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Mr. George J. Seay, Governor, May 26, 1925.

M. G. Wallace, Counsel.

Letter of Comptroller of the Currency, Dated May 15th, upon the Subject of the Method of Settlement of Claims, which We Have Against Failed Banks.

My dear Governor Seay:

Heretofore there has been no definite rules laid down by the Comptroller for the guidance of Receivers in handling claims presented by Federal Reserve Banks. The positions taken by various Federal Reserve Banks have not been uniform, and the Comptroller in this letter seeks to establish a uniform rule.

Hitherto we have been proving against a failed bank a claim for the entire face amount of rediscounts held by us at the date of failure, and have been receiving dividends upon the face amount until the amount of the dividends, plus collections on rediscounts and marginal collateral equalled to the full face amount of our claim. However, in every estate which has been previously wound up it has been very obvious that we would receive on account of dividends and collections upon rediscounts and collateral a sum sufficient to pay us in full, and no controversy has ever arisen as to the correctness of our position. The letter of the Comptroller to which I refer you makes some changes in our position; in some of which I believe he is amply justified, and in some he is not.

EACH NOTE TO BE PROVEN AS A SEPARATE CLAIM.

1. The Comptroller now requests that a separate claim be proven upon each M. B. C. Note, and upon each rediscount, and that the amount of this claim as of the date of the insolvency of the closed bank be determined by adding interest if the note held by us was past due at the time of insolvency,

and rebating interest if the note was not yet due. This requirement that our rediscounts be proven separately, and that an adjustment be made on account of interest rather than that a claim be filed for the face amount of the note may occasion some accounting difficulties, but I believe that the Comptroller is justified in requiring a separate proof of each claim; because each note individually represents a distinct cause of action against the failed bank, and if any note were paid in full by the maker, unquestionably our claim upon that note would be completely obliterated, and it should not be taken into account in the payment of dividends distributed after the note had been paid in full. Since the insolvency of a member bank is in law considered to work an equitable acceleration of the maturities of all claims against it, making each claim for the purpose of dividends due as of the date of insolvency, I think that it is equitable and in line with the best authority that the amount of the claims, as of the date of insolvency shall be determined by computing the present value of all claims as of the date of insolvency. This is done, of course, by adding interest to those that are past due, and deducting an allowance for unearned interest upon those that are not yet due. The Comptroller requires that this allowance for the rebate of interest be in all cases at the rediscount rate. He does not specify whether this is to be the rediscount rate on the day of insolvency, or at the time of discount, if there has been a change in the rediscount rate. I assume that he considered that the probability of there being any substantial difference on this point would be too small to require consideration.

In rebating interest upon claims not due, I think it clear that the rebate should be allowed at the rediscount rate prevailing when the

discount was made. In computing the present value of a rediscount which is past due at the time of insolvency, I incline to think that the allowance should not be made at the rediscount rate at all, but at the legal rate of interest chargeable upon debts past due, according to the laws of various States. I discuss this more fully below, and since we seldom, if ever, carry a rediscounted note, or a M. B. C. Note for any appreciable time after its maturity, the rate of interest which is to control if the note is past due and before the insolvency of the bank is not important to us.

APPLICATION OF RESERVE BALANCES, AND OF BALANCES DUE ON ACCOUNT OF SURRENDER OF STOCK.

2. Hitherto, we have never applied a reserve balance to any particular rediscount at the time of proving a claim, but have waited until the time for a final settlement, and have applied the reserve balance. No receiver has hitherto objected to this course. We have also taken the position that the amount due on the surrender of the stock held by a failed member bank should be treated as a collection upon marginal collateral. The Comptroller in his letter takes the position that at the time of proving claims, we must apply the money due to the failed bank in its reserve account and the money due on account of the surrender of its stock to our claims against the failed bank. The Federal Reserve Banks are to have an option of applying the funds above mentioned to any selected amount of rediscounts, or of distributing pro rata among all rediscounts.

In my opinion, the position of the Comptroller is correct insofar as it deals with the reserve balance. When a bank becomes insolvent, it is indebted to us as the maker of M. B. C. notes, and as the endorser of rediscounted notes. We are indebted to it on account of its reserve balance.

It is well established, at least, in the Federal Courts that in proving claims against the estate of an insolvent, the claimant is entitled to set off any money due from himself to the insolvent, even though the claim due by the insolvent was as an endorser, and was not presently due, and the money due to the insolvent was presently due. This balancing of counter-claims is an equitable setoff. I think, therefore, that like any other right of setoff, the claimant may be required in proving his claim to take a final and irrevocable position, and to apply his setoff to any portion of his claim, which he prefers, but having once made the application, he cannot afterwards alter his position. He cannot refuse to make his application until after he can determine what will be the probable result of the liquidation of the insolvent estate; because if he files a claim and does not apply his setoff, he then gives the receiver of the failed bank the right to make the application as he sees fit. I do not agree, however, with the Comptroller with respect to the money due on account of the surrender of stock. He apparently proceeds upon the assumption that this money is a simple debt. I do not agree with him. It is well established that the relation of a corporation to one of its stockholders is not that of a debtor. In the absence of an express statute, we would have no lien upon the stock of the member bank, but it would simply be one of its assets to be sold or transferred by its receivers, irrespective of any claim which we might have. Our lien upon the stock, therefore, is dependent entirely upon the provisions of the Federal Reserve Act. The Act reads as follows:

> "If any member bank shall be declared insolvent and a receiver appointed therefor, the stock held by it in said Federal reserve bank shall be canceled, without impairment of its liability, and all cash-paid subscriptions on said stock, with one-half of one per centum per month from the period of last dividend, not to

exceed the book value thereof, shall be first applied to all debts of the insolvent member bank to the Federal reserve bank, and the balance, if any, shall be paid to the receiver of the insolvent bank."

You will observe that the Act is clear upon two points. The provision that the book value of the stock shall be first applied to all debts of the insolvent member bank, and then the balance, if any, shall be paid to the receiver of the insolvent bank. The receiver has no right to demand an accounting from us on account of the stock of the insolvent member bank until all debts of the insolvent bank have been paid. His right to receive anything on account of the stock is dependent upon the payment of all debts. This provision, therefore, to me clearly indicates that we have a lien upon the stock as general security for all debts, and that money becoming due on account of the surrender of the stock should be treated as a collection upon marginal collateral, and not as an offset.

COLLECTIONS UPON MARGINAL COLLATERAL AND PART PAYMENTS UPON REDISCOUNTS.

3. It is well established in the Federal Courts that the holder of a claim against an insolvent estate secured by the pledge of collateral is entitled to prove his claim for the full amount, and to have dividends paid upon this amount until the dividends and the collections on account of collateral are sufficient to discharge the claim, with interest. The Comptroller recognizes this rule, and accepts it as applying either to collateral especially pledged for M. B. C. Notes or general collateral, applicable for all the indebtedness of the failed member bank. The Comptroller's letter is not clear as to the application of part payments received on account of rediscounts. I think that he intends that when any rediscount is paid in full all dividends on account of that particular claim shall cease. As I state, I believe that he is correct in this. He seems to contemplate that

in proving a claim upon rediscounts credit will be allowed for any part payment which has been received before the claim is proven. In this position, he is sustained by many authorities, and in my judgment he is also sustained by the better reason when the insolvent is the endorser upon an obligation upon which part payment has been made by the maker or a prior endorser. There are some authorities, however, which appear to sustain the contention that a part payment made after insolvency, but before proof of claim, should not be credited in proving the claim, but that the claim should be proven for the amount due on the date of insolvency, and dividends paid upon this amount until the dividends received from the insolvent estate, plus the partial payments made by the other parties to the obligation are sufficient to discharge the obligation, with interest.

The great weight of authority is to the effect that part payments made by other parties after claim is proven against the insolvent should not be taken into consideration in computing future dividends, unless the claim has been entirely discharged by the dividends and the part payments. The Comptroller does not make it clear what position he intends to take with respect to part payments made after proving the claim. In my opinion by the great weight of authority, dividends should still be paid upon the amount due when the claim was proven.

INTEREST RATE ON CLAIMS AGAINST THE BANK AND SURPLUS INTEREST ON CLAIMS COLLECTED.

The Comptroller applicably points out that the amount due upon any claim should be determined as of the date of insolvency, and that accruals of interest after insolvency should not be taken into consideration in determining the amount of dividends, unless the estate of the insolvent is

ample to pay all claims against it with interest, in which case, a special dividend on account of accrued interest should be paid to all claimants. In this , he is, in my opinion, correct, but it is well established that if any security is held for the claim, the claimant is entitled to receive dividends on the original amount proven until dividends and collections upon collateral equal to the face of the claim with interest. In all cases, in which I have examined, this interest was as a matter of course reckoned at the legal rate, and it seems clear that in the case of a claim filed by any other correspondent bank against an insolvent bank, the interest would in a final settlement be reckoned at the legal rate. The Comptroller takes the position that in a settlement with us, interest should only be reckoned at the rediscount rate (he does not specify whether he means the rediscount rate at the time of discount; at the time of insolvency; or at the time of settlement). I do not understand the reasoning which has led the Comptroller to select the rediscount rate as the legal rate of interest collectible by Federal Reserve Banks upon past due claims. It is thoroughly established, as a matter of law, that if a note be given bearing interest at a rate less than the legal rate, this provision is to be construed as applicable only up to maturity. After maturity the debt bears interest at the legal rate. The reason which the Courts have given for this rule of construction is that the lender usually agrees to a rate of interest less than the usual rate, because he thinks that in the particular case, the loan would be promptly and certainly paid. If the borrower defaults in payment, he cannot expect to continue to enjoy the benefit of the low rate of interest after having destroyed the lender in his expectation of certain and prompt payment. This rule is well established by authority, and it appears to command itself as reasonable. I can see no reason why it should

not be applied with even greater force in the case of a rediscount at a rate less than the legal rate than it does in the case of a loan, which by express agreement bears interest from date at less than the legal rate.

It is true that State laws concerning interest do not apply to banking corporations created by Congress, if such laws in any way conflict with the Federal laws applicable, but I believe if the Federal law is silent, it shows that by necessary implication the State law applies. It might be that the power given to the Federal Reserve Board to determine rediscount rates may be construed as giving it power to fix the rates of interest chargeable upon past due notes, but the Federal Reserve Board has never attempted to fix such rates of interest, and the rates as established apply only to discounts; consequently it seems to me that the Federal law is silent upon the rate of interest which a note in our hands bears after maturity; and that consequently we are entitled to consider it as bearing interest at the rate lawful in the State in which it is payable and to collect such rate either from the maker or endorser.

I, therefore, disagree with the Comptroller in his position with respect to the rate at which interest is to be computed.

The Comptroller has not only provided that in a final settlement between ourselves and the failed bank interest on our claims is to be computed at the rediscount rate, but he has also provided that in case a rediscounted note is collected from the maker or some endorser prior to the insolvent bank, we are to treat the amount of interest collected over and above the rediscount rate as a collection on account of marginal collateral. I fail to see any line of reasoning which could possibly lead to this result. If, as I stated above, we consider that there is in the Federal Reserve Act

an implied limitation upon the rate of interest which Federal Reserve Banks may collect, it would seem that this limitation would prevent our collecting from the makers or prior endorsers any interest above the rediscount rate. If we may lawfully collect the interest (and in my judgment, as I state above, I think that we lawfully may) I can conceive of no theory of law which requires us to credit this interest to the insolvent endorser, and to apply it upon other claims which we may have against that endorser.

When we rediscount a note, we become the holder of it - entitled to enforce it against all the parties thereto by all the remedies of law. The right to enforce the note to my mind necessarily implies the right to collect such interest as the note may lawfully bear after maturity. If the holder of a note collects from the maker the amount of the note with lawful interest after maturity, there seems to be no principle of law which can be invoked to justify a claim by the endorser that he is entitled to require the holder to account to him for any part of the interest accruing after maturity.

ALLOWANCE FOR ATTORNEYS' FEES, COSTS, ETC.

The letter of the Comptroller deals to some extent with the question of the payment of attorneys' fees, costs, etc. incurred by Federal Reserve Banks in collecting marginal collateral and rediscounts. He deals with this phase of the question, however, only in cases in which the collateral held by Federal Reserve Banks provides for reimbursement by the member bank for attorneys' fees, costs, etc. thus incurred. We have never obtained from member banks an express pledge covering marginal collateral, but have relied upon our general bankers lien. In reliance upon this lien, I think that in crediting collections made on marginal collateral, we are

entitled to deduct attorneys' fees, and other costs and expenses incurred in collecting such marginal collateral, because we hold marginal collateral as in some sense a trustee, and it is generally established that a trustee may charge a trust fund in his hands with any expenses reasonably incurred in the hands of it, and need account only for the net proceeds. If we incur attorneys' fees, or other costs or expenses in collecting rediscounts, in my opinion, we could not charge such expenses to the estate of the insolvent bank; because in collecting a rediscounted note, we are merely enforcing a claim of which we are the holder in our own right, and we have no right to look to any other person for indemnity against an expense incurred in enforcing a claim which is solely our own. We have usually met this situation by telling the Receivers that in view of this situation, we would not bring suits upon rediscounted notes, but would hold them past due, awaiting the payment of dividends upon them, and would first endeavor to collect on the marginal collateral notes, unless the receiver was willing to agree that all expenses incurred in bringing suits upon rediscounts could be charged against the proceeds of the marginal collateral notes. It is obvious that it is usually expedient for the receiver to make this arrangement with us, and hitherto it has always been done. The Comptroller's letter does not cover this point, and if we have any correspondence with him, it might be advisable to take it up.

You will see from the above discussion that I think that we may accept the System proposed by the Comptroller as substantially correct upon all points, except the application of the amount due on account of the surrender of stock in a Federal Reserve Bank held by an insolvent member bank, and the rate at which interest is to be computed on claims against an in-

solvent member bank, and the distribution to be made of interest collected from the makers of rediscounted notes.

We should call to the attention of the Comptroller the question of the application of part payments made on rediscounts after a claim is proven and before we receive full payment of it, and we should call his attention to the necessity for some arrangement concerning the costs and expenses incurred in suits brought to enforce rediscounted notes.

I remain

Very truly yours,

M. G. Wallace,
Counsel.

MGW:IB.