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January 26, 1929.

Honorable A. Ueland,
401 New York Life Bldg.,
Minneapolis, Minnesota.

Dear Judge Ueland:

I have received your letter of January 14 and have read with much interest the enclosed memorandum addressed by Mr. Sigurd Ueland to the Federal Reserve Bank of Minneapolis with regard to the policy to be followed by that bank in asserting rights on behalf of depositors of unremitted for transit items against receivers of insolvent member banks.

You suggest that this raises a question of policy which is of interest not only to the Federal Reserve Bank of Minneapolis but to the other Federal reserve banks, and request an informal and entirely unofficial expression of my views.

I agree with you that the questions raised in this memorandum are of interest to the entire Federal reserve system; and, inasmuch as they vitally affect the understanding arrived at between counsel for all the Federal reserve banks and the office of the Comptroller of the Currency during the conference of counsel held on July 13, 1925, I telegraphed for your permission to send copies of this memorandum to counsel for all Federal reserve banks. Having received your consent, I am sending copies of this memorandum to counsel for all Federal reserve banks and am requesting an expression of their views. I am omitting from the copy which I am sending them, however, subdivisions 5 and 6 of the memorandum, which pertain solely to the peculiar situation of the Federal Reserve Bank of Minneapolis and which you do not desire to have circulated. Of course, I shall respect the confidential nature of this memorandum and not disclose the contents of the same to anyone in the office of the Comptroller of the Currency.

In view of the importance of the questions raised by this memorandum and in view of the changed situation resulting from the court decisions discussed therein, I believe that it would be well to have a conference of counsel of all Federal reserve banks in Washington some time in the near future to discuss this entire subject, endeavor to reach an agreement among ourselves, and then discuss the subject with the Comptroller of the Currency in an effort to reach an agreement with that office. I have not yet been authorized by the Federal Reserve Board to call such a conference,

but expect to take the matter up with Governor Young in the near future and I shall appreciate an expression of your views as to the advisability of calling such a conference.

I am so greatly pressed for time that I cannot at this moment give you a full statement of my views with regard to the matters discussed in your memorandum. My offhand views, however, based upon only a hasty consideration of the subject, may be stated briefly as follows:

(1) With all due respect, I disagree with all three of the legal conclusions stated on page 8 of the memorandum. In doing so I recognize that the decision of the Circuit Court of Appeals in the Early case and the decisions in the cases of Keyes v. Federal Reserve Bank of Minneapolis and Federal Reserve Bank of Minneapolis v. First National Bank of Eureka apparently sustain your views on the first point. The Early case, however, will be taken to the Supreme Court of the United States, and I believe the decision of the Circuit Court of Appeals will be reversed. Even if the Supreme Court does not reverse the Circuit Court of Appeals, I think the decision in the Early case is distinguishable from any case arising in a district where checks are collected on the remittance basis instead of the charge basis; because the Circuit Court of Appeals based its decision so largely upon the fact that the normal course of business of the Federal Reserve Bank of Richmond was to collect checks by charging same to the reserve account of a drawee, and the banks which deposited such checks with the Federal Reserve Bank of Richmond did so in reliance upon the belief that they would be collected by charging them to the reserve accounts of the drawee banks. The Circuit Court of Appeals sustained the District Court on the question of the use of the proceeds of the canceled Federal reserve bank stock, holding that, under the specific provisions of the Federal Reserve Act, the proceeds of this stock could not be used to pay the cash letters. On the question of the application of the collateral, I believe the decision in the Midland National Bank case is clearly wrong and is also distinguishable from the case of a Federal reserve bank collecting checks under Regulation J, which specifically provides that the Federal reserve bank shall act only as agent and that, "The amount of any check for which payment is actually and finally collected funds is not received shall be charged back to the forwarding bank, regardless of whether or not the check itself can be returned".

(2) I agree with you that, in the present state of the law, it is unsafe for a Federal reserve bank to release to the receiver the reserve account and probably the collateral, but not the proceeds of the canceled stock, without first obtaining a release of liability from the depositors of its uncollected cash items drawn on the insolvent bank or a court order instructing the Federal reserve bank to release such assets to the receiver.

(3) I believe that, if your views of the law as expressed on page 8 of the memorandum are upheld by the courts, there is

grave danger that the courts will hold that, having the right to apply the reserve account, the proceeds of the canceled stock and the collateral to the collection of outstanding unremitted for cash letters, the Federal reserve bank has the duty to do so and cannot, as an agent have any interest adverse to its principal, utilize these assets to protect itself against losses on rediscounts. I have no positive view that the courts should reach this conclusion, but I feel that there is danger that they may do so.

(4) I believe, therefore, that, in order to avoid placing the Federal reserve banks on the horns of the dilemma pointed out by Mr. Sigurd Ueland at the bottom of page 9, the Federal reserve banks should, as a matter of policy, not insist upon the right to collect cash letters out of the reserve accounts, the proceeds of the canceled stock, or the collateral, but, on the contrary, should do everything in their power to divest themselves of this right and the corresponding possibility of a duty to exercise it.

(5) I believe this is especially important in view of the fact that, if the courts should hold that the Federal reserve banks have such a duty and must exercise it, it would seriously interfere with the freedom of the Federal reserve banks in extending aid through rediscounts or loans to a member bank in a badly extended condition. By taking additional collateral they can often extend financial assistance and sometimes prevent the insolvency of a member bank; but would hesitate to grant additional credit without taking additional collateral. If the courts hold that the collateral must first be applied to the collection of unremitted for cash letters, the possibility of extending such aid will be greatly curtailed, because the additional collateral will not afford the same protection to the Federal reserve bank as it has in the past.

(6) I also disagree with the view expressed at the top of page 7 that the recent amendment to Regulation J was not intended to prevent the reserve balance from being available to pay unremitted for cash letters after notice of suspension. On the contrary, that was the sole purpose of the amendment.

I have the greatest respect for your opinions and those of Mr. Sigurd Ueland; and it is with much regret that I disagree to such a large extent with the views expressed in the memorandum. I could not, however, conscientiously refrain from expressing my disagreement when you requested an informal expression of my views.

With kindest personal regards and all best wishes for both you and Mr. Sigurd Ueland, I am

Cordially yours,

Walter Wyatt,
General Counsel.

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FEDERAL RESERVE BANK

OF MINNEAPOLIS

January 14, 1929.

Walter Wyatt, Esq.,
Counsel Federal Reserve Board,
Washington, D. C.

Dear Mr. Wyatt:

We are taking the liberty of enclosing copy of a rather lengthy communication from us to the Federal Reserve Bank of Minneapolis, dealing with a question of policy which it seems to us is of interest not only to the Minneapolis bank but to the other Federal Reserve Banks. You are familiar with the questions discussed in this communication and if you feel so inclined we would very much appreciate having an expression of your views. We would understand, of course, that any such expression of views would be entirely unofficial.

We do not know how the Minneapolis bank will deal with this problem. If the bank should adopt our recommendations it occurs to us it might be advisable to have a discussion of the whole subject with representatives of the Comptroller's office. If this were done, we believe your good offices might prove invaluable in bringing about an understanding.

We should be glad to have you show the enclosed opinion to Governor Young or any member of the Board, but of course we would not want it submitted to the Comptroller's office in its present form.

Yours very truly,

(S) A. Ueland
Sigurd Ueland

SU:ME

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X-6226-b

January 8, 1929.

Harry Yaeger,

Deputy Governor.

The recent decision of the Supreme Court of Minnesota in the case of Midland National Bank & Trust Company vs. First State Bank of Sioux Falls et al. has again brought to the fore the question which has repeatedly vexed the Federal Reserve Bank of Minneapolis. That question has various phases, but broadly it may be stated thus:

> What is to be the policy of the Federal Reserve Bank of Minneapolis with respect to asserting rights on behalf of its depositors of unremitted for transit items against receivers of insolvent member banks?

The failure to answer this question correctly involves the possibility of so much future trouble, litigation and liability that we have deemed it wise to reconsider it in all its aspects at the present time. On account of your interest in and familiarity with the subject, we will deal with it at some length, without making much of an attempt at condensation.

1.

A member bank closes and your bank has an unremitted for transit letter addressed to that bank outstanding. The letter may be returned with the items unpaid and protested. In that case there is no problem. The items are simply charged back to your endorsers. In such a case, with rare exceptions, the closed bank never became liable on the items.

But suppose the drawee bank has charged up the checks to the respective drawers and has attempted to remit to your bank by draft or otherwise. In such a case your bank has sometimes charged up the draft to the reserve account of the member bank, after notice of its suspension. More often the credits given for the items deposited with you have been charged back to the respective depositors. Where this has been done, your bank has requested authority from each depositor to file a general claim in the receivership of the closed bank as the depositor's "agent" and "with the understanding" that the depositor "would not look to" your bank "except for such dividends as it might receive" on account of the depositor's items. In a typical case some of the depositors of the checks represented by the dishonored remittance draft have authorized your bank to file a claim on their behalf and others have preferred to file their own claims. Accordingly the amount of the transit claims filed by your bank has, in most cases, been less than the aggregate amount of the unremitted for items.

In some cases the closed bank is liable to your bank on rediscounts or bills payable. The closed bank has stock in your bank; it may have a reserve balance to its credit, and it may have deposited collateral securities under a collateral agreement almost identical in terms with the one involved in the Midland National Bank case. Hence, the general question under consideration may be subdivided as follows:

(1) Are you entitled to charge remittance drafts to the reserve account after notice of the suspension of the remitting bank?

(2) Are you entitled to hold the proceeds of the cancelled Federal Reserve bank stock for the benefit of depositors of unremitted for transit items?

(3) Are you entitled to hold the collateral securities and the proceeds thereof for the same purpose?

(4) If the preceding three questions are answered in the affirmative, is there a correlative duty to your depositors to assert these rights in their favor?

2.

In the Midland National Bank case the court held that collateral securities held pursuant to a collateral agreement in the form used by your bank could be held as security for dishonored remittance drafts notwithstanding the fact that the items attempted to be remitted for by such drafts had been deposited for conditional credit and subject to the right to charge back if not collected, and notwithstanding the fact that such checks had actually been charged back to the depositors after notice of the suspension. The view of the court was that the collection of checks creates a liability on the part of the collecting bank to the forwarding bank; that such a liability is within the terms of the collateral agreement, and that it is no business of the collecting bank or its receiver that the forwarding bank may stand in a relation of trust to its depositors, or that the latter may be the parties beneficially interested.

If the Midland decision is good law, as we think it is, then in every case where your bank holds a collateral agreement you are entitled to hold or foreclose on excess collateral from a closed national bank until your claim on account of unremitted for transit items has been paid in full. We limit this conclusion to national banks because there are statutes in certain of the states of the ninth district, notably North Dakota and Minnesota, which might affect the result in the case of member state banks.

As the decision of the state court would not be controlling in cases in the federal courts, we will consider briefly the relevant decisions of the latter.

In the case of Keyes, as Receiver of the First National Bank of Clarkfield v. Federal Reserve Bank of Minneapolis, the United States District Court for this district decided in 1918 that the reserve account was available by way of setoff to pay unremitted for transit items the credits for which had been charged back to its depositors by the Federal Reserve Bank after notice of suspension.

In Federal Reserve Bank of Minneapolis v. First National Bank of Eureka (277 Fed. 300) it was held by the United States District Court for South Dakota that the reserve account and also the proceeds of the cancelled stock could be applied towards the liquidation of a dishonored draft sent in attempted remittance of a transit letter.

In the case of Thos. Early, Receiver of the Farmers and Merchants National Bank of Lake City v. Federal Reserve Bank of Richmond, the United States District Court for South Carolina has rendered a decision against the Federal Reserve Bank of Richmond and has held that the latter was not entitled to use a reserve balance to pay unremitted for checks. So far as we know no written opinion was filed by the court. The Richmond bank's method of collecting transit letters was by charging the reserve account in accordance with a time schedule. We doubt, however, whether this could distinguish the case from the Clarkfield and Eureka cases and it seems to us that there is a conflict. An appeal to the United States Circuit Court of Appeals for the Fourth Circuit is pending. We have read the briefs on both sides and it is not unlikely that there will be a reversal.

Federal district courts will usually follow the decision of circuit

courts of appeals for other circuits even though inconsistent with their own previous holdings.

Foster on Federal Practice, #375.

In re Baird, 154 Fed. 215.

Warren Bros. Co. v. Evans, 234 Fed. 659.

Vacuum Cleaner Co. v. Thompson Mnfg. Co. 238 Fed. 239.

However, the decision of the Circuit Court of Appeals in the Richmond case would not be followed here if in conflict with principles laid down by the Circuit Court of Appeals for this circuit (the 8th). That court in the recent case of Storing, as Receiver of the Merchants National Bank of Mandan vs. First National Bank of Minneapolis held that the First National Bank of Minneapolis had the right to hold a deposit balance against the receiver of a national bank to reimburse itself for a transit letter where the remittance draft in attempted payment thereof was received after notice of suspension. This case was submitted in such a way that the point that the depositors of the First National Bank were the beneficial owners of the claim against the insolvent bank was probably not before the court. The receiver, however, is attempting to make this point in his petition for reargument which is still pending. On this point Judge Cant, the trial judge, said in his opinion:

> "No matter what the relation of the two banks here in question may have been with their respective patrons on and prior to December 21, 1923, the banks themselves were dealing with each other as principals."

In any litigation between your bank and a receiver of a national bank it is probable that the receiver could either bring the action in or remove it to the federal court.

See Studebaker Corporation vs. First National Bank, 10 Fed. (2nd) 590.

All we can say at present about the law in the federal courts is that the decision of the lower court in the Richmond case raises doubt as to what will be the ultimate answer to questions (1) (2) and (3) put above.

3.

The Federal Reserve Board has recently amended paragraph (4) of Section V of Regulation J by eliminating the clause: "any Federal reserve bank may reserve the right in its check-collection circular to charge such items (checks) to the reserve account or clearing account of any such bank at any time when in any particular case the Federal reserve bank deems it necessary to do so." This amendment becomes effective February 1, 1929.

The right indicated has been reserved by your bank in your check-collection circulars since August 1, 1924. Such reservation certainly strengthens the claim of your bank to apply the reserve balance against unremitted for transit letters.

The reason for amending Regulation J was doubtless the feeling that if the Federal reserve banks had the right to utilize reserve balances for the payment of check collections, there might be a correlative duty to the prejudice of their own claims on rediscounts, and notes of the member banks maintaining the balances. See letter of A. Ueland to Gov. Geery dated April 11, 1928. The comptroller's office will undoubtedly contend that this amendment of Regulation J shows an intention that the reserve balance is no longer to be available to pay unremitted for transit letters after notice of suspension. In our opinion this was not the purpose or effect of the amendment.

The pledge agreement form used by your bank provides that your bank "shall also have a lien upon any balance of the deposit account" of the member bank "existing from time to time * * * <u>for any liability</u>" of the

member bank to your bank "now existing or hereafter contracted." Under the construction given in the Midland National Bank case this is an express agreement that the reserve shall be available to pay unremitted for checks.

The reserve balance of a member bank is also, in a sense, a clearing balance. As to non-member clearing banks the Federal Reserve Act, #13, provides that such banks must maintain "a balance sufficient to offset the items in transit held for its account by the Federal reserve bank." A former counsel of the Federal Reserve Board has ruled that this phrase "items in transit" refers to checks drawn upon the non-member clearing bank and forwarded to it for collection by the Federal Reserve Bank. Federal Reserve Bulletin, Vol. 3, p. 617. If this view is correct, then there is clear intention shown on the part of Congress that the credit balance of a non-member clearing bank shall stand as security for clearing balances against it. While not expressed in the Act itself it is persuasive to us that Congress intended the same as to reserve balances.

We will summarize our own views upon the questions under consideration as follows:

1. Where a member bank or a non-member clearing bank fails to return or to remit for transit letters, you are entitled to charge the amount thereof to the reserve or clearing account even though the remittance draft be received after notice of suspension.

2. Where a member bank fails to return or remit for transit letters, you are entitled to use the proceeds of the cancelled Federal Reserve bank stock to reimburse your depositors of the items in such letters even though such items have been charged back to such depositors.

3. Where a member national bank fails to return or remit

for transit letters, and your bank holds collateral securities pursuant to the usual form of collateral agreement you are entitled to hold this collateral or its proceeds to reimburse your depositors of the items in such letters. We reserve our opinion as far as collateral securities deposited by member state banks is concerned.

With the decisions in the somewhat muddled condition pointed out above, a legal opinion is only what the law should be; we can only guess what the law will be. While we have always been able to maintain the foregoing views in litigation up to the present time, decisions in other litigation may prove controlling against them.

However, we do not believe that even though the Circuit Court of Appeals should affirm the lower court in the Richmond case that would necessarily require us to revise our opinion as to the rights of your bank in another circuit. Such an affirmance would only have the effect of making your rights and obligations more doubtful than they are at present.

4.

The next question to be considered is whether the rule in the Midland National Bank case, the rule we are contending for, has as a corollary the requirement that the pledgee bank must share pro rata in the collateral securities with its depositors of unremitted for checks. In our opinion this does not follow and we feel confident that your collateral securities may be appropriated first to the promissory notes and notes rediscounted by the insolvent member bank.

See U. S. Natl. Bank v. Westervelt, 55 Nebr. 424.

Freeman & Shaw v. Citizens Natl. Bank, 78 Iowa 150.

The next question is whether, assuming your bank has the rights herein indicated, there is not also a corresponding duty to utilize the balance in the reserve account, proceeds of cancelled Federal reserve stock, and excess collateral for the benefit of your depositors of unremitted for checks? In other words is your bank liable, as for a breach of trust, in cases where it has surrendered reserve balances or excess collateral to a reciever of a suspended member bank? On this point Sigurd Ueland in his memorandum to you dated June 20, 1928 (First National Bank of Colman) said:

> "In other words the Federal Reserve Bank * * * finds itself to some extent on the horns of a dilemma. If the surplus is paid over to your endorsers of the transit items your bank may be liable to the receiver; if surrendered to the receiver there might possibly be liability to your endorsers.
>
> "There may be a question whether your bank is not under some moral duty to its depositors to protect them as far as possible. Especially in cases where an attempt was made to remit by draft on the reserve account, it seems unfair that the balance in that account should be returned to the receiver rather than used for the purpose intended by the officials of the suspended bank."

We are firmly of the opinion that if there is any obligation in this situation to either the receiver or your depositors of unremitted for checks, it is emphatically to the latter. In the light of the Midland National Bank decision it is certain that your bank cannot continue surrendering excess collateral to receivers without incurring a certain amount of unpopularity with the better posted among such depositors.

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Our recommendations are as follows:

1. That all settlements already made or agreed upon between your bank and the comptroller's office or a receiver, including all of the so-called "Oswego agreements" entered into, be allowed to stand.

2. That hereafter no reserve balance, proceeds of cancelled stock, or excess collateral held under a collateral agreement be surrendered to a receiver until all transit claims filed by your bank have been paid or until a court of last resort has so ordered.

3. That your form of collateral agreement be amended so as to state expressly that your bank has a prior lien on the reserve balance and collateral securities for the note, rediscount and overdraft indebtedness and a secondary lien for liability resulting from unremitted for transit and collection letters. (N. B. Some special consideration would have to be given to the case of member state banks in this connection.)

4. That the comptroller be advised of this change of policy and the reasons therefor, and that negotiations be opened looking toward a speedy determination of the questions involved by the Circuit Court of Appeals of this circuit.

Counsel.

Assistant Counsel.