FEDERAL RESERVE BOARD

WASHINGTON

ADDRESS OFFICIAL CORRESPONDENCE TO
THE FEDERAL RESERVE BOARD

X-6264

March 14, 1929.

Dear Sir:

As I wired you last night, the Federal Reserve Board has directed me to arrange a conference of counsel of all Federal reserve banks to be held in Washington concurrently with the forthcoming Governors' Conference, which will be held in Washington commencing on Monday morning, April 1. For reasons which will hereinafter be explained, it is important that our conference begin as early as possible on Monday morning and I suggest that we all try to meet in my office at nine o'clock.

The purpose of this conference is to consider the various questions dealt with in Mr. Ueland's memorandum of January 8 (X-6226-b), which I sent you under date of January 30, dealing with the policy to be pursued by the Federal reserve banks in asserting rights on behalf of depositors of unremitted for transit items against receivers of insolvent member banks in the light of recent court decisions. The feeling here is that counsel for all of the Federal reserve banks ought to endeavor to agree upon a uniform policy to be recommended to the Conference of Governors, with a view of having such recommendations considered immediately by the Conference of Governors while counsel for the various banks are still in Washington and available for consultation either with their respective governors or with the Governors' Conference as a whole.

There are enclosed for your information in this connection copies of letters received from Messrs. Stroud, Agnew, Parker, Wallace, and McConkey, commenting upon Mr. Ueland's memorandum. As soon as I receive comments from other counsel, I shall furnish you with copies of same.

While it is true, as pointed out by Mr. Wallace, that certain of the cases giving rise to this discussion are still in the process of appeal, it is believed that an early consideration of this subject by counsel may lead to the adoption of policies and possibly of amendments to Regulation J, the check collection circulars of the Federal reserve banks, and the forms used by the Federal reserve banks in connection with the pledge of collateral which will be calculated to minimize the confusion,

litigation, and possible loss to Federal reserve banks which might otherwise result from recent court decisions such as those in the case of Early v. Federal Reserve Bank of Richmond and Midland National Bank and Trust Company v. First State Bank of Sioux Falls.

In this connection, I believe that it would be advisable for each of us to consider in advance of the conference the advisability of:

(1) Amending Regulation J so as to provide expressly that the reserve balance either shall, or shall not, be available for the purpose of collecting unremitted for cash letters on insolvent member banks;

(2) Inserting similar express provisions in the check collection circulars of the various Federal reserve banks;

(3) Amending the forms used by the Federal reserve banks covering the pledge of collateral so as to provide expressly either that such collateral shall, or shall not, be available for use by the Federal reserve bank for the same purpose; and

(4) Amending Subdivision 4 of Section V of Regulation J so as to eliminate therefrom the words, "Or at the option of such Federal reserve bank to authorize such Federal reserve bank to charge their reserve accounts or clearing accounts".

In connection with the last suggestion, it is important to note that all of the Federal reserve banks are now collecting checks on the remittance system, the Federal reserve banks of Richmond and Philadelphia having recently changed from the system of collecting checks by charging same to the reserve accounts of the drawee banks as a normal method of collection.

If any of the counsel believe that amendments such as those outlined above are advisable, it would be very helpful if, in advance of the conference, they would prepare drafts of such amendments as they consider appropriate. It would also be helpful if any counsel having very definite and well crystallized views as to the policy which the Federal reserve banks should adopt in connection with this problem would prepare drafts of resolutions recommending such policies to the Governors' Conference.

In order to leave as much time as possible for the consideration of this subject by the Conference of Governors before that conference adjourns on April 3, the Conference of

Counsel should endeavor, if possible, to formulate its recommendations on the questions raised by Mr. Ueland's memorandum by Monday night, April 1, and transmit same to the Governors' Conference on Tuesday morning. We can then proceed to the consideration of other matters until such time as the Governors' Conference may call upon us for consultation.

It is quite possible that some of the counsel will have other topics which they would like to have considered during the conference; and it would be conducive to more thorough consideration if such topics could be suggested in advance, a formal program arranged, and all of the counsel notified in time to enable them to study such additional topics in advance of the conference. Hence, the last suggestion contained in my telegram of March 12.

I regret exceedingly that circumstances prevented me from wiring all of the counsel in advance and obtaining suggestions as to the dates most convenient to all parties for this conference. The Federal Reserve Board had already fixed the date of the Governors' Conference before I was able to get them to take this matter up for consideration; and, when the subject of a conference of counsel was taken up, Governor Young felt very strongly that it should be held concurrently with the Governors' Conference.

I sincerely hope that you can attend our forthcoming conference and that you will not hesitate to call upon me if there is anything I can do to be of assistance to you.

Yours very truly,

Walter Wyatt,
General Counsel.

Enclosures

COPY

X-6264-a

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Law Office Of
LOCKE, LOCKE, STROUD & RANDOLPH,
American Exchange Building,
DALLAS, TEXAS.

February 11, 1929.

Mr. Walter Wyatt,
General Counsel,
Federal Reserve Board,
Washington, D. C.

Dear Mr. Wyatt:

We have read with interest the memorandum of Mr. Sigurd Ueland to the Federal Reserve Bank of Minneapolis, dated January 14, 1929.

We think that the questions of policy raised in this memorandum are of vital importance to the Federal Reserve System. In view of the fact that our ideas with reference to the proper policy of federal reserve banks in exercising their check clearing and collection functions are different from those expressed in Mr. Ueland's memorandum, we are giving you hereafter a very complete statement of our views on the questions of policy raised.

FEDERAL RESERVE ACT AND REGULATIONS
OF FEDERAL RESERVE BOARD.

It seems to us that any question of policy in connection with the collection of checks by federal reserve banks must be determined in the light of the Federal Reserve Act and regulations of the Federal Reserve Board made pursuant thereto.

Under the terms of Section 13, any federal reserve bank may receive from any of its members deposits of checks and drafts payable upon presentation and, also, for collection maturing notes and bills. It may receive from other federal reserve banks solely for the purpose of exchange or collection, checks and drafts payable upon presentation within its district, and it may receive from non-member banks and trust companies, under certain conditions, solely for the purpose of exchange and collection, notes and drafts payable upon presentation or maturing notes and bills.

Section 16 provides that federal reserve banks shall receive certain checks for deposit from member banks and federal reserve banks and authorizes the Federal Reserve Board to make and promulgate from time to time regulations requiring federal reserve banks to exercise the functions of a clearing house for its member banks.

While Section 13 authorizes federal reserve banks to accept deposits of checks from its member banks and Section 16 provides that they shall receive

certain checks for deposit, it is a fact, which we think cannot be contradicted, that in no instance has a federal reserve bank, within recent years at least, accepted checks from member banks in all practical respects for any other purpose whatsoever than that of collection. We think no federal reserve bank would wish to depart from such policy.

The authority for regulation J, as we view the law, proceeds from Section 16 of the Federal Reserve Act. The policy of the Federal Reserve Board, as it has existed continuously since the institution of the check clearing and collection functions, is expressed in regulation J as follows:

> "The Federal Reserve Board, desiring to afford, both to the public and to the various banks of the country, a direct, expeditious and economical system of check collection and settlement of balances, has arranged to have each federal reserve bank exercise the functions of a clearing house and collect checks for such of its member banks as desire to avail themselves of its privileges, etc."

The functions of a clearing house, as commonly understood, and as is undoubtedly intended in regulation J, is to present checks for payment. This intention upon the part of the Federal Reserve Board is further emphasized in sub-paragraph (1) of Section V, in which it is stated:

> "A federal reserve bank will act only as agent of the bank from which it receives such checks, etc."

In other words, as we view the Federal Reserve Act and the regulations of the Federal Reserve Board made pursuant thereto, in handling checks a federal reserve bank acts purely and simply as a collection agent. To this extent, we think there is no disagreement.

Thus we think that in determining policies to be followed by a federal reserve bank we should always have in mind the fact that the federal reserve bank is discharging the functions of a clearing house and acting purely in the capacity of an agent for collection.

RESERVE BALANCE.

In determining the policy which a federal reserve bank should follow with respect to the uses of the reserve balance of a member bank, it is important to consider the nature of reserve balances and how the same are treated by the Federal Reserve Act and the regulations of the Federal Reserve Board.

As we understand, it has for many years been considered prudent and proper that a bank should retain, in cash or its equivalent, such a percentage of all of its liabilities as, in the ordinary course, it could be expected to need in meeting the demands that might be made at any one time by all of its creditors.

The fund so maintained is designated "Reserves."

The amount maintained, insofar as banks that are now members of the Federal Reserve system is concerned, was formerly very much larger than the amount required under the terms of the Federal Reserve Act. It was felt at the time

the Federal Reserve Act was passed that the reserves could be materially reduced because of the concentration brought about through the establishment of federal reserve banks. The practice upon the part of banks to carry secondary reserves, consisting of securities that can be readily converted into money, to meet unusual or unexpected demands contributed to the reduction of the amount of reserves. The so-called secondary reserves are under the full control of the member bank.

Prior to the establishment of federal reserve banks, the commercial banks of the country were permitted to carry their reserves partly in the form of cash in their vaults and partly with other banks of their own choosing, provided such other banks had been designated as proper reserve agents.

Upon the establishment of the Federal Reserve Bank, however, all reserves were required to be carried with the Federal Reserve Bank of which a commercial bank was a stockholder, thus making it mandatory that the reserves be concentrated in the Federal Reserve Bank rather than to be carried in the vaults of the commercial banks or with agents of the bank's selection.

If we have the correct understanding of the nature of reserves and of changes brought about through the enactment of the Federal Reserve Act, then it would seem to follow that, reserves being intended as a protection against all liabilities of a member bank and being by law concentrated in federal reserve banks, the federal reserve banks are to some extent, insofar as the reserve is concerned, a trustee for all creditors, rather than for those creditors only who seek to effect collection of their indebtedness through the medium of the federal reserve bank.

That the reserves of a member bank are intended as a protection for all liabilities of a member bank, rather than a fund set up in the federal reserve bank to use in effecting collection of checks, is, we think supported by an analysis of the Federal Reserve Act and regulations of the Federal Reserve Board. In this connection, we call attention to the following points:

1. Under the terms of the Federal Reserve Act, the amount of reserves which a bank is required to carry is determined by the amount of demand and time deposits of the bank. Had the reserve been considered a fund out of which federal reserve banks might collect checks sent them for collection, it would appear that the amount of this fund should have been calculated in some proportion to the average amount of checks which the federal reserve bank had outstanding for collection.

2. We find the following provision in Section 19 of the Federal Reserve Act:

> "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."

Referring to regulation D of the Federal Reserve Board, the first thing we notice is the provision contained in section 3 (c) which prohibits checks deposited by a member bank from being counted as a part of the bank's reserves until such time as may be provided in the appropriate time schedule referred to in section 4 of regulation J. The effect of this provision, as we understand it, is to prohibit federal reserve banks from accepting deposits of checks for immediate credit as might be contemplated by sections 13 and 16 of the Federal Reserve Act, and we believe that this practice has been upheld by the Federal Courts in the case of Pascogoula National Bank v. Federal Reserve Bank of Atlanta, et al, 11 Fed. (2d) 866.

In section 4 of regulation D, we find the following language:

> "Inasmuch as it is essential that the law with respect to the maintenance by member banks of the required minimum reserve balances be strictly complied with, the Federal Reserve Board, under authority vested in it by section 19 of the Federal Reserve Act, hereby prescribes the following rules governing penalties for deficiencies in reserves:"

Then follow some rather drastic penalties for a bank failing to maintain its reserves intact, such provisions consisting of (a) Penalties to be assessed against the bank; (b) Instructions to Federal Reserve Agents to take matter up with the bank; and (c) Provisions for a progressive penalty.

Section 5 of this regulation calls attention to the fact that it is unlawful for any member bank to pay dividends or make any loans while its reserve is deficient.

All of these provisions of the act and regulations point towards an intention of Congress and the Federal Reserve Board to require banks to maintain reserves for the very purpose for which reserves were maintained prior to the enactment of the Federal Reserve Act and not to cause member banks to create a fund out of which the federal reserve bank might effect collection of checks sent it for that purpose. In other words, the collection of checks is incident to the maintenance of reserves rather than the maintenance of reserves being incident to the collection of checks.

We think this view is further supported by the discussions in Congress preceding and leading to the enactment of the Federal Reserve Act.

If such is the policy of the Federal Reserve Board and of Congress with respect to reserves, then certainly the policy is, to some extent at least, defeated by the arbitrary appropriation and use by federal reserve banks of the reserve balances as a fund charged primarily with the payment ofchecks.

Nor do we think the argument advanced on page seven of Mr. Ueland's memorandum, with reference to non-member clearing banks is at all persuasive against the view hereinabove expressed because of the fact that a non-member clearing bank is limited by law from doing any character of business whatsoever with the federal reserve bank except that of clearing checks. The deposit required of the non-member clearing bank is not, insofar as the Federal Reserve

Act is concerned, a reserve of any kind or character, whereas the deposits of a member bank are purely and wholly reserves.

Summarizing, - it is our opinion that the reserves maintained in the federal reserve bank by a member bank are intended (a) from the origination of the practice of carrying reserves; (b) the Federal Reserve Act; and (c) the regulations of the Federal Reserve Board, as a fund intended for use by the member bank in meeting demands that might be made upon it at any one time for all of its liabilities, and not a fund which should be used by the federal reserve bank, simply because it might have the power to do so, for the protection of the particular creditors of the member bank which might see fit to use the federal reserve bank as their agency for collection.

CAPITAL STOCK SUBSCRIPTIONS.

Section 6 of the Federal Reserve Act gives specific directions as to what shall be done with the stock of a member bank which shall have been declared insolvent. The substance of this section is that the cash paid subscriptions on said stock, together with the accumulated dividend, 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. Certainly, in a broad sense, if not in a narrow and technical one, claims existing against drawee banks on account of checks which a federal reserve bank has handled purely as agent for someone else cannot be said to be a debt due the federal reserve bank. And, therefore, we think that it clearly was not the intent of the Federal Reserve Act to use the capital stock subscription of a member bank as a fund from which checks might be collected.

COLLATERAL.

We find no provision in the Federal Reserve Act for a federal reserve bank taking collateral for any purpose other than as security for member banks' 15-day promissory notes. We think that undoubtedly, under section 4-Seventh, as follows:

> "To exercise by its board of directors, or duly authorized officers or agents, all powers specifically granted by the provisions of this act and such incidental powers as shall be necessary to carry on the business of banking within the limitations prescribed by this act,"

a federal reserve bank has ample power to require collateral from a member bank to secure both rediscounted notes and member bank promissory notes. We also think that under special and peculiar circumstances, there would be no doubt but that under this provision a federal reserve bank would have the right to require collateral to secure transit items forwarded for collection. We doubt, however, the necessity for collateral generally in order to carry on the business of banking, within the limitations prescribed by the act governing the check clearing and collection functions of the federal reserve bank, because we believe, as hereinafter outlined, that the proper course to pursue is to use ordinary care in collecting checks at the time the collection is undertaken, rather than to set up avenues of protection to be resorted to at a later date.

COURT DECISIONS.

We observe, and to some extent are familiar with, the cases referred to

in Mr. Ueland's memorandum. We do not in the least disagree with the effect of the decisions in these cases. At the outset, however, we wish to make this observation, - that while these cases are undoubtedly precedents, we question the principles which they attempt to assert.

We make this observation because we wish to approach these questions from the standpoint of principle, rather than precedent, that is, not what we can do but what we should do.

It must be borne in mind that the twelve federal reserve banks have heretofore been, and in the future will be, to a much greater extent required to litigate cases of this character in many jurisdictions. It is not unlikely that every appellate court of each state in the Union, as well as of the United States, may have occasion to pass upon some phase of the questions involved. It would be practically impossible to present the same questions, under the different conditions that would necessarily exist, to such a large number of courts without obtaining conflicting precedents. Therefore, we feel that, due to the fact that precedents are such a guiding factor in court decisions, the Federal Reserve system as a whole should be highly interested and guard with the greatest care the precedents which are established.

Furthermore, with our complex and varied judicial procedure, we think it fairly easy to establish most any sort of a precedent. To illustrate what we mean, without intending in the least to be offensive, if we were involved here in litigation affecting some point set out in Mr. Ueland's memorandum and in such case should have opposed to us counsel with no familiarity with check collections and with no ability as a lawyer, we might obtain one precedent; whereas, in the same case, with competent and well informed opposition an entirely different outcome might easily result.

Therefore, in our opinion, we cannot lean too strongly, in determining these questions of policy, upon precedents which have heretofore been established, and for these reasons we will not attempt in this communication to state our opinions with reference to what should or should not have been the result of the particular cases mentioned.

VIEWPOINT.

We recall the old geometrical expression, that in order to arrive at a proper perspective it is first necessary to establish a viewpoint. This is the important principle involved here. If we can establish as a policy the proper viewpoint, then we feel sure that the perspective, that is, the subordinate questions of policy, will necessarily be uniform and correct. At the present time it appears to us that there is, generally speaking, two viewpoints from which these questions are approached:

FIRST: In discharging the check clearing and collection functions a federal reserve bank shall act as agent only, employing those means for presenting and collecting checks which are the normal, natural and accepted means afforded by the commercial structure of the country.

SECOND: In discharging their check clearing and collection functions a federal reserve bank shall act as agent, employing those means for

presenting and collecting checks which are the normal, natural and accepted means afforded by the commercial structure of the country, and, in addition, shall take every other means available by virtue of the peculiar nature of federal reserve banks and involving unusual, uncommon and extraordinary practices not expected, required nor undertaken by a person acting in the capacity of agent only.

Those banks having the first viewpoint approach the collection of checks somewhat as follows: A circular is sent to every bank or other person authorized to send checks to a federal reserve bank for collection. This circular states just how the federal reserve bank will collect checks and briefly may be summarized as follows:

(1) We will use ordinary care under all circumstances in presenting your check for payment.

(2) Ordinarily we will present your check direct to the bank on which it is drawn, because we feel that this is the most direct and expeditious manner of collecting checks.

(3) We will take a bank draft from the drawee bank in payment of these checks because you must realize that under the accepted practices of this country funds are transferred from one point to another through the medium of checks and because we have no means of presenting all of the checks sent to us, other than those afforded by the commercial structure of the country, notably the postoffices.

(4) It would not be practical for us to employ any means of collection other than the postoffice, except in unusual cases where we will exercise ordinary care under the special circumstances surrounding the collection.

(5) You do not have to send us your checks for collection. If our methods of collecting checks is not suitable to you, you may employ other agents.

(6) In the event we have used ordinary care under the circumstances to collect your check and fail to do so, you must look elsewhere than to us to recover your loss.

Banks having the second viewpoint, say by their circulars to member banks substantially that stated above but, in addition, and contrary to the normal, natural and accepted practices of an agent only, they undertake to resort to unusual practices in the following respects, if not others:

(1) By appropriating the reserve account of the member bank to which checks have been sent for collection.

(2) By attempting to use capital stock refund due the insolvent member bank.

(3) By seeking to apply collateral given by the member bank primarily to secure loans made to it by the federal reserve bank in the discharge of an entirely distinct function from that of collecting checks.

Banks having the first viewpoint, in the event the drawee bank fails before remitting for checks transmitted to it for collection, find themselves in this situation: The only parties that can complain are the parties from whom they receive checks. If such parties do complain, but one question arises and that is: Did the federal reserve bank exercise ordinary care in presenting the checks for payment? This question can always be decided in favor of the federal reserve bank, provided that bank has taken pains to exercise ordinary care under the circumstances at the time the collection is undertaken. 252

Banks having the second viewpoint, find themselves involved in litigation frequently, not only with the persons sending the checks for collection but with receivers of insolvent banks. This is but natural because federal reserve banks following such practice encourage their endorsers to feel that they should not, under any circumstances, sustain a loss; and likewise they necessarily find themselves in conflict with the office of the comptroller of the currency and receivers of insolvent banks, because it is their duty to see that the funds of the insolvent bank are applied pro rata to all creditors and are not used to the preference of one over another.

It is not hard to understand how a bank with the last mentioned viewpoint can frequently find itself "to some extent on the horns of a dilemma" because "if the surplus is paid over to your endorsers of the transit items your bank may be liable to the receiver and if surrendered to the receiver there might possibly be liability to your endorsers." We cannot help but feel that the federal reserve bank makes the dilemma by the course of conduct which it has chosen to follow and, in this connection, we wish to state that we are in entire accord with the thought expressed in paragraph numbered four on the last page of Mr. Wyatt's letter to Mr. A. Ueland, of date January 26, 1929.

CONSIDERATION OF FUNCTIONS AND RESPONSIBILITIES OF FEDERAL RESERVE BANKS OTHER THAN THOSE OF COLLECTING CHECKS.

Every federal reserve bank operating in a district that has experienced a large number of bank failures (and bank failures are the cause of our considering any of the questions of policy involved) have found themselves confronted with a situation similar to the following:

> A member bank is in a rather strained and extended condition. This condition has been known by the federal reserve bank for sometime. It finally works itself to more or less of a crisis. The bank's reserve balance is very much depleted, if not exhausted. The bank has sent in, and the federal reserve bank is considering, an offering for rediscount, sent for the purpose of restoring the bank's reserve. At the same time and on the very day that this offering is being considered, cash items have been received drawn against this member, aggregating as much, or more, than the offering and required reserve balance.

Under such conditions, the reserve bank is confronted generally with two questions:

I. Are we going to rediscount the offering?

II. What steps are we going to take looking towards the proper discharge of our duty in the collection of these checks?

Those banks having the first viewpoint mentioned above will decide these questions somewhat along the following lines:

I. Insofar as the rediscount offering is concerned the questions that will be considered will be-

(a) Are the notes offered for rediscount acceptable from a credit standpoint?

(b) Does the bank's condition justify the extension of the credit?

(c) Does the situation of the member bank, as we know it to be, justify us in expecting, if the loan is made, that the bank will be assisted in restoring itself to a sound and safe condition?

II. Insofar as the collection of the cash letter is concerned, this bank approaches the question somewhat as follows:

(a) Does the knowledge which we have of the bank's condition justify us in sending the checks direct by mail?

(b) What course of collection should we follow in order to discharge our duty to the holders of these checks to use ordinary care in their collection?

Thus the two questions are decided upon their merits, having in mind the distinct functions which a federal reserve bank is discharging.

Banks having the second viewpoint must necessarily, in order to be logical, approach the two questions somewhat in this manner:

I. Insofar as the rediscount offering is concerned they must take into consideration:

(a) The matters outlined under I (a); I (b) and I (c) on pages 11 and 12 hereof.

(b) And in addition, they must necessarily have in mind at the time the rediscount is made, if it is made, the fact that the cash letter is to go forward and, therefore, they must necessarily think of the collateral which they are taking to secure the advances made the bank in the light of subsequent indebtedness that might be created by virtue of the outgoing cash letter and, hence, the member bank is to this extent penalized in its rediscount operations; and

(c) The offering has been made to restore the reserve balance and that the reserve balance is treated as a fund to protect the cash letter. Therefore, assuming that the

notes are perfectly good but that the member bank's condition generally would not justify the federal reserve bank in extending the credit, would not the federal reserve bank find itself again in a dilemma, that is, should it discount the notes and build up the reserve balance to protect the endorsers of the checks or should it refuse to discount the notes because such action is to the best interest of the member bank concerned.

II. In as far as the collection of the cash letter is concerned, they must necessarily take into consideration:

(a) The matter referred to under II (a) and II (b) on page 12 hereof; and

(b) In the event the checks are not actually paid by the bank to which they are sent, will the reserve balance of such bank be sufficient to protect our endorsers?

(c) If the reserve balance is not sufficient, will the sum in it plus the collateral which we are holding, including the capital stock refund, be sufficient?

If these questions are decided in the affirmative, will such bank use ordinary care in presenting the checks for collection or will it be prone to rely upon the protection which it has in the forms above outlined, rather than to use ordinary care in the presentation of the checks. If it fails to use ordinary care and thus renders itself liable, what assurance does it have that the reserve balance will not be withdrawn before it can be used by the federal reserve bank and, also, what assurance does the federal reserve bank have that the collateral in its hands, after the failure of the member bank, will be worth as much as had been counted on?

DUTY OF THE FEDERAL RESERVE BANKS TO THE COMMUNITY IN WHICH INSOLVENT BANKS ARE LOCATED AND TO THE CREDITORS OF SUCH INSOLVENT BANKS.

Because of the confidential relationship existing between federal reserve banks and their members and because of the fact that the great majority of member banks, that is, national banks, are compelled to retain their membership in the Federal Reserve system in order to keep their charters and because of the peculiar nature and functions of federal reserve banks, we feel that each federal reserve bank owes a duty to the community in which an insolvent bank is located and to the creditors of such insolvent bank.

Furthermore, if there is anything in our thought that insofar as reserves are concerned federal reserve banks are to some extent trustees for all creditors of any particular bank maintaining such reserve, then we think it necessary follows that a federal reserve bank is charged, to some extent at least, with the same responsibility as that of the comptroller of the currency in seeing that, in the event of insolvency, these reserves are applied pro rata to all creditors rather than to the select few who might have happened to choose the federal reserve bank as their agency through which to effect collection of their indebtedness.

It is true that knowledge gained by a federal reserve bank in its confidential dealings with member banks will put a federal reserve bank on notice initially that extraordinary steps might be required in order to exercise ordinary care in the collection of checks. This cannot be helped and, to this extent, we think it proper for a federal reserve bank to use its confidential information. To go further and to set up avenues of preferment for those creditors selecting the federal reserve bank as their agency for collecting their debts would, in our opinion, be a failure to discharge the proper functions of a federal reserve bank.

In the event any question of preference should arise, we would prefer to let it arise from some voluntary act of the member bank, rather than from some arbitrary action of the federal reserve bank.

DOES THE FEDERAL RESERVE BANK BEST SERVE ITS ENDORSERS BY FOLLOWING THE POLICY OF APPLYING RESERVE BALANCES, COLLATERAL AND CAPITAL STOCK REFUNDS TO CLAIMS ARISING BY FAILURE OF THE DRAWEE BANK TO REMIT FOR TRANSIT SENDINGS.

We are familiar with the fact that many decisions hold, in effect, that where checks are sent to the drawee bank and are by that bank received, stamped paid and charged to the account of the drawer, the drawer is discharged from liability by such action.

In our opinion, however, these decisions are unsound and while we must admit that, at the present time, they express generally the law in most jurisdictions, nevertheless, having the convictions we do, we cannot help but feel that when properly presented this question will be decided otherwise. We base this feeling upon the fact that the mere stamping of a check paid and charging it to the account of a person does not in any manner constitute payment nor does it in anywise conform to the definition of payment which is generally and uniformally laid down by practically all courts dealing with the question of payment in other cases.

Assuming that a federal reserve bank should follow the policies suggested in Mr. Ueland's memorandum and the reserve balance, collateral and capital stock refund is not sufficient to pay the entire amount of the transit sendings involved, then nedessarily the amount on hand must be pro rated. In such event, it occurs to us that necessarily the drawer would be discharged and the payee or his endorser would be required to look elsewhere than to the drawer for the recovery of the amount unpaid.

To this extent, we feel that to pursue the policies recommended by Mr. Ueland would be a detriment rather than a help.

In this connection, we feel that the questions which we are now considering would become academic should the various states of the Union be prevailed upon to pass a proper statutory enactment to the effect that where the payee or his endorser of a check uses ordinary care and the usual and customary means of collection, the drawer of the check is not discharged regardless of whether the check in question has been stamped paid and charged to his account, unless the drawee bank has actually paid the check.

CONCLUSION.

For the reasons herein stated, it is our opinion that federal reserve banks should, in discharging their check collection functions, adhere strictly to the idea that they are acting as agent only and that in discharging such duty they will use ordinary care, under all circumstances, to collect checks sent them for collection, employing those means for presentation and collection which are the normal, natural and accepted means afforded by the commercial structure of the country, but that they shall not undertake unusual, uncommon and extraordinary practices not expected, required nor undertaken by a person acting in the capacity of agent only.

We think it very important that uniformity exist throughout the entire Federal Reserve System as to the policies herein referred to, so that federal reserve banks in one district shall not establish precedents embarrassing to federal reserve banks in other districts. We feel this so strongly that we would be glad to recommend to the Federal Reserve Bank of Dallas that they make their practices conform to those practices favored by the majority of the federal reserve banks.

Yours very truly,

(S) Locke, Locke, Stroud & Randolph.

EBS:lm

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FEDERAL RESERVE BANK

OF SAN FRANCISCO

February 5, 1929.

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

Dear Mr. Wyatt:

I acknowledge your letter of January 30, 1929, transmitting the draft of memorandum prepared by Mr. Sigurd Ueland with respect to the policy to be pursued by the Federal Reserve Bank of Minneapolis in relation to reserve balances; also copy of your letter of January 26 commenting on Mr. Ueland's opinion.

I can say without reserve that I agree entirely with the conclusions which you have reached and in the expression of policy contained in your letter. I have felt from the beginning that the Midland National Bank case was bad law and would result in the creation of situations embarrassing to the Federal reserve banks. The adoption in toto of the theory of that case by Mr. Sigurd Ueland, and presumably by his father, makes the situation still more difficult. While, like you, I have the utmost respect for Judge Ueland's legal ability, as well as that of his son, I cannot but feel that these gentlemen have accorded the decisions to which they refer greater weight than that to which they are entitled and have given the principles announced therein broader application than is deserved. Personally I feel that if the Federal Reserve Bank of Minneapolis were to adopt and put into effect the recommendations contained in Mr. Sigurd Ueland's memorandum, a situation would be created fraught with grave danger to all Federal reserve banks. Even though the conclusions reached were justified under the decisions of the Supreme Court of Minnesota and the United States District Court in the Eureka case (a premise which I do not at all concede), the adoption of those conclusions as a basis of future policy on the part of the Federal Reserve Bank of Minneapolis would undoubtedly arise to confront all other Federal reserve banks even though such other Federal reserve banks followed entirely different methods of procedure. In other words, if the Federal Reserve Bank of Minneapolis alone, or perhaps in concert with the Federal Reserve Bank of Richmond, is to adopt the policy of treating reserve balances and funds created from the caneellation of capital stock as trust funds primarily or secondarily for the payment of obligations arising from unremitted cash letters, all other Federal reserve banks will ultimately have to adopt the same policy or be confronted with vexatious and expensive litigation engendered by following a different policy.

It has always been the endeavor of the Federal Reserve Bank of San Francisco, and I believe of most of the other Federal reserve banks, to maintain a strict agency relationship in the handling of cash items. Once the theory of

agency is departed from in the slightest degree, there is no way of telling to what extent member banks and non-member clearing banks may be able to hold the Federal reserve bank responsible for the fate of unpaid cash items. I therefore consider any departure from such agency relationship or any admission, express or implied, that such relationship does not continue, extremely dangerous.

Mr. Ueland refers to the recent amendment of Regulation J eliminating therefrom that provision to the effect that any Federal reserve bank may reserve the right to charge checks to the reserve account or clearing account of a bank at any time when in any particular case the Federal reserve bank deems it necessary to do so, and expresses the opinion that this amendment does not show an intention that the reserve balance is not intended to remain available for the payment of unpaid cash items after notice of suspension. I think this conclusion is incorrect. Harking back to the discussion which took place at our last conference in Washington, I am strongly of the opinion that it was for the purpose of removing any question as to the right of a Federal reserve bank to treat a reserve balance as a trust fund for the benefit of the owners of cash items, that we recommended the elimination of this clause, and I am equally firm in the opinion that this was the purpose of the Federal Reserve Board in causing this elimination.

I believe the entire matter of the treatment of reserve balances and the rights of forwarding banks in relation thereto should receive early and thorough treatment and I agree with you that as a preliminary to any action on the part of the Federal Reserve Board, it would be well to hold a conference of counsel at Washington for the purpose of a thorough discussion.

I should be glad to attend such a conference at any time that may be selected. Personally I should prefer that if a meeting is held it be set for the month of April, as engagements here would make it difficult for me to be present during either March or May.

I have thoroughly discussed the matters referred to herein with the executive officers of this bank. Governor Calkins suggests that if a conference is held, it might be well to arrange to have Mr. Baker present.

Yours very truly,

(S) Albert C. Agnew,
Counsel.

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FEDERAL RESERVE BANK

OF ATLANTA

February 5, 1929.

Mr. Walter Wyatt, General Counsel,
Federal Reserve Board,
Washington, D. C.

Dear Mr. Wyatt:

I have read with interest your letter of January 26, addressed to my firm, with which there was enclosed a copy of a letter written to you by Judge Ueland and Mr. Sigurd Ueland, as well as a copy of the memorandum prepared by Mr. Sigurd Ueland and a copy of your letter to Judge Ueland - all having reference to the policy to be pursued by the Federal Reserve Bank of Minneapolis in asserting rights against receivers of insolvent member banks on behalf of the owners of unremitted for transit items.

In obedience to your request, I am herein expressing my views on the questions discussed in the above mentioned correspondence and memoranda. In considering the matter I have, of course, been mindful of the weight which should be given any opinion representing the matured judgment of the Messrs. Ueland. I am, however, constrained to disagree with these Gentlemen in the conclusions which they have reached. My opinion accords with your own.

It seems to me that we should not lose sight of certain fundamental propositions which, but for the recent decision in the case of the Federal Reserve Bank of Richmond vs Earley, Receiver, might well have been regarded as elementary, and which are not necessarily foreclosed by that case:

1. Whenever a receiver is appointed, whether in bankruptcy, by a court of equity or by other authority, bank balances to the credit of the insolvent automatically become not withdrawable upon his check, but may be withdrawn only by such receiver, acting pursuant to the general or statutory authority vested in him. Whether such result is brought about by a statute, such as the Bankruptcy Act, or upon general equitable principles seems to be immaterial.

2. The reserve account of a member bank, as well as the clearing account of a non-member clear-

ing bank, may, for the purposes of this discussion, be regarded as nothing more nor less than a "checking account", subject to the same legal principles as would apply to a deposit account maintained under ordinary banking usages by a depositor in a commercial bank.

3. The Federal Reserve Bank handles cash items only as agent for banks forwarding the same to it for collection, or, at least, if such is not the status of the Federal Reserve Banks, quoad such checks, Regulation J fails of its intended purpose in this regard.

4. Federal Reserve Banks do not take such checks and drafts on general deposit and thereby become the owners thereof, and, unless they stand in the relation of owners to such checks, it is difficult to see upon what rule they would be justified in off-setting checks, for which remittances have not been received, against reserve balances or in applying collateral in their hands for the protection of the same, in the absence, at least, of an express agreement authorizing any such procedure.

5. The underlying purpose of Regulation J and of the cognate collection circulars of the various Reserve Banks was to relieve the banks of the duty or obligation to do precisely the things which it is now suggested should be done.

I realize that, since the decision in the Earley case, any opinion must be given dubitante. I cannot, however, believe that the Earley case will finally stand as the last word on the subject, and I am, furthermore, hopeful that, in any event, the holding of that case would not, in subsequent litigation, be extended beyond the particular facts which were there involved. In so far as concerns the banks using the so-called "remittance" system in collecting cash letters, the case would not, necessarily, be conclusive. The Richmond bank, under its own collection circular, had adopted the practice of charging cash letters to reserve accounts at the expiration of a specified transit time, and the Court seems to have predicated its opinion very largely upon this practice.

The banks using the remittance system customarily receive returns on cash letters in the shape of checks drawn

upon the reserve balances of the remitting banks or in acceptable and immediately available exchange. It would clearly seem that after a member bank has been closed the Federal Reserve Bank could not thereafter pay a draft drawn upon itself by the closed member, even though the same had been mailed prior to suspension of business. The banks using the remittance system sometimes accept in payment of cash letters express written authorizations to charge reserve accounts with the amount of the same. I see no difference in legal effect (in so far as concerns the questions now under discussion) between a check drawn upon the reserve account of a member and its written authorization to charge its reserve account with a specified amount; and, if the authorization to charge be not received until after the closing of the bank, the situation is exactly the same, in my opinion, as if remittance had been attempted by draft.

Prior to the recent revision of Regulation J, the Atlanta bank, and perhaps others using the remittance system, reserved the right in their check collection circulars to charge cash letters to reserve account whenever returns thereon were not received when, in the light of railway mail schedules and ordinary experience, they should have been in hand. It was intended, however, by such stipulation merely to provide a method for forcing payment as against slow remitting banks. It was not the intention to provide such method for enforcing payment after a member bank had been closed; nor do I believe that a general reservation in the check collection circular of the tenor indicated would alter or vary the fundamental propositions outlined above.

It is generally recognized that it is unjust and inequitable for a drawee bank to pay and discharge the checks of its customers and then fail to remit therefor, but I do not believe that the Federal Reserve Banks should undertake to correct this injustice by adopting a policy which might, in effect, force them to protect all checks sent to them for collection for which remittances had not been received and which could not be returned to their endorsers.

In the first place, in every instance where a Federal Reserve Bank might hold a reserve balance or collateral in sufficient amount, it would almost be compelled to protect unremitted for items, even at its own expense. Mr. Ueland, in his memorandum, states that collateral securities and reserve balances could legally be appropriated, first, in satisfaction of obligations due to the Reserve Bank by the closed member. Theoretically, this may be true, although I am not so certain about the proposition as is Mr. Ueland. Practically speaking, however, any Reserve Bank which protected itself primarily and its endorsers of transit items secondarily, would be subjected to criticism which

would certainly prove embarrassing. My own opinion is that, in practice, the policy advocated by Judge Ueland, even if legally permissible, would result in a prior, or at least pro rata, payment by the Reserve Banks of such transit items in any case where payment could be effected out of the reserve balance or general collateral in its hands.

In the second place, it is most important, in my opinion, that nothing be done to affect the strict agency relationship touching collections which should be maintained by the Federal Reserve Banks. The volume of checks passing through the Federal Reserve system is enormous and will inevitably increase from year to year. While no one questions the utility of the Federal Reserve Bank collection system, nor begrudges the expense entailed thereby, the Reserve Banks should not be burdened with responsibilities beyond those which inhere in the proper discharge of their duties as agents. For its own negligence, a Federal Reserve Bank should pay, but for the negligence or defaults of others it should not be held liable. It seems to me that anything which tends to superimpose upon a pure agency status an indicia of ownership, with respect to the subject matter of the agency, is a step in the wrong direction. The tendency, at least, of the plan proposed for the Minneapolis District would be to make a Federal Reserve Bank responsible for items entrusted to it for collection, even though the failure to secure returns thereon, in actually collected funds, may not have been due to any negligence or fault on its part. There is no more reason to require a Federal Reserve Bank to pay a check out of a reserve account (or charge the same with the amount thereof) after the insolvency of the drawer than to expect an ordinary commercial bank to make payment under similar circumstances; and, unless remittance in actually available funds has been received, a mere collection agent should not be held responsible.

I shall not attempt to discuss at any length the cases cited in Mr. Ueland's memorandum. I have not read the unreported case of Keyes, Receiver, vs Federal Reserve Bank of Minneapolis. The pertinent holding of Federal Reserve Bank vs First National Bank of Eureka, which I have not read for some time, was, as I recall it, based on the theory that the reserve account of a member was a clearing fund through which "balances" in favor of the Reserve Bank might be extinguished just as such balances are wiped out in the operation of a clearing house. This theory is certainly incompatible with the rationale of Regulation J.

The recent case of Storing, Receiver vs First

National Bank of Minneapolis, which has been the subject matter of prior correspondence between us, seems clearly distinguishable. In the Storing case the Court was careful to point out that items which were received for collection by the First National Bank from its own customers "were credited to the accounts of the respective customers on the books of defendant", i.e. the Minneapolis Bank. At the time, therefore, when they were forwarded to the North Dakota Bank (which subsequently became insolvent) the same had been placed on general deposit with the Minneapolis bank and were treated by the Court as being the property of that bank. The Court also held that the "accounts of the two banks with each other constituted mutual accounts", for which reason a right of off-set existed. The distinguishing elements in the Storing case emphasize the dangers of undertaking to apply the doctrine of that case to the check collection functions of the Reserve Banks. To make the Storing case applicable, the relation between a Reserve Bank and its members might have to be regarded as that of banks maintaining "mutual accounts" - certainly the Reserve Bank would necessarily have to be conceded to be (prima facie at least) the owner of all checks in its hands for collection, despite the contrary declaration of Regulation J. The legal complications which might ensue readily suggest themselves.

No specific comment is made upon the case of Midland National Bank, etc. vs State Bank of Sioux Falls, et al, for the reason that this letter is written in an attempt to show the unsoundness of its holdings.

There are one or two other considerations which, in my opinion, might be urged on the negative side of the questions raised, but I hesitate to burden the debate with any further comment, particularly since your letter to Judge Ueland of January 26 really needs no supplementing.

With best personal regards, I am

Sincerely yours,

(S) Robt. S. Parker.

RSP/w.

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FEDERAL RESERVE BANK

OF RICHMOND

February 5, 1929.

Federal Reserve Board,
Washington, D. C.

Attention: Mr. Walter Wyatt, General Counsel.

Dear Mr. Wyatt:

I read with much interest the interesting and helpful memorandum prepared by Mr. Sigurd Ueland. I am personally much gratified by the knowledge that I do not stand alone in my view with respect to the soundness of the decision of the Circuit Court of Appeals in Farmers and Merchants National Bank of Lake City v. Federal Reserve Bank of Richmond.

The proposition for a conference of Counsel of the Federal Reserve banks always carries such pleasant suggestions that I am never exactly opposed to such a conference, but in thinking over the matter it appears to me that very little in the way of definite action could be taken by such a conference at the present time. The Lake City case cannot be regarded as a final decision because it may be reviewed by certiorari. The case of Storing v. First National Bank, 28 Fed. (2nd) 587, is in the same situation. The case of Midland National Bank and Trust Company v. First State Bank is a final decision by a State court but rests upon the terms of a particular contract, which terms are not identical with the terms of the circular or collateral agreement used by any Federal Reserve bank. The decisions in all of these cases are constructions of contracts except that part of the Lake City case which deals with the surrender value of the stock held by a member bank in a Federal Reserve bank. The circulars used by the respective Federal Reserve banks are not uniform, and therefore if the object of the conference is to discuss past transactions, it seems to me that we should merely be in the position of attempting to forecast decisions upon our respective circulars in the light of decided cases which are still subject to reversal.

If the conference is to concern itself with future transactions, it appears to me that we shall be greatly handicapped by the fact that the decisions which at present form the last known statement of the law are subject to reversal and may be modified or distinguished in the cases which are now pending in the Atlanta and San Francisco Districts. We therefore would meet with no positive assurance of what the law now is upon the contracts which are at present in force, and could not even make an intelligent guess at what the courts may decide with respect to contracts which might hereafter be drawn. It therefore seems to me that a conference

held after a final decision in the Lake City case, and perhaps after a decision in the cases effecting the Federal Reserve Banks of Atlanta and San Francisco, would be much more profitable than one held at the present time.

In addition to the above, it seems to me that the main source of our difficulties at present lie in a difference of view with respect to policy. There are three funds which might possibly be made applicable to the protection of cash letters. These are: (1) The reserve balance; (2) The collateral; (3) The surrender value of the stock.

I am, of course, persuaded that the decision of Judge Parker in the Lake City case is the correct interpretation of the contract existing between the Federal Reserve Bank of Richmond and its member banks, but I believe that all of us would concede that he is at least correct when he says that the question depends upon the construction of the circular. It should be fairly easy to prepare a circular which would make it clear that any reserve balance apparently due to a failed bank at the time of its failure should be applied to any unpaid cash letters regardless of whether or not the remittance system or charge system was used by a particular Federal Reserve bank. It would certainly be easy to provide by express words in the circular and Regulation that the reserve balance should not be chargeable with cash letters unless specific authority to make the charge was received and the charge made against an available balance sufficient to cover the letters before the failure.

The right of the Federal Reserve bank to hold the collateral is likewise merely a matter of contract. There can be no doubt that the Federal Reserve bank might make a contract under which the collateral was applicable to cash letters even though the Reserve bank had the right to charge these cash letters back to the depositors. In other words, the Federal Reserve bank might, by express contract, take and hold the collateral for the benefit of its depositors as well as for its own benefit and could provide that its own claims upon rediscounts and other matters should be preferred over the claims of persons interested in the cash letters so far as the collateral was concerned.

The application of the surrender value of the stock depends upon the construction of the Federal Reserve Act and no contract which could be made would alter the status of the surrender value. I am inclined to accept the decision in the Lake City Case as final upon this latter point, even though it appears to be contrary to Federal Reserve Bank v. First National Bank, 277 Fed. 300; but,

in any event, whether the Lake City case is on this point sound or not, nothing which could be inserted in the Regulations of the Board or in any circular would change the ultimate result.

It seems to me, therefore, that inasmuch as the present situation arises out of the possible differences in the interpretation of the circulars of various Federal Reserve banks, that there are three possible courses which may be adopted in the future.

All of the Federal Reserve banks may elect or be required by the Federal Reserve Board to adopt a uniform policy under which the reserve balances and the collateral will be applicable to cash letters; or the banks may elect or be required to adopt a policy under which neither of these funds can be applied to unpaid cash letters; or each bank may adopt one policy or the other as its own judgment determines. It is obvious that the decision upon these courses of action involves questions of policy rather than questions of law. If the Board intends to require all banks to adopt a uniform policy upon the points mentioned, then it should be fairly easy for you, with such assistance as Counsel for the Federal Reserve banks could give you, to prepare a regulation which would clearly and equivocably state the policy adopted. If the Board does not wish to require a uniform policy, then obviously the officers of each bank must determine for themselves the course which they will follow.

It therefore appears to me that very little could be accomplished by a conference of Counsel until the Board, which I assume would desire to confer with the Governors of the banks, had made a definite decision with respect to the questions of policy involved. When this decision was made, it then seems to me that a conference of Counsel would be most helpful as a means of embodying the decision in clear and unambiguous words.

With best personal regards, I remain,

Very truly yours,

(S) M. G. Wallace,
Counsel.

MGW L

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FEDERAL RESERVE BANK

OF

ST. LOUIS

February 20, 1929.

Mr. Walter Wyatt, General Counsel,
Federal Reserve Board,
Washington, D. C.

Dear Mr. Wyatt:-

Since writing to you on February 2, 1929, I have gone more carefully into the cases referred to in the correspondence passing between you and Judge Ueland relative to the Legal Rights and corresponding obligations of Federal Reserve Banks in their Clearing House operations with National Bank Receiverships.

In the case of THOS. A.EARLY, Receiver of the FARMERS & MERCHANTS NATIONAL BANK of LAKE CITY, S. C. vs. the FEDERAL RESERVE BANK OF RICHMOND (hereinafter referred to as the EARLY case) the Court had before it two separate causes of action - (1) - the recovery of the deposit account standing on the books of the Federal Reserve Bank - (2) - the surrender value of the stock in the Federal Reserve Bank and counter claim filed by the Reserve Bank on the unremitted for cash letters.

The District Court, after referring to the Regulation and Circular letter, found in favor of EARLY on both counts,

> "The charges made on account of the outstanding cash letters against the insolvent bank, I do not regard as proper allowances or deductions. The right of the Reserve Bank to make the charges terminated with the insolvency of the member bank." **** "The counter-claim of defendant is based on items in transit that were being handled by the Reserve Bank for collection. They were received for deferred credit, under regulations and check collection circulars which provide that the Reserve Bank will act only as agent for the bank from which it receives such checks. The items cannot be regarded as the property of the Reserve Bank. The circumstances shown in respect to the counter-claim make it clearly apparent that the claims upon which the suit is brought, and the claim set out by defendant in its counter-claim, do not arise between the parties in the same capacity."

On appeal, the Circuit Court affirmed the ruling of the District Court as to the second cause of action:

"On the second question, we do not think that the Reserve Bank has the right to set off the balance due by the insolvent bank on the checks against its stock liability. The Reserve Bank was not the owner of these checks. It was merely an agent for collection; and although it credited them to the accounts of the forwarding banks, this was upon agreement that they might be charged back if not collected, and the second lot of checks has been charged back. The stock liability is a liability created by statute which provides that it "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." 12 U.S. C. A. 288. It is perfectly clear that the liability of the insolvent member bank for these checks is a liability owing to the owners of the checks in which the Reserve Bank is not interested except as collection agent, and is not "a debt of the insolvent member bank to the Federal Reserve Bank" within the meaning of the statute.

Even in the absence of a statutory direction as to how the liability should be applied, a set off of checks held for collection against such a liability would not be allowed, for the reason that demands to be set off against each other must be mutual, that is they must be due to and from the same parties and in the same capacity."

The Circuit Court reversed the ruling of the District Court as to the first count:

"The checks were forwarded by the Reserve Bank to the insolvent bank under an agreement that they should be charged against its account at the expiration of three days, unless returned immediately. They were so sent because the owners for whom the Reserve Bank was acting as agent had consented to the arrangement. As a substitute for the right to have them presented through another bank and collected in cash, the owners had agreed that they be sent direct to the drawee under the agreement that if not promptly returned they be charged against the drawee's reserve balance. When, therefore, they were accepted by the drawee, the owners had the right to demand that they be charged against the drawee's account and that the balance in that account be applied by the Reserve Bank to their payment. The only question that can arise is when does this right of the owners of the checks become fixed so as to constitute it a charge upon the reserve balance. We think that it becomes so fixed when the drawee bank either unequivocally accepts the checks, as in this case, or by failing to return them promptly becomes chargeable with them under the terms of the agreement. " ******
And this right, we think, depends not upon the theory that the Reserve Bank is the owner of the checks or that it has the right of set off against the insolvent bank; but upon

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> the fact that the contract of the parties has created an equitable charge upon the reserve account of the drawee bank and that such agreement operates as an equitable assignment of so much thereof as may be necessary to pay the checks when they are unequivocally accepted by the drawee. Under familiar principles of equity, such an equitable charge upon a fund arises in favor of a party when he becomes entitled to have his claim paid from that fund."

It is apparent that the Circuit Court in arriving at the conclusion was governed by the Richmond circular and Regulations in force at the time, and the Richmond bank's method of operating under the 'Time Schedule Charge Account' exclusively - rather than under the 'remittance method' used in most of the other Reserve Banks. Based on the particular method in use by the Richmond bank the reasoning is logical, and, I believe the conclusions reached are sound and will be upheld by the Supreme Court.

Turning our attention now to the cases of KEYES, Receiver of the FIRST NATIONAL BANK of CLARKSFIELD vs. the FEDERAL RESERVE BANK of MINNEAPOLIS - not officially reported (hereinafter referred to as the CLARKSFIELD case)

The FEDERAL RESERVE BANK of MINNEAPOLIS vs. KEYES, Receiver of the FIRST NATIONAL BANK of EUREKA, 277 Fed. 300, and (hereinafter referred to as the EUREKA case); and,

The MIDLAND NATIONAL BANK of MINNEAPOLIS vs. the FIRST STATE BANK OF SIOUX FALLS, 222 N.W. 274, and (hereinafter referred to as the MIDLAND BANK and STATE BANK.)

In the CLARKSFIELD case the reserve bank had forwarded to the Clarksfield bank 'for collection and credit' a cash letter containing a number of items. The items were collected and credit given to the Federal Reserve Bank on the books of the Clarksfield bank on the 18th of September - the day they were collected - and, before the Clarksfield bank was closed on that date and its affairs were taken over by the Receiver, Keyes. At the time credit was given on the 18th, the balances of the Clarksfield bank in the Federal Reserve Bank were ample to sustain the credit. This balance was later augmented by the proceeds from the cancelled stock in the Federal Reserve Bank. After using so much of the augmented balances as were necessary to reimburse the Federal Reserve Bank for certain forged notes it held under rediscount from the Clarksfield bank the remaining augmented balances were applied on the outstanding cash letters.

It is apparent from the fact that the Clarksfield bank gave the Reserve Bank credit on its books for the funds collected on the day the collections were made, and, from the underscored lines in Paragraph 3 of the Minneapolis circular then in force, that the Minneapolis bank (like the Richmond bank) was operating under the "Time Schedule Charge Account" method exclusively:

> "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."

The Court, after quoting the Regulations and Reserve Bank Circular relative to collections, says:

"It is not ('not' evidently a typographical error) apparent that upon the clearance being had between the Clarksfield banks, defendant had the right to a credit with the First National Bank of Clarksfield 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 that amount in its own name and in its own right," and, if this is true it is clear it has had that right every since, and, therefore, has the right of setoff." **** "That the rights of the parties became fixed as of the time of the closing of the bank *** SCOTT vs. ARONSBURG. At that time the Reserve Bank had a right of action against the Clarksfield insolvent bank 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 unrestricted."

If the Minneapolis bank was operating exclusively under the "Time Schedule Charge Account" -as is apparent - the conclusions reached by the Circuit Court in the EARLY case would apply, and, while District Judge Morris arrives at the same conclusion over a different route, it would appear that if the Minnesota Statutes referred to give the agent the right to maintain the suit, then the reasoning used is sound and the result justified.

In the EUREKA bank case, the Eureka bank, at the time it closed, had under rediscount with the Reserve Bank a number of notes, and, just prior to closing it had collected a number of items forwarded to it by the Reserve bank for collection, and, attempted to remit by draft, uncollectible, because of the failure of the Eureka bank. Two questions were before the Court: (1st) - did the Reserve bank have to exhaust all means to collect from the makers of the notes before it was entitled to prove its claim against the trust and receive dividends? - (2nd) - Could the Reserve bank apply the balances it held as a set-off against the unpaid remittance draft?

The Court, after commenting upon the purpose of the Federal Reserve Act, answers the 1st question by holding that the EUREKA bank

was primarily liable on the rediscounted paper, and claim could be filed against the trust just as if the insolvent bank had been the maker instead of the endorser. Answering the 2nd question, the Court, after quoting the following from Regulation 'J'

> "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 the Federal Reserve Bank."
>
> Says - at page 304:
> "From the time of the promulgation of this rule, the credit of a member bank with its Federal Reserve bank was rightfully treated by the reserve bank as a fund to cover all checks received from or for its account by a member bank" ******
> "Immediately upon the refusal of the drawee bank to pay the remittance draft, the sum became a primary obligation of Defendant to the Plaintiff, which constitutes a valid claim against the Receiver."

In this case, the Federal Reserve Bank of Minneapolis seems to have been operating under the 'remittance' instead of the "Time Schedule Charge Account" plan and used in the CLARKSFIELD case, nevertheless, the Court holds that under the terms of the Reserve Act and the Regulations issued thereunder the Reserve bank had the right to make the charge against the balances of the EUREKA bank.

In the case of the MIDLAND BANK vs. the STATE BANK, the Midland bank was the correspondent of the State Bank - loaned it money and rediscounted paper for it. The State bank had given the Midland bank a pledge agreement whereby it was agreed that all securities deposited under the pledge, or, held by the Midland bank in any way, as well as the balances of the State bank, should be held by the Midland bank as security for any liability of the State bank to the Midland bank then existing or thereafter contracted. The Midland bank was using the State bank as its collection agent to collect all items payable in the territory of the State bank.

Under this arrangement, it forwarded to the State bank for collection and remittance a number of checks payable in the vicinity of the State bank. The State bank collected the items, and, attempted to remit the funds so collected by draft on the Midland bank and in its favor, and, failed before the draft reached the Midland bank. The State bank had no funds with the Midland bank to pay the drafts and the drafts were dishonored. The checks in question had been deposited by the depositors with the understanding that they would be immediately credited to the depositor's account but the depositors could not withdraw them until paid, and, if not paid, they would be charged back against the depositor.

Upon suit to foreclose on the collateral and apply the proceeds towards the payment of the uncollected remittance draft an objection was made that since the checks had been deposited with the Midland bank, under an agreement with the depositors that if not paid they could be

charged back to the depositors' account. The Midland bank was neither the owner nor under any legal liability to the owners; consequently, could not apply the proceeds derived from the sale of the collateral to paying the uncollected remittance draft. The Court, in passing upon this claim, says:

> "Whatever the rights between the depositors and the Plaintiff may be or would be if the plaintiff had not charged back the credits, the right of the plaintiff to foreclose the collateral and apply on the unpaid collection is clear.***Immediately upon the failure of the Sioux Falls bank to pay, the plaintiff had a cause of action against it for the amount which it had collected and did not pay. It had the legal title, so to speak, to dishonored drafts drawn by the Sioux Falls bank. Whatever right it had arose upon the failure of the bank to remit what it received, and its right was protected by the security of the pledge agreement."
>
> "The contention that the plaintiff, having charged back the credits against its customers cannot apply the collateral in discharge of the obligation arising from the default of the Sioux Falls bank, is without merit."

In the MIDLAND bank case there was neither circular nor Regulation governing this transaction. There was no contract between the MIDLAND bank and the STATE bank similar to the contract between the RICHMOND bank and the LAKE CITY bank, of which EARLY was Receiver, authorizing the items to be charged against the collecting bank's account, and, which contract the Court, in the EARLY case, held ran to the benefit of and was enforcible on behalf of the owners of the items involved. The Court, however, held that, notwithstanding the MIDLAND bank had the express right to charge the items back to the depositors, the STATE bank had actually collected the funds, released the drawers of the separate items, and, had attempted to remit by uncollectible draft; that the MIDLAND bank had the legal title to the dishonored draft which draft constituted an indebtedness to the MIDLAND bank covered by the pledge agreement and collectible out of the collateral.

It is hard to follow the reasoning in this case in establishing the right unless the Court was of the opinion that the MIDLAND bank - by accepting the draft instead of money - had become liable to the owners of the items for the loss occasioned by accepting the draft instead of money in payment, and, being so liable, had the legal right to the draft, and, right to a set off against the securities held under the pledge agreement.

I cannot believe that under the Federal Reserve Banks' clearing operations the MIDLAND bank opinion would apply. The debt is not one owing to the Federal Reserve bank. The agency is made so plain that no Court would hold the right to exist unless the express right is reserved in the pledge agreement to hold the excess collateral for the benefit of the owners.

What effect will the ruling in these cases have on Regulation 'J' as amended, effective February 1, 1929?

I believe that the answer to this question depends upon whether the Federal Reserve Banks follow the "Time Schedule- Charge Account" method in use by Richmond when the EARLY case arose, and, by Minneapolis when the CLARKSFIELD case arose, or, whether they follow the 'Collection and Remittance' plan in use in the other Federal Reserve Banks.

The Federal Reserve Bank of St. Louis has never considered that the 'at any time' charge account clause afforded any practical protection. It was only intended as a weapon to enforce prompt remittance and useless for the reason that whenever a member bank reached a condition that the weapon had to be used it was then too late to accomplish the intended purpose.

The Federal Reserve Bank of St.Louis has gone on the theory that the member bank in the first instance could pay in cash, or, remit by draft acceptable to the reserve bank; that a draft on a correspondent collectable on the day of receipt was acceptable; that a draft against the member bank's balances (if the balances justified the charge) was acceptable; that a telegraphic order of the member bank to charge its balances (if sufficient) with the sum collected in the particular instance had the same force and effect as a draft against sufficient balances; that whether the remittance was made by draft against the member bank's balances or by an order directing the charge against member banks balances, the only option the Reserve bank had was to reject the draft or the order when the member banks' balances were not sufficient to withstand the charge.

If this is the correct interpretation of the amended Regulation, it would follow that Federal Reserve Banks will have to discontinue the exclusive "Time Schedule Charge Account" method and we will not be bothered further by the ruling in the EARLY case.

If, on the other hand, the 'at the option of such Federal Reserve Bank to authorize such Federal Reserve bank to charge their reserve account" - which was left in the amendment, - is susceptible to an interpretation that the amended Regulation gives to the Federal Reserve bank the option to obtain from member banks blanket authority to charge the member banks' accounts with the funds collected, and, the Federal Reserve Bank, exercising this option, has obtained the blanket authority, then the Federal Reserve Bank would be in just the same position with reference to its rights and obligations as the Richmond bank was in, under the rule in the EARLY case before the amendment was made; and, further, if the amended Regulation is susceptible to this interpretation, might it not be plausibly argued with sufficient force to gain the ear of the Court that since the Regulation gives to the Federal Reserve bank the option to require the authorization to charge the member banks' balances with the collections, it is liable to the owner if in a particular instance it could have protected the owner by obtaining the authority and did not do so: THEREFORE, would it not be better for the several Federal Reserve Banks to get together on a Uniform Method, and adopt either the "Time Schedule Charge Account" method and reinstate the original Regulation - or, adopt the "Collection and Remittance" method exclusively, accepting in payment money, draft on its correspondent (collectible on day of receipt), draft against sufficient balances in the

Reserve bank, or a telegraphic or written order to charge the account when the balances justified the charge.

If the 'Collection and Remittance' method was adopted, would it not be better to leave the "at the option of such Federal Reserve Bank" out of the amendment entirely and have the amendment read:

> "Checks received by a Federal Reserve Bank on its member or non-member clearing banks will ordinarily be forwarded or presented direct to such banks, and, such banks will be required to remit or pay for them at par in cash or bank draft acceptable to the collecting Federal Reserve Bank."

Then to have the reserve bank circular provide that a draft against a correspondent bank is acceptable within the meaning of Regulation 'J' when it can be collected in money upon the day of receipt; that a draft against the reserve account of the member bank or the clearing account of the non-member bank is acceptable within the meaning of this Regulation when the books of the Federal Reserve Bank show sufficient funds in the account to justify the payment of the draft; that a telegraphic order from the member or non-member clearing bank to charge its account with the collection will be treated the same as a draft on its account.

My personal views are that, in the event the EARLY decision is affirmed and any of the banks continue to operate under the "Charge Account" instead of the "Collection and Remittance" method, we will be heading for trouble. Especially will this be true if the decision in the MIDLAND bank case is sound law.

Based on the 14 years' Clearing House operations, our observation in the 8th District shows that in practically every member bank failure, the reserves, stock cancellation proceeds, and all we can collect on collateral held under our Collateral Pledge Agreement, are rarely sufficient to more than take care of the insolvent bank's rediscount liability to the Federal Reserve Bank, and, if the right to charge the reserves, stock cancellation funds, and, proceeds received from the sale of the collateral held under the Collateral Pledge Agreement, are chargeable with the payment of unremitted for cash letters, there will not be sufficient funds to pay both.

How would the allocation of such funds be made as between the debt due to the bank on rediscount operations and the debt due the bank, as agent, for the owners of the unremitted for collection items?

Courts do not look with favor upon the transactionsof an agent holding a fund as security for a debt due the agent individually, and, a debt due him in his agency relation, preferring himself to the disadvantage of the person for whom he is acting as agent.

It is true that provision might be made in the pledge agreement to the effect that the proceeds derived from the Collateral Pledge should

first be applied to the rediscount and over-draft obligations, and, so much of the remainder (if any) as was necessary be applied towards paying outstanding unremitted for cash letters. The Pledge Agreement would probably solve the question of the allocation of the pledge funds, but, the same question would arise covering the reserve balances and the stock cancellation funds as between the discount indebtedness and the indebtedness on unremitted for cash letters.

We are familiar with the different holdings of the Courts on Commercial Law questions prior to the adoption of the Uniform Negotiable Instruments Act and the chaotic condition incident thereto, and, with how much assurance we can now advise a client as to his rights and corresponding obligations in Commercial Law matters.

We know from practical experience how hard it has been to get the Courts to recognize that the rights and corresponding obligations of Federal Reserve Banks operating under the Federal Reserve Board's Regulations and the Federal Reserve Banks' circulars, are different from the rights and corresponding obligations of Commercial bank's operating under the Negotiable Instrument Act.

Now that we have been able (in a limited degree) to gain the recognition of the distinction between a Commercial Bank's rights and obligations under the Negotiable Instruments Law and the Federal Reserve Banks' rights and obligations under the Federal Reserve Board's Regulations and banks circulars, we ought not to confuse the situation further by having two reserve banks, operating under the same Regulations and practically the same circular letter, operate under such entirely different methods as to enable the Courts in one District to rule one way and the Courts in another District to rule directly to the contrary on the same Regulations and Circular Letter.

It would therefore seem that a uniformity of action by the Federal Reserve Banks is highly desirable and you might say necessary if we would adopt the safest course.

Very truly yours,

(S) Jas. G. McConkey,
Counsel.

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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.

WW:vdb

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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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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?

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(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. 284

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.