

## FEDERAL RESERVE BOARD

WASHINGTON

ADDRESS OFFICIAL CORRESPONDENCE TO  
THE FEDERAL RESERVE BOARD

X-7598

September 21, 1933.

SUBJECT: Liability of banks on deferred  
certificates issued to depositors.

Dear Sir:

There is inclosed herewith for your information a copy of a letter the Federal Reserve Board has addressed to the Auditor of Public Accounts of the State of Illinois with regard to the liability of certain banks in that State on deferred certificates issued to depositors who waive their right to demand immediate payment of a part of their claims against the bank.

Yours very truly,



L. P. Bethea,  
Assistant Secretary.

Inclosure.

TO ALL FEDERAL RESERVE AGENTS.

C O P YX-7598-a  
September 21, 1933.

Hon. Edward J. Barrett,  
Auditor of Public Accounts,  
State of Illinois,  
Springfield, Illinois.

Dear Mr. Barrett:

Reference is made to the conferences which you and members of your staff had with members of the Federal Reserve Board and the Board's staff on September 11, and 12, 1933, with regard to the obligation of reorganized State banks located in the State of Illinois on deferred certificates which they have issued to their depositors who have waived their right to demand immediate payment of their deposits. Reference is also made to your letter of September 12, 1933, inclosing copies of the Depositor's Agreement and the Deferred Certificate which have been used in the reorganization of the State Bank of Collinsville, Collinsville, Illinois. It is understood that the provisions of this agreement and certificate are substantially similar to the provisions of agreements and certificates which have been used in the reorganization of many other State banks in Illinois, and the Federal Reserve Board has given most careful and sympathetic consideration to the problems involved in this matter.

It has been observed that the Depositor's Agreement provides that, in lieu of payment in cash of 50 per cent of his deposit claim, the depositor will accept a deferred certificate issued by the bank for a like amount, payable out of future recoveries on segregated assets and the net profits of the Bank, and before any dividend or

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returns of any kind or character are payable to stockholders. The Deferred Certificate which is issued by the bank states that the bank agrees to pay the amount represented by the deferred certificate to the holder thereof solely out of the future net profits of the bank and recoveries, but, in all events, before the payment of any dividends to the stockholders of the bank. It further provides that, in the event of liquidation, the termination of the bank's business, the consolidation with or transfer of all or a major part of its assets to another banking institution prior to the payment of the deferred certificate, the holder of the certificate shall be entitled to share in the proceeds of the liquidation, sale, merger, or consolidation after liabilities of the bank to its depositors and other creditors shall have been paid or provided for and that, in any event, the holder of the certificate shall be entitled to priority over any of the stockholders of the bank.

In these circumstances, it seems apparent that a bank issuing such a deferred certificate assumes a definite obligation to pay the amount of such certificate at some time, and that there is no way by which it can be released from such obligation except by the consent of the certificate holder. The obligation of the bank for the payment of such deferred claim is a liability of the bank, to the same extent as the obligation of the bank to pay the claim of any depositor. The only differences between the two classes of claims are as to time of payment and preference of payment in the event of liquidation, and it

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seems clear that these differences do not justify a conclusion that there is no liability on the bank for the payment of the deferred certificates described above.

The Board has considered the suggestion which has been made that the stockholders of the bank have authorized the bank to act merely as agent in distributing to deferred certificate holders future recoveries and earnings, to which the stockholders would normally be entitled, and that, accordingly, the liability for the payment of such deferred certificates is on the stockholders of the bank rather than on the bank itself. However, it does not appear how this can be true, on the basis of the facts involved in the case presented, when the stockholders of the bank are not parties to any of the agreements but such agreements are between the bank itself and the depositors thereof. It may also be noted that there does not appear to be any way in which a stockholder can relieve a bank from its liability to pay the claims of depositors, but that a bank can only be relieved of such liability by the agreement of the depositor and in accordance with the terms of any agreement executed by the depositor. As noted above, the depositors here involved have not relieved the bank of the obligation to pay their deposits but have merely entered into agreements with the bank, permitting a deferment of payment of such claims.

After a careful consideration of all the circumstances involved in this matter, the Federal Reserve Board is of the opinion that a bank which issues deferred certificates such as the one inclosed

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in your letter of September 12, 1933, has a liability for the payment of such certificates.

Under the provisions of Section 9 of the Federal Reserve Act, a State bank may not be admitted to membership in the Federal Reserve System unless it has an unimpaired capital. Accordingly, in any case where a bank has issued deferred certificates of the kind described above and the amount of liability on such certificates, together with the other liabilities of the bank to depositors and other creditors, as compared with the amount of the assets of the bank, is sufficient to impair the bank's capital stock, it would not be eligible for admission to membership in the Federal Reserve System.

As suggested when you conferred with members of the Board, the fact that reorganized Illinois State banks may not at this time be eligible for admission to membership in the Federal Reserve System on account of an impairment of their capital, as a result of liability on deferred certificates of the kind described above, need not necessarily result in serious consequences to such banks. It is possible that these banks may obtain the benefits of the Federal Deposit Insurance Corporation and, while entitled to such benefits, eliminate their liability on deferred certificates and become eligible for admission to membership in the Federal Reserve System. It is understood that you have taken this matter up with the Federal Deposit Insurance Corporation.

It would seem that the liability of a bank on such deferred certificates might be eliminated by having the bank transfer all charged off assets to trustees for the benefit of deferred certificate holders and obtain from each certificate holder an agreement releasing the bank from any liability on such certificates and accepting, in lieu thereof, a certificate from the trustees entitling the certificate holder to a pro rata share of any recoveries from the charged off assets transferred to the trustees.

If deemed advisable, agreements might also be obtained from the stockholders of the bank to the effect that, until all certificates issued by such trustees have been paid in full, the stockholders will transfer to the trustees, for the benefit of the certificate holders, any dividends declared on their stock by the bank. The Board questions the advisability of a bank obtaining any such agreement from its stockholders, since it is apparent that, for a considerable period of time, any dividends on the stock of the bank will not be for the benefit of stockholders and that, for such period, the bank's stock will have little, if any, value from the standpoint of the earnings of the bank and, accordingly, will not be marketable. It appears questionable, therefore, whether on such a basis the people of the community will retain confidence in the bank so as to enable it to maintain or increase its deposits in competition with other banking institutions. The Board feels that, in any case of a reorganization of a bank where

the stockholders have done everything possible to discharge their obligation to the bank and to save the depositors from loss, the depositors are not equitably entitled to future earnings of the bank. However, there may be circumstances where the stockholders have not fully discharged their obligation and the depositors have already agreed to a plan of reorganization and accepted the obligation of the bank to conserve future net earnings for the benefit of depositors, until their claims are satisfied, which justify the execution of agreements by stockholders to turn over any dividends to deferred certificate holders, in lieu of the agreement of the bank to conserve earnings for the benefit of such certificate holders.

As you know, the State Bank of Collinsville, Collinsville, Illinois, is now a member of the Federal Reserve System, and the question involved in that case is whether the Secretary of the Treasury should issue a license to that bank to reopen as a member bank. This question is not one for the determination of the Federal Reserve Board, but, since it is understood that the liability of the bank on the proposed deferred certificates would substantially impair, if not entirely eliminate, its capital, it would not seem advisable to reorganize and reopen this member bank until its capital is restored. It is suggested that, in the case of the State Bank of Collinsville and similar cases, the procedure outlined in the first paragraph commencing on page five of this letter be followed prior to the reopening of the bank in order to eliminate the liability of the bank on deferred certificates and the consequent impairment if not entire elimination of its capital. Of course, as you know, this bank might voluntarily withdraw from membership in the Federal Reserve System and reopen as a nonmember State bank and, after its liability on the deferred cer-

tificates has been eliminated, apply for readmission to the Federal

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Reserve System. The Board feels, however, that it would be more desirable for such elimination of liability to be accomplished prior to the reopening of the bank.

The Board fully appreciates the efforts you are making to effect sound reorganizations of banks in your State, and it desires to be of all possible assistance to you in this connection. Accordingly, if there is any further information you desire or anything that properly can be done by the Board to be of assistance, it will be appreciated if you will advise the Board.

Very truly yours,

(Signed) E. R. Black

E. R. Black,  
Governor.