Indiana Law Journal

Volume 9 | Issue 5 Article 7

2-1934

Right of a Bank to Pledge its Assets as Security for a Public Deposit

RIGHT OF A BANK TO PLEDGE ITS ASSETS AS SECURITY FOR A PUBLIC DEPOSIT—The directors of a bank organized under the laws of Indiana as-

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[9] Higgins v. Block (1924), 216 Ala. 153, 192 So. 739; Bragg v. Ives (1927), 149 V. 482, 140 S. E. 656.

[10] Stoddard v. Snodgrass (1925), 117 Or. 262, 241 Pac. 73, 43 A. L. R. 1160; L. D. Pearson and Son v. Bonnie (1925), 209 Ky. 307, 272 S. W. 375; Westcott v. Middleton (1887), 43 N. J. Eq. 478, 11 Atl. 490.

[11] Dean v. Powell Undertaking Co. (1922), 55 Cal. App. 545, 203 Pac. 1015.

[12] Cunningham v. Miller (1922), 178 Wis. 22, 189 N. W. 531; Sair v. Joy (1917), 198 Mich. 295, 164 N. W. 507; Dillon v. Moran (1926), 237 Mich. 130, 211 N. W. 67; Beisel v. Crosby (1920), 104 Neb. 643, 178 N. W. 272; Meagher v. Kessler (1920), 147 Minn. 182, 179 N. W. 732; Osborn v. City of Shreveport (1918), 143 La. 932, 79 So. 542; Jordan v. Nesmith (1928), 132 Okl. 226, 269 Pac. 1096; Meldahl v. Holberg (1927), 55 N. W. 523, 214 N. W. 802; Turrelin v. Ketterlin (1924), 304 Mo. 221, 263 S. W. 202; Leland v. Turner (1924), 117 Kan. 294, 230 Pac. 1061; City of St. Paul v. Kessler (1920), 178 N. W. 171, 146 Minn. 124; Arthur v. Virkler (1932), 258 N. Y. S. 886, 144 Misc. 483.

[13] Cooley, Torts (1932, 4th ed.), vol. 3, sec. 435.

[14] (1923), 182 Wis. 148, 196 N. W. 451.

signed promissory notes which were part of the assets of the bank to certain stockholders and directors of the bank to indemnify them on a personal surety bond given for the purpose of securing deposits of public funds according to statute. The notes were left with the bank so that as the notes were paid by the makers, other notes of like amount could be substituted. At the time of the pledging of the notes, the bank was insolvent and subsequently a receiver took possession of the assets including the notes so pledged. The sureties, having been forced to pay on their bond, requested the receiver to turn over the notes so pledged, and upon his refusal this suit was brought for their recovery. No fraud or bad faith on the part of the bank in pledging the notes was shown. Held, that a bank had the power to so pledge such assets.[1]

Under the public depository act,[2] it is provided that a bank may secure a public deposit by presenting to the board of finance personal or surety company bonds, or in lieu of them, the bonds of any county of this state, bonds issued by any county of this state for the improvement of roads, or bonds of the United States. It is obvious in this instance, that the bank did not pledge such assets for security as are specifically named in the act. And thus the legality of such a pledge depends on whether the judiciary deems the pledging of assets to secure deposits as odious or desirable. For if we begin with the premise that the pledging of assets to secure a deposit is odious, then it follows that the bank may pledge only such assets as are set out in the act. But if on the other hand, we begin with the premise that such pledging is desirable, then it is immaterial what assets are pledged as long as the public funds are protected according to the act. Therefore, we arrive at the conclusion that the act is no guide and the question must be solved as if there was none on the subject.[3]

The question whether a bank may pledge its assets to secure a public deposit has frequently been before the courts for determination The authorities, outside of statutory authorization, are in sharp conflict; the numerical weight of authority being that the bank has the right to pledge its assets to secure a public deposit,[4] although the more recent and seemingly better considered cases hold to the contrary.[5] The majority view

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[1] Schornick v. Butler et al. (1933), 186 N. E. 326 denying petition for rehearing of former opinion in 185 N. E. 111 superceding previous opinion in 172 N. E. 181.

[2] Burns (1926) sections 12621 and 12622.

[3] 79 U. Pa. L. Rev. 608 (a comprehensive note).

[4] Williams v. Hall (1926), 30 Ariz. 581, 249 Pac. 755; Andrew v. Odebolt Savings Bank (1927), 203 Iowa 1336, 214 N. W. 559; McFerson v. National Surety Co. (1923), 72 Colo. 482, 212 Pac. 489; United States Fid. & Guar. Co. v. Village of Bassfield (1927), 148 Miss. 109, 114 So. 26; Ainsworth v. Kruger (1927), 80 Mont. 468, 260 Pac. 1055; Page Trust Co. v. Rose (1926), 192 N. C. 673, 135 S. E. 795; Grigsby v. Peoples' Bank (1928), 158 Tenn. 182, 11 S. W. (2nd) 673; Ward v. Johnson (1880), 95 Ill. 215; Cameron v. Christy (1926), 286 Pa. 405, 133 A. 551.

[5] Arkansas-Louisiana Highway Improvement Dist. v. Taylor (1928), 177 Ark. 440, 6 S. W. (2nd) 533; Commercial Banking and Trust Co. v. Citizens' Trust and G. Co. (1913), 153 Ky. 566, 156 S. W. 160; Farmers and M. State Bank v. Consolidated School Dist. (1928), 174 Minn. 286, 219 N. W. 163; Farmers State Bank v. Marshall County (1928), 175 Minn. 363, 221 N. W. 242; Divide County v. Baird (1927), 55 N. D. 45, 212 N. W. 236; Foster v. City of Longview (1930), 26 S. W. (2nd) 1059, (Texas); Austin v. County of Lamar (Texas 1930), 26 S. W. (2nd) 1062; Schornick v. Butler et al. (1930), 172 N. E. 181 (well reasoned opinion of the case under discussion); Parks v. Knapp (C. C. A. 1928), 29 F. (2nd) 547 (dicta

and the one adopted by the Indiana court expound three reasons why such a pledge should be upheld and these three reasons will be taken up in order.

First, the courts have used the following syllogism. A bank may pledge its assets to secure a loan, a deposit is a loan, and therefore a bank may pledge its assets to secure a deposit.[6] It is conceded that a bank has the power to borrow money and to hypothecate its assets in order to secure a loan,[7] but to say that a loan and a deposit are one and the same thing is not correct. A real difference between a deposit and a loan has always been assumed, as a matter of custom in the banking business itself, and in all legislation dealing with the subject.[8] The writer is cognizant of the Indiana case[9] holding that there is no distinction between a loan and a deposit but the error in such reasoning is obvious. A bank is allowed to accept loans of money although knowing of its insolvency[10] and if there is no distinction between a loan and a deposit, then a bank can receive deposits when conscious of its insolvency, although in contravention to statute expressly prohibiting such a procedure.[11] It is true that both a deposit and a loan gives rise to the relation of debtor and creditor,[12] but that does not mean that they are the same thing. A deposit is a transaction peculiar to the banking business and one that the courts should recognize and deal with according to commercial usage and understanding. The parties deal with each other on a basis, not merely that of borrower and lender, but on the basis that the party receiving the money is a bank organized under the law and subject to the provisions of the law and in the belief that such provisions respecting the custody of the deposit will be observed.[13] Further, in their inception, the two are different; the

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in accord); Bliss v. Pathfinder Irrigation Dist. (1932), 122 Neb. 203, 240 N. W. 291; State Bank of Commerce of Brockport v. Stone (1933), 261 N. Y. 175, 184 N. E. 750; Texas & P. Ry. Co. v. Pottorff (C. C. A. 1933), 63 F. (2nd) 1; Smith v. Baltimore & O. R. Co. et al. (D. C. 1931), 48 F. (2nd) 861 and affirmed (C. C. A. 1932) 56 F. (2nd) 801; United States Senate Report No. 67, 71 Cong. Second Session; 79 U. Pa. L. Rev. 608; 42 Harv. L. Rev. 272; 22 Ill. L. Rev. 449; 41 Yale L. J. 1076; 77 U. Pa. L. Rev. 916; 18 St. Louis L. Rev. 259.

[6] Schornick v. Butler et al. (Indiana Supreme Court 1933), 186 N. E. 326; Williams v. Hall (1926), 30 Ariz. 581, 249 Pac. 755; Grigsby v. Peoples' Bank (1928), 158 Tenn. 182, 11 S. W. (2nd) 673.

[7] Coats v. Donell (1883), 94 N. Y. 168; Sibley State Bank v. Ex-change National Bank (1925), 159 La. 214, 105 So. 294; Harris v. Randolph County Bank (1901), 157 Ind. 120, 60 N. E. 1025; Citizens' Bank v. Waddy Bank, 126 Ky. 169, 103 S. W. 249.

[8] Divide County v. Baird (1927), 55 N. D. 45, 212 N. W. 236; Carter v. Brock (1926), 162 La. 12, 110 So. 71; 27 Col. L. Rev. 88.

[9] Harris v. Randolph County Bank (1901), 157 Ind. 120, 60 N. E. 1025.

[10] See Chief Justice Treanor's dissent to case under discussion in 185 N. E. at page 113.

[11] Burns (1926), section 2479.

[12] Union National Bank v. Citizen's Bank (1899), 153 Ind. 44, 54 N. E. 97; Shofert v. Indiana National Bank (1908), 41 Ind. App. 474, 83 N. E. 515; Olinge v. Sanders (1931), 92 Ind. App. 358, 174 N. E. 513.

[13] Boyd et al. v. Schneider et al. (C. C. A. 1904), 131 F. 223; Elliott v. Capital City State Bank (Iowa 1905), 103 N. W. 777; Farmers and Merchants State Bank v. Consolidated School Dist. (1928), 174 Minn. 286, 219 N. W. 163; Arkansas-Louisiana Highway Improvement Dist. v. Taylor (1928), 177 Ark. 440, 6 S. W. (2nd) 533; Leach v. Bazely (1926), 201 Iowa 337, 207 N. W. 374; Allibone v.

lender deals with the bank reasonably supposing that the bank is in pressing circumstances or it would not have demanded his aid, while a depositor entrusts the bank with his money depending upon its apparent solvency and ability to repay.[14]

Secondly, the courts adopting the majority view have said that the private depositor has no reason to complain as the amount received as a deposit is equal, if not more, than the assets hypothecated, thus they are benefited by having the bank more liquid, inasmuch as it has now cash rather than securities.[15] While this reasoning is at first tinged with a semblance of persuasion, it is not very satisfactory after further examination. As long as the bank is solvent, there is little fault to find with such a pledge, but the validity of it is never assailed until the bank has become insolvent. And in that event, it means that the repayment of the secured deposit will be insured by the other and unsecured depositors, for manifestly, a pledge, in the event of insolvency, would reduce the assets available to pay the general depositors by the amount or value of the pledged securities.[16]

Lastly, it is argued that it is not against public policy for a bank to pledge it as assets to secure a deposit.[17] But it is indeed difficult to comprehend that a scheme whereby large depositors, if secured, might absorb a large part of the assets of a bank, inflicting loss upon unsecured depositors, and a scheme, the publicity of which the bank could not stand, is not against public policy. For if it were known that a bank was in such a practice, no prudent person would deposit his money therein without security, and the very fact that the transaction cannot stand the test of publicity is a strong argument against its legality.[18] The laws have been framed to secure a fair, honest, and uniform dealing by the bank with all its depositors and a practice whereby the favored few would be protected at the expense of the equally deserving others should not be tolerated.[19]

Ames (1896), 9 S. D. 74, 68 N. W. 165; Law's Estate (1891), 144 Pa. 499, 22 Atl. 831; Foster v. City of Longview (Texas 1930), 26 S. W. (2nd) 1059.

[14] Farmers and Merchants State Bank v. School Dist. (1928), 174 Minn. 286, 219 N. W. 163; Hunt v. Hopley (1903), 120 Iowa 695, 95 N. W. 205; 18 St. Louis L. Rev. 256.

[15] Page Trust Co. v. Rose (1926), 192 N. C. 673, 135 S. E. 795; Grigsby v. People's Bank (1928), 158 Tenn. 182, 11 S. W. (2nd) 673; Schornick v. Butler et al. (Ind. 1933), 186 N. E. 326.

[16] Smith v. Baltimore and O. Ry. Co. et al. (D. C. 1931), 48 Fed. (2nd) 861, affirmed in (C. C. A. 1932), 56 Fed. (2nd) 801; Divide County v. Baird (1927), 55 N. D. 45, 212 N. W. 236; Commercial Bank and Trust Co. v. Citizen's Trust and Guaranty Co. (1913), 153 Ky. 566, 156 S. W. 160; Hougen, The Right of Banks to Pledge Their Assets to Secure General Deposits (1928), 2 Dak. L. J. 68; 2 Dak. L. J. 258.

[17] Divide County v. Baird (1927), 55 N. D. 45, 212 N. W. 236; Commercial Bank and Trust Co. v. Citizens' Trust and Guaranty Co. (1913), 153 Ky. 566, 156 S. W. 160; Schornick v. Butler et al. (Ind. 1933), 186 N. E. 326; Cameron v. Christy (1926), 286 Pa. 405, 133 Atl. 551; Grigsby v. Peoples Bank (1928), 158 Tenn. 182, 11 S. W. (2nd) 673.

[18] Divide County v. Baird (1927), 55 N. D. 45, 212 N. W. 236; Commercial Bank and Trust Co. v. Citizens' Trust and Guaranty Co. (1913), 153 Ky. 566, 156 S. W. 160.

[19] Commercial Bank and Trust Co. v. Citizens' Trust and Guaranty Co. (1913), 153 Ky. 566, 156 S. W. 160; 22 Ill. L. Rev. 449.

Thus, when a legislative act is susceptible of a dual construction, one of which secures equality and fair dealing and the other paves the way to the perpetration of fraud, no court should hesitate to adopt that construction insuring fair dealing.[20]

The Indiana court also goes on to say that for a disclosure of the public policy of the state, legislative enactments are the safest guides and the fairest in that they operate prospectively and as a guide to future negotiations.[21] Such statement is taken without objection for if we are to examine the legislative intent, made manifest in the statutes governing the business of banking, we would find that practically every possible safeguard is thrown up around the rights of the general depositors; as for instance, criminal liability of officers of bank fraudulently receiving deposits while insolvent,[22] double liability of stockholders,[23] provision for publication of sworn statements as to the bank's condition made at regular intervals,[24] stipulation that assignments with a view of preferring creditors are void,[25] and a requirement that a surplus fund should be kept.[26] As all important functions of the banks are carefully limited and regulated so as to enable complete examinations by state examiners, it would be unreasonable to assume that the legislature would recognize the existence of so vital a power as that to pledge assets to secure deposits and yet fail to provide for its supervision.[27]

The same reasoning and argument should be applicable to the pledging of assets to secure deposits of individuals and private corporations. In fact, the writer is of the opinion that the pledging in these instances would be more odious than in the case of public deposits because of the more probable collusion between the depositor and the officials of the bank. In recent years, statutes have been passed in various states to the effect that a pledge of assets by a bank to secure a private depositor is void.[28] But it would seem that such a result should be reached without a statute and the majority of the recent cases have so held.[29]

In conclusion, the writer wishes to state, that although he is fully cognizant of the authority supporting the decision in the instant case, yet he feels that the contrary view is more in line with business practices and with the manifest public policy to protect the small depositor. S. E. M.

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[20] Commercial Bank and Trust Co. v. Citizens' Trust and Guaranty Co. (1913), 153 Ky. 566, 156 S. W. 160.

[21] Schornick v. Butler et al. (Ind. 1933), 185 N. E. 111.

[22] Burns (1926) section 2479.

[23] Burns (1926) section 3858.

[24] Burns (1926) section 3870.

[25] Burns (1926) section 3866.

[26] Burns (1926) section 3867.

[27] 22 Ill. L. Rev. 449.

[28] Idaho Sess. Laws (1925) c. 133, No. 39; Minn. Laws (1927) c. 257; N. D. Laws (1925) c. 92, No. 1; S. D. Laws (1919) c. 124, p. 109; Ore. Sess. Laws (1921) c. 17, p. 45; Utah Comp. Laws (1917), No. 1006; Kan. Rev. Stat. (1923) c. 9, No. 142.

[29] Parks v. Knapp (C. C. A. 1928), 29 Fed. (2nd) 547 (dicta); State Bank of Commerce of Brooksport v. Stone (1933), 261 N. Y. 175, 184 N. E. 750; Texas & P. Ry. v. Pottorff (C. C. A. 1933), 63 Fed. (2nd) 1; Smith v. Baltimore & O. R. R. (D. C. 1931), 48 Fed. (2nd) 861, affirmed in (C. C. A. 1932) 56 Fed. (2nd) 799.