escudos* each, carrying the picture of Vasco da Gama, and to deliver the notes to the ring. In the course of the year another 280,000 notes followed. With the criminal assistance of the Portuguese envoy at the Hague the plotters had succeeded in convincing the unusually gullible head of Waterlow & Sons that they acted by authority of the Portuguese government. They also asserted, and he believed, that the notes, after later addition of a special imprint were to be used for increase of the currency of the Portuguese colony of Angola. That is why, as Mr. Waterlow fully understood, the *Banco de Portugal*, the only Portuguese bank of issue, had to be kept uninformed of this extraordinary transaction. The gold parity of the *escudo*, the Portuguese monetary unit, had originally been four shillings five and one-quarter pence. At the time of the crime it had depreciated to about two and one-half pence, the notes of the *Banco de Portugal*, having been inconvertible since 1891. 500 escudos were therefore equivalent to about five pounds sterling (gold). Through a bank established by them in Portugal, the swindlers, by the end of 1925, had circulated more than 200,000 of the notes, amounting to about 100 million *escudos*. The crime was discovered, in December, 1925, under dramatic circumstances. The *Banco de Portugal*, in

42. See Daniel, *op. cit.*, III, sec. 2000.

As for notes fraudulently and surreptitiously put into circulation, see *Cooke v. U. S.*, 91 U. S. 389, 23 L.Ed. 237 (1875). Notes issued by the Comptroller of the Currency to national banks for circulation were to be redeemed by the bank even though the signature of the bank official was missing or forged. 27 Stat. 322, 12 U.S.C. 125. This cannot be generalized, but the principle underlying the statute supports the rule set forth in the

text. *U. S. v. Barnard*, 72 F.Supp. 531 (W.D. Tenn., 1947), does not indicate a different view because there the coin was sold as a collection specimen. Regarding the ineffectiveness of private marks on paper money, see *infra*.

43. *Infra*, sec. 14 III.

44. [1932] A.C. 452 (H. of L.). On the criminological aspects of the case, Rhodes, *The Craft of Forgery* (1934) 173.

order to avert a monetary catastrophe, decided, not only to exchange the spurious notes issued by the swindlers, but also to call in the whole Vasco da Gama series and replace it with a new issue. The exchange of the spurious notes was facilitated by the fact that the bank was authorized to emit notes up to 195 million for its commercial business, and at the time of discovery had actually issued only 64 million. This left a balance more than sufficient for carrying through the exchange. The *Banco de Portugal* sued Waterlow & Co. for damages suffered as a result of the printer's breach of contract and negligence. The bank claimed the full exchange value of the unauthorized 500 *escudo* notes turned in (£1,092,281) plus the printing cost of the genuine notes given in exchange (£6,541), deducting, however, an amount of £488,430 realized from the compulsory liquidation of the swindlers' bank. The House of Lords by a 3 to 2 decision allowed the claim. The majority of the Court of Appeal had granted half the claim, Scrutton, L. J., voting for its entire dismissal.<sup>45</sup> Each judge of both Courts gave a separate opinion. An entire volume on the case was published in 1932 by Sir Cecil H. Kisch under the title "The Portuguese Bank Note Case", which, while treating the case primarily from a financial angle, offers as well much data of legal value.<sup>46</sup>

Despite the abundant discussion in the hearings, in the opinions, and by Kisch, the case offers a wealth of unexplored material on the peculiar nature of inconvertible paper money.<sup>47</sup> The decision of the House of Lords was based essentially on the argument that the bank, in exchanging its genuine for spurious notes, had suffered a loss measured by the value which the notes would in the normal course of events, have realized. This in the opinion of the Court was the full exchange value of the notes. The minority relied on the argument that the notes, in the hands of the bank, had no value over and above the printing cost which would obviously have been the only loss suffered had the notes been burned in the bank's vaults. The exchange of the genuine for the spurious notes did not add to the bank's burden if the inconvertibility of the notes were taken into account.

As a matter of fact, there is an important difference between notes in the hands of the bank of issue and notes in circulation.

45. 100 L.J. (K.B.) 465 (C.A., 1931).

46. See also Hollond "The Portuguese Bank Note Case," 5 *Cambridge Law Journal* 91 (1935).

47. A unique feature is the fact

that the inflationary injection was made into a perfectly anaesthetic patient. No experiment even of highest ingenuity could reproduce such a situation.

The latter may be used by the holder at his whim, which is not the case with notes held by the bank. A bank of issue, particularly a central note institution like the *Banco de Portugal*, is both by law and the exigencies of currency protection strictly confined to certain types of transactions, principally discounting (or rather rediscounting) of bills of exchange and commercial paper. The law of Portugal provides much as do the laws of other countries that the bank's discount and loan operations must be effected for a period not exceeding three months; bonds or commercial papers which are discounted should as a rule carry the signatures of three, never less than two, firms of established credit and recognized solvency, *etc.*<sup>48</sup> Opportunities for such discounting will depend on the changing business conditions of the country. The bank is, on principle, unable to create the conditions of the note issuance by its own action. (The qualifications of this proposition are irrelevant for the purposes of this discussion.) Hence, the inconvertible note in the hands of the bank has a potential value which is far below that of a circulating note and difficult to formulate in exact figures. We are then faced with a sort of economic miracle: the value of the note is entirely metamorphosed by the issuance process. The two values are not equal nor does a definite ratio pertain between them. Hence when the bank issues a genuine note for a forged one, the gain of the recipient is not the same as the loss to the bank. Nevertheless the bank is damaged, since it has reduced its future permissible issue.

In the Portuguese Bank Note case there was neither allegation of, nor inquiry into, the amount of loss suffered in terms of this or a similar analysis. A scrutiny of the transactions of the swindlers' bank would perhaps have permitted a rough estimate of the rediscounting profit lost by the Bank of Portugal because of the reasonable credit demands satisfied by the swindlers' bank which had circulated spurious notes up to six per cent of the entire Portuguese currency.<sup>49</sup> In no event, however, could the loss of the bank have equalled the face value of the notes. Had the bank used the two hundred thousand 500-escudo notes for discounting rather than for exchange purposes, the discounted commercial paper would not have become a definitive asset of the bank in a financial sense; it would rather have been security for the repayment of loans made by the bank. The borrower would have delivered to the bank, in discharge of his obligation, notes subject to the issuance restrictions mentioned.

48. See Kisch, *op. cit.*, at 155.

49. The total note circulation in

Portugal was, in 1925, about 1700 million *escudos*. See [1932] A.C. 452 at 465.

26  
units  
in  
trois de  
dupliques

?

Seigniorage  
foregone

No profit other than discounts could accrue to the bank, and nothing could lawfully be claimed by the bank as damages except loss of such discounts and the cost of printing new notes.

Sir Cecil Kisch, viewing the matter from the economist's angle, also feels that the bank did not suffer the loss claimed. He stresses the fact that the bank had done nothing to eliminate the fraudulent inflation, to do which would indeed have required expenditure of its own funds. It had acquiesced in the inflation. Not even the yield arising from the liquidation of the swindlers' bank was withdrawn from circulation; it was appropriated by the government in return for Treasury bills.<sup>50</sup> Moreover, co-operating with the government, the bank proceeded to a further expansion of the paper currency. A government decree of July 19, 1926, authorized the bank to raise its note circulation (1) by 100 million *escudos* in lieu of the amount consumed through the exchange of the spurious notes, (2) by another 100 million *escudos* to be issued on a commercial basis, and (3) by an additional 125 million to be advanced to the government for purposes of colonial development.<sup>51</sup> Through the use of these powers, the quotations of the English pound in terms of the *escudo* rose about 13.7 per cent from 95 in December, 1925, to 108 in 1928. The factual stabilization at the latter point was made a legal one in 1931, but did not last long.<sup>52</sup> In the opinion of Kisch, the policy described resulted in very great profits to the bank, and he concludes his book, somewhat sardonically, with "congratulation to the bank on the results achieved."

From a legal viewpoint, it is certain that if the bank had incurred real expenses in order to soak up the inflationary issue, it would have been entitled to recovery. But this is an academic question. On the other hand, the decree of the government restoring the impaired power of the bank constituted the independent act of a third person and, therefore, could not have been relied upon by the defendant, particularly as the Portuguese government had taken the precaution, in granting the substitute issuing power, to reserve all rights against the defendant. The other measures of the government and the bank are less relevant. Kisch seems to assume that the "success" of the illicit inflation moved the Portuguese authorities to indulge in an inflationary policy thereby offsetting the bank's loss. This is mere conjecture. There is no reason for assuming a connection be-

50. See Kisch at 238.

51. *Id.* at 170, 192, 230.

52. The Portuguese currency very

soon became implicated in the crisis of the English pound. Kisch, at 280.

tween the alleged financial outcome of the bank's monetary policy up to 1928 or even 1931 and the Portuguese Bank Note case. Success or failure of such a course of conduct depends to a great extent on the general business conditions of the country. On the whole, 1925 to 1928 were boom years. Hence Kisch has shown no legal point militating against the decision of the House of Lords.

Nevertheless, his discussion is highly instructive.<sup>53</sup> It discloses the interpenetration of bank and government which is the inevitable result under a regime of inconvertibility. For instance, the Portuguese government paid the bank so-called interest of 1 per cent on its debts which amounted to more than 90 per cent of the entire note issue; five-eighths of the interest was devoted to an amortization fund while three-eighths covered the bank's own cost in issuing the notes.<sup>54</sup> Practically, this meant no redemption and no interest. Yet the debt was, to its full extent, a basis of note issue. Increase or decrease of the debt had little actual significance except for possible repercussions on note circulation. A shift to the government of the amount recovered by the bank from Waterlow & Co.<sup>55</sup> would have required a ledger

53. The discussion of the case by R. G. Hawtrey, the well-known author on money and credit, in 52 *Economic Journal* 391 (1932), is less helpful. He believes the adjudication of the case to be correct. He sees only one possible objection to the decision, namely, that the decree of 1926 had added 100 million *escudos* to the commercial issue, thus seemingly compensating the bank for its loss. Hawtrey points out that even this objection fails because it is a mistake to suppose that a bank of issue necessarily *can* recoup itself for its losses by increasing the issue. This may or may not be so, but the real objections are not seen by Hawtrey. Incidentally, expansion of the issue will ordinarily enhance the bank's profit chances and thus will in some measure offset its loss.

54. *Id.*, at 165, 207.

55. This was obviously what hap-

pened. Under the decree of July 19, 1926, the bank could not keep the pounds received without using them for a contraction of the currency. This the bank did not do. Kisch, 230, 238. The Government, having compensated the bank by the expansion of the issuance power for the injury suffered, had been subrogated to the bank's rights to the yield of the lawsuit. Hence the Government obtained the pounds sterling just as it had appropriated the yield out of the liquidation of the swindlers' bank. It would have been clear from the beginning that the Government was the real party in interest, had the Government after the discovery of the crime, expressly guaranteed the bank. This a letter of the Government to the bank ostensibly declined to do. But, according to a record of the bank's board of directors (Kisch, 232), "the governor [of the bank] said that as representative of the State, this [namely, declining the guaranty] was not precisely the

operation without actual transfer of equivalent assets from the government to the bank.

In any case, the lawsuit came as an extraordinary stroke of business for the bank and the affiliated Portuguese government. The financial gain was enhanced by the English rules as to foreign currency debts. Assuming it to be true that, as a result of the crime, the bank had foregone a profit of about 90 million *escudos*, the fact remains that it would have been unable to convert this sum into English pounds at the rate applied by the court, since selling such large amount of *escudos* would have depressed their price. However, under the English rule, which holds the time of the wrongdoing determinative of the rate of conversion,<sup>56</sup> the bank collected the equivalent, in pounds, of the *escudos* at the rate prevailing at the date of the wrongdoing; it thus also achieved—and this is a remarkable aspect of the English rule—a gratuitous protection of the sum awarded against the depreciation of the *escudo*, a depreciation effectuated by the bank itself.

One cannot help concluding that the reasons advanced by the members of the highest English court were not very convincing. The court did not clearly appreciate the core of the controversy, that is, the restrictions laid upon a central note institute in the use of its notes, with their corollaries regarding the valuation problem. The question whether the loss in discounts was not the limit of the bank's damage was not even touched upon. This criticism applies, although in somewhat lesser degree, to the opinions of the dissenting judges. There is still another side to the case. A foreign bank had brought a suit against an honest and reputable English firm for an amount sufficient to break a firm of the highest financial standing. The merits of the foreign bank's case were by no means clear. England's highest authority on commercial law, Lord Justice Scrutton, had decided against it. Nevertheless, the majority of the House of Lords turned the scale in its favor. This is a splendid example of impartiality. As such, it is perhaps even more gratifying than a judgment which is only juridically accurate.

#### V. American Paper Money

Paper money is fully under the control of the Federal government. The Constitution, Art. I, sec. 10, par. 1, expressly forbids the States to issue "bills of credit," that is, notes of a monetary

opinion of the State and he, the governor, was in agreement with the government." The record is

perhaps more surprising than the fact recorded.

56. *Infra*, sec. 25 II.

# Money in the Law

## National and International

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OF LAW AND ECONOMICS

*A completely revised edition of "Money in the Law"*

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