FEDERAL RESERVE BOARD

WASHINGTON

X-4990

ADDRESS OFFICIAL CORRESPONDENCE TO
THE FEDERAL RESERVE BOARD

November 5, 1927.

Dear Sir:

Through the courtesy of Governor Geery, of the Federal Reserve Bank of Minneapolis, I enclose for your information a copy of an unpublished opinion rendered in 1918 by the U.S. District Court for the District of Minnesota in the case of Keyes v. Federal Reserve Bank of Minneapolis, wherein that court upheld the right of a Federal reserve bank to charge checks to the account of a drawee bank subsequent to insolvency even if it was handling such checks as agent of the banks from which it had received them.

I never heard of this decision until Governor Geery called it to my attention during the Governors' Conference.

Please do not take the trouble to acknowledge receipt of this letter or any similar letters transmitting for your information copies of opinions, briefs, etc., unless you wish to comment on same.

Very truly yours,

Walter Wyatt
General Counsel

Enclosure.

C O P Y

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IN THE UNITED STATES DISTRICT COURT,

DISTRICT OF MINNESOTA, FOURTH DIVISION.

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PAUL C. KEYES, as Receiver of the First National Bank of Clarkfield, Minnesota,

Plaintiff,

vs.

REDERAL RESERVE BANK OF MINNEAPOLIS, a corporation,

Defendant.

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This cause came on to be heard at Minneapolis, on the 9th and 11th days of October, 1918, J. N. Johnson, Esq., appearing on behalf of the plaintiff, and A. Ueland, Esq., appearing on behalf of the defendant.

The stipulations and testimony having been taken, and each side having rested, by agreement between Court and Counsel, briefs were furnished to the Court and exchanged between Counsel, and thereafter, on the 21st day of October, 1918, the case was orally argued by Counsel.

And now the Court, having duly considered the same,

It is ADJUDGED, ORDERED and DECREED, That the plaintiff take nothing in this action, and that the defendant has a right to a claim against the Receiver for $462.06, which he may file in the Receivership proceedings, and that defendant have judgment for its costs and disbursements, to be taxed by the clerk.

By the Court,

(Signed) Page Morris
Judge.

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M E M O R A N D U M.

At all times mentioned herein the First National Bank of Clarkfield, Minnesota, was a national banking association duly incorporated under and pursuant to the banking laws of the United States, and up to the 18th of September, 1917, conducted business as a national bank at Clarkfield, Minnesota.

At all times mentioned herein the defendant was a corporation duly organized and existing under and pursuant to an act of Congress of the United States entitled "Federal Reserve Act," approved December 23d, 1913, and conducting the business of a Federal Reserve Bank at Minneapolis, Minnesota.

The plaintiff's insolvent, First National Bank of Clarkfield, Minnesota, was on the 18th day of September, 1917, insolvent, and was on that day closed by order of the Comptroller of the Currency under and by virtue of the power and authority conferred upon him by the banking laws of the United States, and by virtue of the same power and authority the plaintiff was appointed the Receiver thereof and on the 4th day of October, 1917, duly qualified as such Receiver. Said First National Bank of Clarkfield was a member bank of the defendant under the provisions of the Federal Reserve Act. Pursuant to the provisions of the Federal Reserve Act the Federal Reserve Board, in the month of June, 1916, established a collection and clearing system by rules and regulations which have since been in force and effect, and prior to the transactions herein involved the defendant had become a part of such collection and clearing system, under such rules and regulations. The rules and regulations of the Federal Reserve Board provide, under the heading "Check Clearing and Collecting", as follows:

(Exhibit "C"):

Each Federal Reserve Bank shall exercise the functions of a clearing house under the following general terms and conditions:

(1) Each Federal Reserve Bank will receive at par from its member banks and from non-member banks in its district which have become clearing members checks drawn on all member and clearing member banks and on all other nonmember banks which agree to remit at par through the Federal Reserve Bank of their district.

(2) Each Federal reserve bank will receive at par from other Federal Reserve Banks and will receive at par from all member and clearing member banks, regardless of their location, for the credit of their accounts with their respective Federal Reserve Banks, checks drawn upon all member and clearing member banks of its district and upon all other nonmember banks of its district whose checks can be collected at par by the Federal Reserve Bank. The Federal Reserve Banks will prepare a par list of all nonmember banks to be revised from time to time, which will be furnished to member and clearing member banks.

(3) Immediate credit entry upon receipt subject to final payment will be made for all such items upon the books of the Federal Reserve Bank at full face value, but the proceeds will not be counted as part of the minimum reserve nor become available to meet checks drawn until actually collected, in accordance with the best practice now prevailing.

(4) Checks received by a Federal Reserve Bank on its member or clearing member banks will be forwarded direct to such banks and will not be charged to their accounts until sufficient time has elapsed within which to receive advice of payment.

(5) In the selection of collecting agents for handling checks on nonmember banks, which have not become clearing members, member banks will be given the preference.

(6) Under this plan each Federal Reserve Bank will receive at par from its member and clearing member banks checks on all member and clearing member banks and on all other nonmember banks whose checks can be collected at par by any Federal Reserve Bank. Member and clearing member banks will be required by the Federal Reserve Board to provide funds to cover at par all checks received from or for the account of their Federal Reserve Banks. Provided, however, That a member or clearing member bank may ship currency or specie from its own vaults at the expense of its Federal Reserve Bank to cover any deficiency which may arise because of and only in the case of inability to provide items to offset checks received from or for the account of its Federal Reserve Bank.

(7) Section 19 of the Federal Reserve Act provides that - -

The required balance carried by a member bank with a Federal Reserve Bank may, under the regulations and subject to such penalties as may be prescribed by the Federal Reserve Board, be checked against and withdrawn by such member bank for the purpose of meeting existing liabilities: Provided, however, That no bank shall at any time make new loans or shall pay any dividends unless and until the total balance required by law is fully restored.

It is manifest that items in process of collection can not lawfully be counted as part of the minimum reserve balance to be carried by a member bank with its Federal Reserve Bank. Therefore, should a member bank draw against such items the draft would be charged against its reserve balance if such balance were sufficient in amount to pay it; but any resulting impairment of reserve balances would be subject to all the penalties provided by the Act.

In as much as it is essential that the law in respect to the maintenance by member banks of the required minimum reserve balance shall be strictly complied with, the Federal Reserve Board, under authority vested in it by section 19 of the Act, hereby prescribes as the penalty for any deficiency in reserves a sum equivalent to an interest charge on the amount of the deficiency of 2 per cent, per annum above the ninety day discount rate of the Federal Reserve Bank of the district in which the member bank is located. The Board reserves the right to increase this penalty whenever conditions require it.

For the purpose of keeping their reserve balances intact member banks may at all times have recourse to the rediscount facilities offered by their respective Federal Reserve Banks.

(8) Each Federal Reserve Bank will determine by analysis the amounts of uncollected funds appearing on its books to the credit of each member bank. Such analysis will show the true status of the reserve held by the Federal Reserve Bank for each member bank and will enable it to apply the penalty for impairment of reserve.

A schedule of the time required within which to collect checks will be furnished to each bank to enable it to determine the time at which any item sent to its Federal Reserve Bank will be counted as reserve and become available to meet any checks drawn.

(9) In handling items for member and clearing member banks, a Federal Reserve Bank will act as agent only. The Board will require that each member and clearing member bank authorize its Federal Reserve Bank to send checks for collection to banks on which checks are drawn, and, except for negligence, such Federal Reserve Bank will assume no liability. Any further requirements that the Board may deem necessary will be set forth by the Federal Reserve Banks in their letters of instruction to their member and clearing member banks. Each Federal Reserve Bank will also promulgate rules and regulations governing the details of its operations as a clearing house, such rules and regulations to be binding upon all member and nonmember banks which are clearing through the Federal Reserve Bank.

And the rules and regulations governing the details of its operations as a clearing house promulgated by defendant provide, under the heading "Check Clearing and Collecting," as follows, (Exhibit "B"):

1. The Federal Reserve Bank of Minneapolis will discontinue its present collection system on July 15, 1916, in accordance with Federal Reserve Board Circular 1, Series of 1916, already sent you, and will thereafter, until further notice, receive from its member banks for immediate credit at par, checks drawn on all member banks in the United States and on such non-member banks as can be collected at par.

A par list of all non-member banks will be prepared, to be revised from time to time, which will be furnished member bank.

All such checks, except those drawn on Minneapolis and St. Paul banks, received by the Federal Reserve Bank by 3:00 P.M., except Saturday, when the hour will be 12:00 o'clock noon, will be credited subject to final payment at full face value upon day of receipt. Those received later than these

hours will be credited upon the following business day. The proceeds, however, will not be counted as reserve, nor become available to meet checks drawn, until actually collected. Owing to the clearing hour, checks drawn on Minneapolis and St. Paul banks received after 10:30 A.M., will not be credited nor proceeds become available until the following business day; those received before that hour will be credited on day of receipt and proceeds will be available that day.

3. Checks received by the Federal Reserve Bank, drawn on its member banks, will be forwarded direct to such member banks, and will be charged to their accounts on the date which, under usual conditions, advice of payment may be expected. Member banks should credit all remittances received from the Federal Reserve Bank upon day of receipt, advising the Federal Reserve Bank, and should not remit their drafts in payment. Member banks are required by the Federal Reserve Board to provide funds to cover at par all checks received from, or for the account of, their Federal Reserve Bank.

Section 19 of the Federal Reserve Act provides that:

"The reserve carried by a member bank with a Federal Reserve Bank may, under the regulations, subject to such penalties as may be prescribed by the Federal Reserve Board, be checked against and withdrawn by such member bank for the purpose of meeting existing liabilities: Provided, however, that no bank shall at any time make new loans or shall pay any dividends unless and until the total reserve required by law is fully restored."

7. In handling items for member banks, the Federal Reserve Bank of Minneapolis acts as agent only. It is understood that each member bank authorizes it to send checks for collection direct to banks on which checks are drawn, and except for negligence the Federal Reserve Bank of Minneapolis assumes no liability until funds are actually in its hands.

In September, 1917, there was and still is at Clarkfield, Minnesota, where the First National Bank of Clarkfield was located and doing business, a bank organized under the laws of Minnesota called the Clarkfield State Bank; and during all of said month this bank was a non-member bank of defendant upon which defendant could collect checks at par; and said bank was on the par list of non-member banks prepared by defendant and furnished to its member banks in accordance with said rules and regulations.

On the 17th of September, 1917, checks payable on presentation amounting to $1998.21 were deposited with defendant. These checks to the amount of $1943.96 were on said Clarkfield State Bank and to the amount of

$54.25 on said First National Bank of Clarkfield. These checks to the amount of $548.49 were so deposited by the Northwestern National Bank of Minneapolis, Minnesota, a member bank of defendant; and to the amount of $555.21 by the Merchants National Bank of St. Paul, Minnesota, a member bank of defendant; and to the amount of $218.30 by the Peoples Bank of St. Paul, Minnesota, a member bank of defendant; and one check for $570.86 by the First National Bank of Chicago, Illinois, a national banking association, and as such a member of the Federal Reserve Bank; and one check for $5.35 by the Corn Exchange National Bank of Chicago, Illinois, a national banking association, and as such a member of the Federal Reserve Bank; and one check for $100. by the Des Moines National Bank of Des Moines, Iowa, a national banking association, and as such a member of the Federal Reserve Bank. Each check when deposited with defendant contained on the back thereof the unrestricted and unconditional endorsements in blank of the payee thereof and of the bank depositing the same with defendant and credit was on that day given by defendant at par to the bank depositing the same.

After said checks were deposited with defendant and credit given for them as aforesaid, and on said 17th day of September, 1917, defendant forwarded all said checks by mail to said First National Bank of Clarkfield, for payment and credit as to the checks for $54.25 on said bank, and for collection and credit as to the checks for $1943.96 on the Clarkfield State Bank, and all said checks were received by said First National Bank of Clarkfield on the 18th of September, 1917.

On said 18th of September, 1917, the First National Bank of Clarkfield cleared with said Clarkfield State Bank checks which each then held against the other, and in this clearing the First National Bank of Clark-

field used all the checks on the State Bank of Clarkfield received from defendant as aforesaid and received credit for the same from said Clarkfield State Bank, but received no money. In said clearing the First National Bank of Clarkfield surrendered and delivered to the Clarkfield State Bank as fully paid and cancelled, all the checks on the latter bank which it had received from defendant, and the First National Bank of Clarkfield thereupon and on said 18th of September, 1917, and before it was closed or a receiver appointed for it, gave defendant credit on its books for all the checks which it received from defendant on that day as aforesaid, to wit: for the sum of $1998. 21.

The checks for $54.25 on the First National Bank of Clarkfield were returned by said bank or the plaintiff to the various drawers thereof, and the checks for $1943.96 on the Clarkfield State Bank were returned by it to the various drawers thereof, by reason whereof a more particular description of any of said checks can not be given.

No remittance or payment was ever made to defendant or any of the payees or endorsers of any of the above mentioned checks for or on account of such checks, or for or on account of the credit which defendant received on the books of said First National Bank of Clarkfield for said checks.

Thereafter, and on the 16th of October, 1917, defendant charged back severally to the various banks which had deposited the checks aforesaid, amounting to $1998.21, the amount of said checks which had been so deposited by each of said banks. And thereafter, and on the 14th day of May, 1918, this action was brought.

On the 18th of September, 1917, the First National Bank of Clarkfield had a balance to its credit on the books of defendant of $8647.04.

On the 25th of January, 1918, upon an accounting between plaintiff and defendant it was found that said bank was entitled to a credit for the amount of its stock in defendant with dividends accrued thereon to September 1, 1917, of $963., and to a further credit for unearned discounts on notes due March 1, 1918, of $21.90, making in all $9631.94, and that defendant had a right to deduct therefrom the amount of certain forged notes, the forgery having been discovered after the closing of the bank for insolvency with interest, which had been discounted by said bank with defendant prior to the 18th of September, 1917, for the purpose of replenishing the reserve of said bank with defendant and the proceeds of which forged notes constituted a part of said balance of $8647.04. After making these credits and deductions a balance of $1536.15 was found to be due from defendant to said bank unless defendant has the right to set off against this balance the amount of the aforesaid checks for $1998.21.

On said 18th of September, 1917, and for some time prior thereto , said First National Bank of Clarkfield was insolvent and was known by its cashier and one of its directors to be insolvent.

The sole contention and question to be decided here is as to whether or not the defendant is entitled to offset against the aforesaid balance of $1536.15, the amount of the aforesaid checks, $1998.21, the plaintiff contending that it has not the right to do so and the defendant that it has.

Under the pleadings and proofs here whether the offset be legal or equitable in its nature the right to its allowance can be determined in this action U. S. Comp. Statutes, Sec. 1251-b, (Judicial Code 247-b, as amended by Act of March, 1915, Ch. 90, 38 U. S. Statutes at large, 956.)

That defendant handled said checks as a clearing house, for the pur-

pose of collection and clearing, and for no other purpose is mutually conceded by counsel. Considering the matter then as a clearing house transaction it seems to me clear that, if the First National Bank of Clarkfield and the Clarkfield State Bank had been banks doing business in Minneapolis and the clearing had been had there on the 18th of September, 1917, upon finding that the $1998.21 was due from the First National Bank of Clarkfield to defendant, the defendant would have had the right to immediate payment thereof to it by that bank either in money or by check on its balance with defendant, or to charge said amount to said bank's account and have said bank give it credit therefor, and that being done the transaction would have been completely closed. But the defendant was the clearing house for banks in a wide territory, embracing the whole state of Minnesota, and was the clearing house for these two Clarkfield banks, and these checks had to be forwarded by mail and the clearance had at Clarkfield. Is it not apparent that upon the clearance being had between the Clarkfield banks defendant had the right to a credit with the First National Bank of Clarkfield for this amount and to charge the same to the account of said bank? That credit was given, but the charge was not made. It seems to me that defendant then had a right of action against that bank for said amount in its own name and in its own right. And if this is true it is clear it has had that right ever since, and therefore has the right of set off. The Receiver, the plaintiff here, took the assets of the bank as a mere trustee for creditors, and not for value and without notice, and, in the absence of statute to the contrary, subject to all claims and defences that might have been interposed as against the insolvent bank. The subsequent charging back of the checks by defendant or the subsequent statements of counsel for the defendant in his letters would not in any way affect the conclusion. The recovery of the set

off here will fully protect the plaintiff and he has no interest in, and is not concerned to inquire into, what was done between defendant and the banks depositing these checks or what advice has been given to defendant by its counsel. Elmquist V. Markot, 45 Minn. 305. Vanstrum V. Liljengren, 37 Minn. 191.

But let us consider the matter not as a clearing house transaction but as one of an agency for collection. The whole argument of plaintiff's counsel rests upon the proposition that as at the time the suit was brought the defendant was not the owner of the checks, they having, on the 16th of October, 1917, been charged back to the banks which had deposited them with defendant for collection, defendant has now no right of set off. He also quotes from letters written by defendant's counsel subsequent to the closing of the bank which he contends supports his proposition, and he claims that these letters and the charging back of the checks work an estoppel against the defendant's now asserting the right of set off. It does not seem to me that these statements of counsel and the charging back of the checks in any way affect the rights of the parties here. As to the claim of estoppel it may be said that the most essential element of an estoppel is absent. In the charging back of the checks and the statements of counsel for defendant there has been no act, representation or concealment upon which plaintiff or his insolvent has been induced to act, nor has there been any action by plaintiff or his insolvent in reliance thereon of a character to result in substantial prejudice to him or to his insolvent or to the creditors for whom as receiver he is trustee of the assets of the insolvent. It seems to me that the rights of the parties became fixed as of the time of the closing of the bank. Scott v. Armstrong, 146 U.S., 499-511. At that time defendant had a right of action against plain-

tiff's insolvent for the amount of the checks, whether or not they were only received by it as an agent for collection and conditional credit, and whether or not the endorsements thereon were restricted or uninrestricted. General Statutes of Minnesota 1913, Section 5848 and 5849. The subsequent ownership of the checks is unimportant. There was no defense as to the checks and no defense as to the credit arising therefrom on the books of the insolvent bank. The plaintiff has no standing to inquire into the relations between defendant and its depositing banks. Neither the insolvent nor its receiver has any concern with the question of the ownership of the checks, unless a defense be shown as against the endorsers or drawers thereof, or that defendant became the holder thereof after the closing of the bank for insolvency, or after knowledge of its insolvency. There is no such showing, and on the contrary the opposite appears. Farmers Deposit National Bank v Penn. Bank, 123 Pa. 283, Penn. Bank v. Farmers Deposit National Bank, 130 Pa. 209.

Plaintiff's counsel contends that the allowance of the offset would work a preference contrary to the provisions of sections 5234, 5236 and 5242, Revised Statutes of the U. S., 1878, (the National Banking Act). This contention is, I think dully disposed of adversely thereto by the decision of the Supreme Court in the case of Scott v. Armstrong, supra.

I am therefore of the opinion that defendant is legally entitled to the set off in question. And if I am in error as to that, I still think that under all the facts and circumstances of this case it is equitably entitled thereto. Scott v. Armstrong, supra. It must be remembered that the insolvent bank and its creditors received the full benefit of the amount of the checks. If the doctrine of estoppel can be invoked at all here, it would be to prevent the receiver from objecting to the setoff, at least to the amount of $1943.96,

the amount of the checks drawn on the State Bank of Clarkfield. Plaintiff's insolvent, was, on the 18th of September, 1917, and for some time prior thereto, insolvent, and known to be so by its chief managing officer. Notwithstanding that fact it held itself out to be solvent, and received and handled these checks as above set forth. Relying on its solvency and induced by its holding itself out to be so, defendant forwarded these checks to it when it might have forwarded them direct to the State Bank of Clarkfield, which of course was to the substantial prejudice of defendant.

The result is, that the balance of $1531.78 is wiped out, and defendant has the right to a claim against the receiver for the difference between that amount and $1998.21, the amount of the checks, to-wit, $462.06.

(Signed) Page Morris
Judge.