June 28, 1915.

S i r :

The following question has been referred to this office for an opinion:

(1) Must rediscounts held by a federal reserve agent as collateral for Federal reserve notes be endorsed payable to such agent?

The term "collateral security" or "collateral" has been defined in Jones on Collateral Securities and Pledges to mean "a pledge of incorporeal property assigned or transferred and delivered by a debtor * * * to a creditor as security for the payment of a debt or the fulfillment of an obligation."

In consequence, Section 16, in providing that a Federal reserve bank shall deposit collateral with the Federal reserve agent as security for Federal reserve notes, impliedly requires that notes and bills made eligible for this purpose be pledged with the Federal reserve agent.

In order, therefore, to determine what steps must be taken to effect a valid pledge of the securities deposited with the Federal reserve agent as collateral for Federal reserve notes, it is necessary to discuss briefly the legal points involved in the law of pledges.

A pledge is more than a lien. Both depend upon a continuance of possession by the pledgee or lienee and, generally speaking, title remains in the debtor in both cases. But the pledgee, unlike the lienee, has an implied power of sale, and this is the main distinguishing feature between the two. Doane v. Russell, 3 Gray (Mass.) 382; First National Bank v. Harkness, 42 W. Va. 156,164.

A mortgage, on the other hand, is more than either of these, for it is in no way dependent upon possession and legal title vests in the mortgagee outright, the mortgagor retaining a mere equity of redemption. In the case of the pledge, however, the general property or title remains in the pledgor, the pledgee obtaining a specific property merely for the security of the obligation. Jones v. Baldwin, 12 Pick. (Mass.) 316; Thompson v. Dolliver, 132 Mass. 103;

Parshal v. Eggart, 52 Bab. (N. Y.) 367.

There is an exception or qualification to this general distinction between mortgages and pledges, regarding the transfer of title, in the case of choses in action or negotiable instruments. Jones on Collateral Securities and Pledges, 3d Ed. p. 14. This exception is a natural result of the fact that a negotiable instrument usually can not be pledged without a transfer of title necessarily resulting from the transfer of possession. The fact that the title does pass in such a case does not of itself make the transaction a mortgage. 2 N. Y. 442.

In discussing this point in Gay v. Moss, 34 Cal. 125, 132, the court said:

> "The assignment was absolute in form, but the thing assigned is a chose in action, and the assignment and delivery are necessary to give the pledgee the full authority to readily control it, and afford a prompt means of making the pledge available. For these reasons the fact that the title passes in form by the assignment, in case of a chose in action, does not necessarily make it a mortgage. It is a pledge * * * * ".

On page 15 of Collateral Securities and Pledges, supra, it is stated that -

> "To make the pledge (of negotiable paper) an effectual security, it is necessary that the pledgee should have the legal title. * * * A transfer of the title to such incorporeal property is generally an essential part of the delivery of it in pledge. An absolute transfer of such property as security for a debt is a pledge and not a mortgage. The general property may be regarded as remaining in the debtor, though the legal title may be transferred to the creditor."

It would seem, therefore, that a Federal reserve bank, in transferring eligible paper to a Federal reserve agent as collateral security for Federal reserve notes, should endorse such paper in some manner - to be discussed hereafter - such as will give to the agent the legal right to realize directly on this security whenever it is necessary.

It is true that negotiable paper made payable to order, may be pledged by the delivery of possession without endorsement, but in such case the pledgee obtains a mere equitable security, good as between him and the pledgor. The pledgor retains legal title, and though the pledgee could maintain a suit upon it in the name of the pledgor, - and in some States in his own name, - nevertheless, in such action he would be subject to any equitable defense against the pledgor set up by the defendant.

There is a further objection in the fact that the mere possession of such paper when not endorsed to the Federal reserve agent is not sufficient evidence that he is holding it in pledge. In such a case there must be some further evidence of a contract of pledge before the holder could be declared a pledgee. Jones on Collateral Securities and Pledges, p. 111; Sharmer v. McIntosh, 43 Nebr. 509. In this latter case two notes were delivered to the pledgee, under exactly similar circumstances. One was endorsed, the other unendorsed. The court held that the endorsed note was a valid pledge, under the facts, but that the unendorsed note was not, because there was no evidence of an actual contract of pledge. There must be, of course, a contract, either expressed or implied, in all cases. The general rule is that a mere delivery of the property, without any writing, constitutes a valid pledge, the contract being implied in law, but the delivery of an unendorsed negotiable note is not of itself sufficient evidence.

A collateral agreement giving the Federal reserve agent power of attorney to collect on all paper in his possession would give him only the right to sue on the paper in the name of the Federal reserve bank, and he would be subject to all equities or offsets which could be made against the bank itself.

Because of these objections, it seems a far safer and wiser course to require Federal reserve banks to make a valid legal pledge of paper deposited with the Federal reserve agent as collateral security; and in order to do this, it is necessary that an endorsement be made which would make the note payable to the Federal reserve agent, giving to him the legal right to realize directly, and without danger of equitable defenses, on the security in his possession. It is suggested, therefore, that in any case where the paper is not endorsed in blank by the member bank, the endorsement by the Federal reserve bank may be made in any one of the three following ways:

(1) The Federal reserve bank may endorse the rediscounts in blank;

(2) It may endorse them to the order of the Federal reserve agent; or

(3) It may endorse them, " Pay to the order of any bank or banker, or to the Federal reserve agent, or to ourselves."

It is to be noted, however, that if eligible paper is tendered to the Federal reserve agent as collateral security endorsed in blank by the member bank which secured the rediscount, or if the paper is endorsed to the order of the Federal reserve bank or the Federal reserve agent, it will not be necessary for the Federal reserve bank to make any further endorsement in order to vest the proper title in the Federal reserve agent. In such case, however, the list of rediscounts filed with the Federal reserve agent showing securities deposited as collateral for Federal reserve notes, should contain a full description of all such items in order that they may be identified, if necessary, as a part of such collateral security.

It has been suggested by some of the Federal reserve banks that they would prefer not to re-endorse rediscounts payable to the Federal reserve agent, because such an endorsement would indicate that this paper had been used as the basis of a note issue; but, if the endorsement suggested above,- that is, an endorsement payable " to the order of any bank or banker, or to the Federal reserve agent, or to ourselves", be made, there will be no indication on the paper that it has actually been used as the basis of a note issue, and at the same time, the legal right due the reserve agent will have been afforded. Under such an endorsement he could collect direct on any rediscounts deposited with him for security of note issues.

Another question presented is :

(2) Must gold order certificates made payable to the Federal reserve bank be endorsed to the Federal reserve agent by such bank when such certificates are deposited with the Federal reserve agent for the purpose of reducing outstanding liability on note issues ?

It is suggested that when gold order certificates which are made payable to the order of the Federal reserve banks are deposited with the Federal reserve agent for the purpose of reducing outstanding liability on note issues, the reserve bank should endorse such certificates payable " to the order of the Federal reserve agent or to the order of ourselves." Of course, if gold order certificates are

issued payable "to the order of the Federal reserve bank or the Federal reserve agent," no further endorsement will be necessary.

It is true that these certificates are deposited with the Federal reserve agent to be held by him until the Federal reserve bank offers in exchange its Federal reserve notes, and it may be contended, therefore, that it is not necessary to vest the legal title to such certificates in the Federal reserve agent.

From a practical standpoint, however, he may be called upon to transfer some part of the gold represented by such certificates to the Treasurer for redemption of notes at the Treasury, or he may be called upon to deliver to the Federal reserve bank only a part of the gold so held; and so he must be placed in a position to convert such certificates into gold or into gold certificates, in denominations that will enable him to meet either of these two contingencies.

Respectfully,

(Signed) M. C. ELLIOTT

Counsel.

Hon. Charles S. Hamlin,
Governor.

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