COPY X-6590 428

May 2, 1930.

To: The Federal Reserve Board.

From: Mr. Wyatt, General Counsel.

SUBJECT: Conference of Counsel of Federal reserve banks to consider effect of decision of Supreme Court of United States in Early v. Federal Reserve Bank of Richmond and proposed amendments to Regulation J.

I respectfully recommend that the Board authorize me to call a conference of counsel of all Federal reserve banks to be held in Washington at the earliest convenient date for the purpose of :

(1) Considering the effect of the recent decision of the Supreme Court of the United States in the case of Thomas A. Early, Receiver, v. Federal Reserve Bank of Richmond, upon the rights, duties, and liabilities of the Federal reserve banks.

(2) To give further consideration to the proposed amendments to Regulation J recommended by the last Conference of Counsel, which have been adopted by the Board, but not yet made effective.

(3) To consider what other amendments, if any, to Regulation J should be adopted;

(4) To consider what changes, if any, should be made in the check collection circulars of the Federal reserve banks; and

(5) To confer with representatives of the Comptroller of the Currency with reference to the release of reserve balances of insolvent national banks to the receivers of such banks.

NECESSITY FOR CONFERENCE

A Conference of Counsel on the above subject has been requested by counsel for a number of the Federal reserve banks and by the Governor of one Federal reserve bank.

The decision of the Supreme Court in the above mentioned cases raises serious questions as to the rights, duties and liabilities of the Federal reserve banks in collecting checks and undoubtedly will result in a great

amount of litigation between the Federal reserve banks, the owners of checks on insolvent banks and receivers for insolvent banks. It is extremely important, therefore, that a Conference of Counsel for all Federal reserve banks be held at the earliest possible date to consider the above questions and to take or recommend such steps as may be necessary to clarify the rights and duties of the Federal reserve banks in connection with the collection of checks, to protect the Federal reserve banks against unwarranted liabilities, to reduce the possibilities of litigation, and to consider how such litigation as does arise may best be handled. This Conference should also endeavor to arrive at an understanding with the office of the Comptroller of the Currency on the question under what circumstances Federal reserve banks are justified in releasing to the receivers of insolvent national banks the reserve balances of such banks, in order to avoid litigation between the receivers and the Federal reserve banks and to avoid undue delay in the final liquidation of insolvent national banks.

The matters pointed out above render an early conference of counsel almost imperative. Even, in the absence of such matters, however, a conference would be justified by the benefits derived by this office and by Counsel for the various Federal reserve banks from an interchange of views on the various legal problems of the Federal reserve system. The conferences which have been held in the past have proven very beneficial and helpful to Counsel for the various Federal reserve banks and to this office, and I believe that such conference should be held at least once each year. More than a year has elapsed since the last conference.

THE EARLY CASE

This is the case which I have been calling to the Board's attention from time to time ever since October, 1927, and which, as early as February, 1928, the Conference of Counsel for all the Federal reserve banks said was

"fraught with most dangerous consequences to the entire Federal reserve collection system." It has been considered by two Conferences of Counsel, has been considered by the Governors' Conference a number of times, and for over three years has been a matter of serious concern to this office and to Counsel for all the Federal reserve banks.

The recent decision of the Supreme Court of the United States in this case brings the litigation to a close, but leaves the Federal reserve system in a position where it must carefully consider the effects of the decision and what steps should be taken to avoid dangerous and harmful results.

Facts

The essential facts considered by the Supreme Court and the points of law involved in the court's decision may be summarized briefly as follows:

The Federal Reserve Bank of Richmond was collecting checks on the so-called "charge system" as distinguished from the "remittance system" used by all of the Federal reserve banks except Richmond and Philadelphia. It had in its check collection circular a provision reading as follows:

> "Checks received by us drawn on our member banks will be forwarded in cash letters direct to such banks and each member bank will be required either to remit therefor in immediately available funds or to provide funds available to us to meet such cash letters within the agreed transit time to and from the member bank. Therefore, the amount of any cash letter to a member bank is chargeable against available funds in the reserve account of such member at the expiration of such transit time, which date will be shown on each cash letter. The right is reserved, however, to charge a cash letter to the reserve account of a member bank at any time when in any particular case we deem it necessary to do so."

The Federal Reserve Bank of Richmond forwarded certain checks to the Farmers and Merchants National Bank of Lake City, South Carolina, for collection. These checks were received by the Lake City Bank the next day, marked paid, and charged to the account of the drawers. Before the expiration of the time allowed for the collection of such checks, the Lake

City Bank failed without remitting to the Federal reserve bank for such checks and without specifically authorizing the Federal reserve bank to charge the amount thereof to its reserve account. After notice of the failure of the Lake City Bank, the Federal reserve bank charged the amount of such checks to its reserve account. The receiver of the Lake City Bank brought suit against the Federal reserve bank to recover the reserve balance of the Lake City Bank in the hands of the Federal reserve bank on the day the bank closed, claiming that any general authority which the Federal reserve bank may have had to charge such checks to the reserve account of the Lake City Bank was revoked by the insolvency of the Lake City Bank and that the charge which had been made was unlawful.

Decision

In an opinion rendered by Mr. Justice Holmes, the Supreme Court of the United States held that:

(1) All parties must be taken to have dealt upon the terms of the collection circular of the Federal Reserve Bank of Richmond.

(2) By this circular the Federal reserve bank reserved the right to charge checks to the reserve account whenever deemed necessary.

(3) "This power is reserved more obviously in the interest of the depositors of the checks than of the Richmond bank."

(4) "The existence of the power must be assumed to have been one of the considerations inducing the owner of the check to give the Richmond Bank authority to send it directly to the drawee."

(5) "All parties must be taken to have understood that in the event that happened it was the duty of the Richmond bank when it knew the facts to charge the reserve account of the South Carolina bank, and if so the accounts should be charged."

The Supreme Court, therefore, upheld the legality of the action of the Federal Reserve Bank of Richmond in charging such checks to the reserve account of the drawee bank after insolvency. Moreover, the court said that, under the circumstances existing in this case, it was the duty of the Federal Reserve Bank of Richmond to charge such checks to the reserve account of the drawee bank. By this remark, the court did exactly what I feared it would do and justified the fear expressed by the Conference of Federal reserve bank Counsel in February, 1928, when they adopted a solemn resolution saying that this case "is fraught with most dangerous consequences to the entire Federal reserve system."

Effect of Decision

The decision thus establishes three propositions:

(1) The relations of all parties interested in the collection of checks through the Federal reserve banks are fixed and determined by the provisions of the check collection circulars of the Federal reserve banks.

(2) In their check collection circulars the Federal reserve banks may reserve the right to charge checks to the reserve account of the drawee bank at any time.

(3) If they reserve such right, it is their duty to exercise the right for the protection of the owners of such checks.

It raises the question whether it is the duty of the Federal reserve banks to reserve such right for the protection of the owners of checks collected through the Federal reserve collection system.

In view of the fact that it has not been customary for Federal reserve banks to charge checks to the account of the drawee bank after insolvency, I feel certain that this decision of the Supreme Court will result in a great amount of litigation between the Federal reserve banks and the owners of checks handled by them for collection and possibly between the Federal

reserve banks and the office of the Comptroller of the Currency or receivers appointed by it.

In February, 1924, the Supreme Court of the United States decided the case of Malloy v. Federal Reserve Bank of Richmond, holding that a Federal reserve bank is liable for any loss resulting from the acceptance of a bank draft in payment for checks handled for collection instead of insisting upon the payment of such checks in cash. Although Regulation J and the check collection circulars of Federal reserve banks were amended in May, 1924, so as expressly to authorize the Federal reserve banks to accept bank drafts in payment for checks collected by them, that case has resulted in a great amount of litigation involving many of the different Federal reserve banks; and cases based upon the doctrine of the Malloy case are still pending in the courts.

I feel certain that history will repeat itself in connection with the Early case and that there will be a great amount of litigation. That this will be so is indicated by the fact that counsel for the Federal reserve banks are already receiving letters from attorneys representing the owners of checks on failed banks raising the question whether the Federal reserve bank is not liable for the losses on such checks in view of the decision of the Supreme Court in the Early case.

Matters to be Considered.

Under these circumstances, it is extremely important that the entire matter be given most careful consideration at an early date and that decisions be reached on the following questions:

(1) To what extent are Federal reserve banks liable for losses on checks heretofore handled in view of the decision in the Early case?

(2) What amendments, if any, should be made to Regulation J in order to clarify the legal rights and responsibilities of the Federal reserve

banks and if possible protect them from any unwarranted liability?

(3) What changes, if any, should be made in the check collection circulars of the Federal reserve banks for the same purposes?

(4) What should be the attitude of the Federal reserve banks with reference to releasing to receivers of insolvent banks the reserve balances of such banks where checks on such banks have been charged to the accounts of the drawers, but no remittances have been made to the Federal reserve banks?

(5) What defenses should be interposed to suits brought against Federal reserve banks based on the doctrine of the Early case? and

(6) What changes, if any, should be made in the practices of the Federal reserve banks in handling checks in the light of this decision?

I believe that these questions can best be considered at a Conference attended by the representatives of this office and by counsel for all of the Federal reserve banks and that such a conference should be held at the earliest convenient date.

UNIFORM POLICY AND AMENDMENTS TO REGULATIONS.

In view of the questions of law raised in the Early case and fearing that the Supreme Court could render a decision such as it recently did render, the Federal Reserve Board, on the recommendations of the Conference of Counsel, the Governors' Conference, and this office, adopted an amendment to Regulation J on December 11, 1928, which became effective February 1, 1929, and which eliminated from the regulation the provision thereof authorizing any Federal reserve bank " to reserve the right in its check collection circular to charge such items 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." As a result of this amendment to the regulation, the Federal reserve banks of Philadelphia and

Richmond abandoned the method of check collection which gave rise to the Early case and adopted the remittance system which for many years had been used by the other ten Federal reserve banks. This change in the regulation and the corresponding change in the check collection practice of Federal reserve banks reduces to some extent the danger of the Federal reserve banks being held liable for losses on checks under the doctrine of the Early case. I am under the impression, however, that some of the Federal reserve banks still reserve the right to charge checks to the reserve account of the drawee banks under certain circumstances; and, in view of the decision in the Early case, such banks probably are liable for any losses resulting from a failure to exercise this right.

At a conference of Counsel held in Washington in April, 1929, certain further recommendations were made with a view of protecting the Federal reserve banks against the possible consequences of the decision in the Early case. By a vote of 8 to 4 the conference recommended the adoption of a uniform policy with reference to check collections and the adoption of certain amendments to Regulation J. By a vote of 9 to 3, the Governors' Conference, which was in session at the same time, adopted the uniform policy recommended by the Conference of Counsel and recommended that the Federal Reserve Board adopt the amendments to Regulation J recommended by the Conference of Counsel.

On October 15, 1929, the Federal Reserve Board approved the uniform policy and adopted the proposed amendments to Regulation J, making the latter effective January 1, 1930. Before the amended regulations became effective, however, certain questions were raised as to the possible effect of the regulations on the right of Federal reserve banks to take special steps to protect themselves against liability in collecting checks under extraordinary and unusual circumstances; further differences of opinion

developed amongst the Federal reserve banks on this question; and on December 17, 1929, the Board voted to postpone indefinitely the effective date of the amendments to the regulation.

Advice of the postponement of the effective date of the amendments was telegraphed to all Federal reserve banks on December 17, 1929, and I was requested to prepare a circular letter confirming the telegram. I prepared and submitted to the Board a circular letter confirming advice that the effective date of the amendments to the regulations had been postponed indefinitely, but saying that this had no effect on the uniform policy. The Board has not yet taken any action on this circular letter and no further advice has been sent to the Federal reserve banks with reference either to the amendment to the regulation or the uniform policy. The amendments to the regulation have never become effective and the banks probably are uncertain as to whether or not the uniform policy is in effect.

I am not entirely satisfied with the proposed amendments to the regulation, and certain differences of opinion between individual counsel as to the best form of such amendments has arisen; but it is extremely important that some amendment designed to clarify the rights and responsibilities of Federal reserve banks and to protect them against any unwarranted liabilities under the decision in the Early case be adopted at the earliest possible date.

I believe, therefore, that a conference of Counsel should be called as soon as possible, in order to endeavor to iron out all differences of opinion as to the most appropriate amendments to the regulations. Other possible amendments to the regulation have also been suggested and it would be advisable to consider such other amendments at the same time in order that all necessary amendments to the regulations may be adopted at one time, thus avoiding frequent piecemeal amendments to the regulation.

DURATION OF CONFERENCE

In this connection, I desire to say that the differences of opinion at the conclusion of the last Conference of Counsel probably resulted in part from the fact that the conference was held at the same time as the Governors' Conference and the Conference of Counsel had to hurry in order to submit its recommendations to the Governors' Conference before that Conference adjourned. This did not allow sufficient time to adjust differences of opinion and work out compromises; and I believe that, if another Conference of Counsel is held to consider these questions, each counsel should be requested to come to Washington prepared to remain until all differences of opinion are ironed out or until it is clear that it is impossible to eliminate them.

Respectfully,

Walter Wyatt,
General Counsel.

WW:vdb