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COMMENT / Legal Aspects of Commercial Bank
Issuance of Subordinated Debt*

Section I: Introduction

In recent years, corporations seeking to expand their capital base have found a tremendous market for subordinated debt securities among insurance companies, pension trusts, and other long-term investors.1 Surprisingly, however, the legal implications of this type of financing have received relatively little attention from commentators; commercial bank issuance of these instruments has occasioned even less.2 This comment will discuss the use of subordinated debt instruments by commercial banks.3 The concept, origin and

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1. A review of securities offerings placed through underwriters in the first half of 1967, shows that United States corporations sold over $1,680,000,000 of subordinated debentures on the domestic market. See Investment Dealers' Digest, Aug. 11, 1967, at 25-43.

2. Several excellent articles have dealt with the economic aspects of bank issuance of subordinated debt. See generally citations in Section III infra. But thus far there has been no treatment of the legal aspects of this relatively new phenomenon in banking.

3. The term “commercial bank” identifies financial institutions which hold demand deposit accounts, transferable by check, which are used as money or means of payment. These institutions should be distinguished from savings and loan associations, mutual savings banks, credit unions, etc., none of which holds demand deposits and all having a more limited scope of financial services than the commercial bank.

As they are known today, commercial banks perform three basic functions: (1) acting as administrators of the money supply, (2) creating new money, and (3) lending. In addition, they provide savings and other time deposit facilities, administer estates through their trust departments, act as insurance agents and underwriters, provide brokerage and mortgage banking services, and perform numerous other services incidental to their primary financial activities.

For an informative compilation of material comparing commercial banks with the numerous other types of financial institutions. See Staff of Subcomm. on Domestic Finance, House Comm. on Banking and Currency, 88th Cong., 2d Sess., Comparative Regulations of Financial Institutions (Subcomm. Print 1963).
prevalence, advantages and disadvantages, and legality of "capital notes" or "debentures"—the "debt that serves as equity"4—will be explored.

Banking is a unique industry in many ways. Unlike other corporations, banks do not exist merely for the sake of their shareholders. They are intimately involved with the general public interest through their depository and money-creating characteristics; their efficient functioning is vital to a strong economy. As a consequence, close governmental supervision of the banking industry has been a constant political pattern since the Civil War. In 1863, the establishment of the National Banking System under the jurisdiction of the Comptroller of the Currency,5 created our unique "dual banking system"6 of state chartered and federally chartered banks (state banks and national banks, respectively). Subsequent legislation added more federal supervisors—the Board of Governors of the Federal Reserve System (the Fed)7 and the Federal Deposit Insurance Corporation (F.D.I.C.).8

5. The Office of the Comptroller of the Currency was created as a bureau of the Treasury Department by the National Currency Act of 1863, 12 Stat. 665. The Currency Act was revised in toto by the National Bank Act of 1864, 13 Stat. 99.
6. This term is used to explain the curious anomaly existing in this country whereby banks are independently chartered and supervised by both the federal government and the individual states. The system is praised by many as the result of great insight by our forefathers who saw that this supervisory structure would create a competitive spirit leading to constant improvement of each system and redounding to the benefit of the public generally. In fact, the dual banking system is the result of a miscalculation by the framers of the early federal banking legislation. A prohibitive tax placed on state bank notes in 1865 was intended to force them out of circulation. Proponents of this measure thought that all state banks would convert to the national banking system in order to retain their note-issuing privileges and that one national banking system would thus result. Instead, the state banks found that they could survive and profit on deposit banking alone. The dual banking system has prospered since that time. For further discussion of the early banking history of this country, see P. Cagan, The First Fifty Years of the National Banking System—An Historical Appraisal, in Banking and Monetary Studies 15 (D. Carson ed. 1965).
7. The Federal Reserve System was created by the Federal Reserve Act, 38 Stat. 251 (1913), 12 U.S.C. §§ 221-26 (1964). The Fed is composed of twelve regional Federal Reserve Banks which operate under the general supervision of the Board of Governors in Washington, D.C. The Board has extensive supervisory authority over banks which belong to the System (member banks). By virtue of the fact that all national banks must be members, certain jurisdictional disputes between the Comptroller and the Fed have arisen over the years.
8. The Federal Deposit Insurance Corporation was created by the Banking Act of 1933, 48 Stat. 168, 12 U.S.C. § 263 (1964), to pay the depositors of failed banks the amount of their insured deposits. Insurance, initially limited to $2,500 for each depositor, has recently been raised to $15,000. In addition to its role as insurer, F.D.I.C. is named, pursuant to 64 Stat. 884 (1950), 12 U.S.C. § 1821 (c) (1964), as receiver in all national bank liquidations, and has been granted extensive supervisory power over state banks which wish to acquire deposit insurance. For enumeration of these powers, see generally 12 U.S.C. §§ 1811-31 (1964).

The supervisory powers of the F.D.I.C. are substantially enhanced by the policy of most
three agencies all have supervisory responsibilities under the federal statutory scheme; however, each one has a distinct mission which colors its approach to banking problems. The Fed is primarily a monetary authority; the F.D.I.C., an insurance agency. Only the Comptroller is primarily concerned with the structure and powers of national banks. The system is further complicated by the fact that state chartered banks (comprising more than 60 percent of the country's commercial banks) are subject to primary regulation by state banking authorities, in addition to regulation by the Fed and/or the F.D.I.C.

It is, therefore, not surprising that in some cases the jurisdictional boundaries of bank regulatory agencies have become blurred. Those situations where more than one supervisory authority may interpret the same statute with respect to a bank's activities have led to conflicts of interpretation and jurisdictional confusion. In fact, the question of the proper function of subordinated debt in banking was recently the subject of dispute among the federal bank regulatory agencies.9

The complexity of the banking structure, when coupled with the topic of subordinated debt, compels the elimination of all possible collateral issues from our consideration. Consequently, this discussion will concentrate primarily upon national bank issuance of subordinated debt. These banks operate under a single federal law, as opposed to the diverse state laws; consideration of the provisions of this single statutory scheme should help to focus attention within a manageable framework. While reference will be made to state law, this will generally be for purposes of illustration and clarification rather than detailed discussion.

The powers which national banking associations (corporations) possess are limited to those expressly conferred or fairly implied by the statutory scheme under which they are incorporated.10 The provisions of 12 U.S.C. §24 (Seventh) and 12 U.S.C. §21 serve as the basis for the implied powers of national banks.11 The theory of these implied powers will be dealt with at some length, since borrowing authority is derived by implication and the issuance of capital notes or debentures is necessarily tied to the power to borrow.

Since subordination agreements of the type to be discussed become operative within the context of insolvency proceedings, the receivership situation

must also be considered. A further complication in the discussion of bank issuance of subordinated debt is created by the express exclusion of banks from coverage under the National Bankruptcy Act, the statute which governs proceedings in most insolvencies. A significant body of case law in the area of subordination has developed under this Act. In contrast, there is no significant case law on the effect of subordinated debt in the event of bank insolvency. It will be necessary, therefore, to analogize from precedents under the Bankruptcy Act to the insolvent bank situation in order to determine the legal positions of the parties where subordinated debt has been issued by a commercial bank.

Section II: The Concept of Subordination and Types of Agreements

Types of Subordination

Subordinated notes or debentures ("capital notes" or "capital debentures" in banking parlance) are a species of the general category of senior securities. Other types of instruments within this classification are mortgage bonds and preferred stock. The latter types of senior securities will not be discussed here, since they generally do not involve the concept of subordination.

A debenture is a bond unsecured by a lien or mortgage against the firm's assets. It is a general obligation of the corporation and holds the same position as obligations to other general creditors. The primary factor that distinguishes a subordinated debenture from an ordinary debenture is the subordination agreement. The basic concept of subordination is quite simple; it is the placement of an indebtedness (subordinate debt) in a position which is subordinate and junior in right of payment to another indebtedness (senior debt) of the common debtor.

The concept of the subordination of a creditor's repayment rights is not new. It has long been used by equity courts as a means of balancing the interests of various creditors of an insolvent debtor; however, subordination

13. The difference between notes and debentures is one of form only. Technically, notes are two party instruments between the issuer and purchaser while debentures are issued to a trustee for the benefit of more numerous lenders. In this comment, as in actual practice, the two terms will be used interchangeably.
17. While the idea of subordination was established in equity, care must be taken not to treat contractual subordination merely as a species or extension of the doctrine of equitable subordination as enunciated in Pepper v. Litton, 308 U.S. 295 (1939) and Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939) (the "Deep Rock" case). Such a treatment was apparently espoused in Herzog & Zweibel, The Equitable Subordination of Claims in Bankruptcy, 15 VAND. L. REV. 83, 92 (1961) and followed by the district court in In re Credit Industrial Corp., 250 F. Supp. 582 (S.D.N.Y. 1966). The circuit court opinion in this case, quoted on point in text at note 178 infra, presents a clear distinction between equitable and contractual subordination.
as treated here does not refer to this type of court-created and enforced equitable subordination. Rather, this comment will discuss contractual subordination, that is, subordination which arises by virtue of a specific agreement between the common debtor and the subordinated creditor, not made in contemplation of bankruptcy, and drawn in favor of other specified creditors who by virtue of the agreement become senior creditors. Limiting the scope of our inquiry still further, this comment will discuss only that type of contractual subordination known as *inchoate* or *ab initio*\textsuperscript{18} subordination. The distinctive characteristic of an ab initio subordination agreement is that the subordination is activated only in the event of any insolvency, bankruptcy, or dissolution proceedings of the debtor. This type of subordination agreement provides for periodic payments of interest to the subordinated creditor and frequently provides either for payment into a sinking fund or direct principal reduction during the term of the agreement. Exempted from discussion here is a type of contractual subordination known as *complete* or *subsequent* subordination, wherein the common debtor is normally precluded from making any payments whatsoever on the subordinated debt until the senior debt has been completely discharged.\textsuperscript{19}

**Common Provisions of Subordination Agreements**

In national bank subordination agreements, which account for the vast majority of the outstanding amount in bank capital notes,\textsuperscript{20} the following is a fairly typical subordination provision:

Anything in this Note to the contrary notwithstanding, the indebtedness evidenced by this Note shall be subordinate and junior in right of payment, to the extent and in the manner hereinafter set forth, to all obligations of the Bank to customers or depositors of the Bank as such, obligations under banker's acceptances and letter of credit, obligations arising out of transactions in federal funds

\textsuperscript{18} The terms are used by Calligar and Everett, *supra* note 16, respectively, with Everett, who had the last word, characterizing the term inchoate as inappropriate, since subordination provisions become binding when the subordinated debt is issued. Everett, *supra* note 16, at 956 n.8. Everett's criticism of the term seems sound when it is recognized that these are agreements to subordinate which are fully in existence, requiring nothing to be done to perfect the rights created, even though those rights are subject to a future contingency, i.e., insolvency, dissolution, etc. Another author has characterized the type of subordination agreements which we will discuss in this paper as "major league subordinations." See Golin, *Debt Subordination as a Working Tool*, 7 N.Y.L.F. 370, 372 (1961).

\textsuperscript{19} Golin, *supra* note 18, refers to this type of subordination instrument as "minor league subordination" and characterizes it as having application principally to medium size, privately owned corporations and being employed mainly to obtain short-term revolving credit. He speaks of this type of subordination as frequently encompassing such types of easily subordinated debt as loans due to officers or stockholders.

\textsuperscript{20} Of the total of $1,350,290,000 of capital notes and debentures issued by commercial banks during the period June 1963 through September 1966, national banks issued $857,365,000 of these debt securities. *The American Bankers Association, Use of Senior Capital by Commercial Banks* 53-70 (1967).
and inter-bank credit facilities, and (except as to any funded debt) its obligations to its other creditors, whether outstanding at the date of this Note or incurred after the date of this Note (such indebtedness of the bank to which the Notes are subordinate and junior being sometimes herein referred to as "Superior Indebtedness") in that:

In the event of any insolvency proceedings, or any receivership, liquidation or other similar proceedings in connection therewith, relative to the Bank or its creditors, as such, or to its property, and in the event of any proceedings for voluntary or involuntary liquidation, dissolution or other winding up of the Bank, whether or not involving insolvency, then the holders of Superior Indebtedness shall be entitled to receive payment in full of all principal and interest on all Superior Indebtedness before the holders of subordinate indebtedness shall be entitled to receive for application in payment thereof any payment or distribution of any kind or character, whether in cash or property or securities, which may be payable or deliverable in any such proceedings in respect of the Notes, except payments or distributions made to holders of the Notes under a lawful plan of reorganization of the Bank approved by final judgment or order of a court or agency having lawful jurisdiction to effect such reorganization which provides for payment to holders of Superior Indebtedness of cash, property or securities fairly and equitably reflecting in accordance with law the prior rights hereby conferred on such holders.

This language constitutes the basic subordination provision. The primary object of such a provision is that, in the event of any proceeding for voluntary or involuntary liquidation, dissolution, or other winding up of the affairs of the bank, whether for insolvency or for any other reason, the holders of the superior indebtedness will be entitled to receive full payment of principal and interest on any amounts owing to them by the bank, before the holders of the notes will be entitled to receipt of any payment of principal or interest thereon. The expansive language of the subordination provision, i.e., "...any proceedings for voluntary or involuntary liquidation, dissolution or other winding up of the Bank, whether or not involving insolvency..." would appear to raise a possible problem for a bank which wishes either to merge or to sell all or substantially all of its assets in a purchase-assumption agreement with another bank. In actual experience, however, this problem has not materialized in view of other language in the typical bank subordination agreement which provides that "...in the event the bank wishes to consolidate or merge with or into another corporation or convert or sell or transfer all or substantially all of its property and assets..." the bank will do so in accordance with a provision which stipulates that any such consolidation, merger, conversion, sale, or transfer shall be upon condition that:
(a) the due and punctual payment of the principal, premium, and interest on the Notes according to their terms and the due and punctual performance and observance of all the terms, covenants and conditions of the agreement or indenture to be kept or performed by the bank shall be assumed by the corporation formed by or resulting from or surviving any such consolidation or merger or conversion or which shall have received the transfer of all or substantially all of the property and assets of the bank as fully and effectually as if such successor corporation had been the original party of the first part and (b) such successor corporation shall be a banking institution subject to supervision or examination by state or federal authority.

In addition to the above provisions, the following is usually added:

No present or future holder of Superior Indebtedness shall be prejudiced in his right to enforce subordination of the Notes by any act or failure to act on the part of the Bank. The provisions of this section are solely for the purpose of defining the relative rights of the holders of Superior Indebtedness on the one hand and the holders of the Notes on the other hand, and nothing herein shall impair, as between the Bank and the holders of any Note, the obligation of the bank, which is unconditional and absolute, to pay to the holders thereof the principal, premium, if any, and interest thereon in accordance with its terms, nor shall anything herein prevent the holder of a Note from exercising all remedies otherwise permitted by applicable law or hereunder upon default hereunder, subject to the rights, if any, under this section of holders of Superior Indebtedness to receive cash, property or securities, otherwise payable or deliverable to holders of the Notes.

The intent of this clause is clearly to emphasize the fact that the bank's obligation to pay the subordinated debt in accordance with its terms is unconditional and absolute. The language is intended to eliminate any doubt that the holders of the subordinated debt are creditors of the bank, not owners or holders of common equity. Also, this is intended to prevent any inference that superior creditors can in any way be prejudiced in their right to enforce the subordination of the subordinated debt by virtue of the bank's acts or failures to act.

The following provision has appeared in relatively few bank capital note agreements; however, the holders of senior indebtedness would do well to insist upon this wording since it precludes any possible arguments as to the relative position of the parties at the time of insolvency.

The Bank agrees, for the benefit of the holders of Superior Indebtedness, that in the event any Note is declared due and payable before its expressed maturity because of the occurrence of a default hereunder, all Superior Indebtedness shall, to the extent permitted
by law, forthwith become immediately due and payable upon de-
mand regardless of the expressed maturity thereof.

This language gives the holders of the superior indebtedness a basis for ac-
celerating the maturity of the senior debt by demanding its payment. Of
course the purpose of the provision is to enable the holder of the superior
indebtedness to prove a matured claim at the same time that the holder of
the defaulted subordinated debt is entitled to prove a matured claim.

Recall that the typical subordination provision set out above specifically
excepted "funded debt" from the category of senior indebtedness and thus
from subordination by capital note holders. The following is a typical defi-
nition of "funded debt" (sometimes referred to as "long-term debt"):

The term 'funded debt' shall mean all indebtedness of the Bank
for borrowed money, whether secured or unsecured, having a final
maturity (or which is renewable or extendable at the option of the
obligor for a period ending) more than one year after the date of
creation thereof, notwithstanding the fact that payments in respect
of the principal thereof are required to be made by the obligor less
than one year after the date of creation thereof. Notwithstanding
the foregoing, the term 'funded debt' shall not include any liability
or obligation of the Bank, incidental to or incurred in the course of
its banking or trust business as from time to time constituted, with
respect to (1) any deposits with it or funds collected by it, (2) any
bankers’ acceptance or letter of credit, (3) any check, note, certifi-
cate of deposit, money order, traveler’s check, receipt, draft, bill of
exchange issued, accepted or endorsed by it, (4) any discount with,
borrowing from, or other obligation to, any Federal Reserve Bank,
(5) any agreement made by the Bank to purchase or repurchase
securities, loans or federal funds or any interest or participation in
any thereof, (6) any lease of real or personal property, purchase
money security agreement or similar instrument not involving an
obligation of the Bank for borrowed money, (7) any transaction in-
volving the lease by the Bank of real or personal property, sold by the
Bank or constructed or improved or to be constructed or improved
or acquired or to be acquired by a third party, which is used or to
be used by the Bank in the conduct of its banking or trust business
as from time to time constituted, (8) any guarantee or similar ob-
ligation as may be incidental or usual in carrying on the banking
or trust business of a bank or trust company or as may be permitted
by the Articles of Association of the Bank or as may otherwise be
permitted by law, (9) any transaction in the nature of an extension
of credit, whether in the form of a commitment, guarantee or other-
wise, undertaken by the Bank for the account of a third party with
the application by the Bank of the same banking considerations
that would be applicable if the transaction were a loan to such
party, (10) any transaction in which the Bank acts solely in a fidu-
ciary or agency capacity, or (11) liabilities incurred on account of
loans made to the Bank with the express approval of the Comp-

Note that the language of the subordination clause proper, when read together with the definition of "funded debt," provides a deep subordination wherein the holders of capital notes stand just one step ahead of the holders of equity securities and on a par with, or senior to, the holders of other funded debt. Note also that the subordination which is typical in subordinated debentures issued by nonbanking corporations is deeper, in the sense that the provisions of those agreements are expressly intended to subordinate the claims of the debenture holders to those of the holders of funded debt, whether outstanding at the date of issuance of the debentures or incurred thereafter. This fact, however, appears to be of minimal effect upon the relative depth of the subordination in capital notes or debentures when it is recalled that there are myriad exceptions to the term "funded debt" as used in these debt securities. This deep subordination, typical of bank subordination agreements, serves to illustrate the description, "subordinated debentures stand in relation to general creditors as common equity stands in relation to preferred stock." In fact, it is just this relationship which has caused the Comptroller of the Currency to rule that national banks may issue capital notes and may, for certain purposes, count them as a part of their capital structure.

The definition of "funded debt" is significant primarily for its exceptions. Because of the various types of debt which a bank will incur in the normal course of its business, the most prominent of which is its deposit liabilities, the rather specific delineation of exceptions to the term "funded debt" has been thought desirable. The exceptions are intended to insure that normal bank transactions will not be impeded by the legitimate restrictions on funded debt which may be required by the capital note purchaser. Most of these exceptions are indispensable if the note agreement or indenture is to receive the approval of the Comptroller of the Currency. Because of this in-

21. Exception 11 to the definition of "funded debt" incorporates, with a slight explanatory comment, the language of exception nine to 38 Stat. 264 (1913), 12 U.S.C. § 82 (1964). Section 82 places a restriction on national banks as to the indebtedness which they may lawfully incur (100% of capital stock and 50% of unimpaired surplus fund) and exception nine removes that limit with respect to loans made to subject bank by another national bank pursuant to the express approval of the Comptroller of the Currency, given to the lending bank, as called for in exception nine to 34 Stat. 451 (1906), 12 U.S.C. § 84 (1964) (section restricting to 10% of capital stock and 10% of unimpaired surplus, the amount which a national bank may loan to any one borrower).

The apparent purpose for including such an exception to "funded debt" is to assure that the powers granted to the Comptroller by statute will not be effectively withdrawn by private agreement of the capital note issuer and purchaser. The thought, no doubt, being that if a large number of banks have capital notes outstanding and this exception is not included in the agreement, such an abrogation of statutory prerogative will have been accomplished.

22. Golin, supra note 18, at 372.

23. See text infra pp. 89-93, for discussion of this point.
sistence by the Comptroller, there is little reason for the parties to negotiate these points. At least two of the noted exceptions, however, directly affect the interests of the parties, are not absolutely required by the Comptroller and thus, on occasion, generate considerable negotiating activity.

The sale and lease-back transaction (exception number 7) is, to the extent that it represents an additional means of raising capital funds, a forerunner of the bank capital note device. Briefly, the transaction works as follows: A bank which desires to acquire additional working capital without selling common stock establishes a real estate affiliate or subsidiary and sells all or a part of its banking premises to the subsidiary. The subsidiary then acquires a mortgage loan on the property, which is additionally collateralized by a lease from the bank. The bank's balance sheet shows a nominal investment in its real estate affiliate and a reduced investment in banking premises. The transaction has the effect of allowing the bank to acquire funds to be used in its normal business operations while not incurring any "debt," since obligations under a lease are normally not considered a liability on the bank's books and do not utilize the bank's legal borrowing limit. 24 Because a sale and lease-back transaction has the effect of removing an asset (the bank building) from the bank, some capital note purchasers are understandably reluctant to allow this exception to the restrictions placed on other types of funded debt. 25

Exception 11 should also be noted, since it allows for an emergency situation in which the bank has become financially distressed and in need of large sums of money to meet a pressing demand. By virtue of this exception, the provisions of exception nine to Sections 82 and 84 of Title 12 26 are preserved; the Comptroller does not lose the flexibility provided him in the law to allow the lending bank (Section 84) to exceed its statutory lending limit to any one person and the borrowing bank (Section 82) to exceed the limitation on the amounts which it might borrow. It is understandable that purchasers of capital notes might balk at this provision, since it effectively rewrites the agreement when the issuing bank experiences a distress situation. On the other hand, it is likely that if an exception 11 emergency situation were to occur, the subordinated creditor would find it in his best interest to

25. Not allowing such an exception causes any debt incurred in such a transaction to be ranked on a parity with, or junior to, the capital notes in the event that the subordination is "triggered." While it is arguable that a lease transaction does not create "funded debt" as it is generally known, drafters of agreements have covered the possibility of such a finding with appropriate language. In addition, and perhaps more important, most capital note agreements have a provision restricting the bank from incurring additional funded debt (other than the capital notes). Thus, if the sale and lease-back transaction is not excepted from the definition of funded debt, the bank may be precluded from entering such a transaction.
allow additional debt to be inserted in a position which is senior in right of payment to his debt. To object to this might well precipitate receivership, thus triggering the subordination clause. The subordinated creditor would then be in the position of having to wait for payment, if any, until all senior creditors have been paid in full. If the Comptroller should find it desirable to invoke the provisions referred to in exception 11, he would certainly do so in a situation where he thought that the bank could be saved. Such action would, of course, be in the best interest of the holders of the capital notes.

Section III: Historical Development and Economic Desirability of the Issuance of Subordinated Debt by Commercial Banks

An exhaustive analysis of the economic advantages and disadvantages of the issuance of capital notes or debentures by commercial banks is not within the contemplation or the competence of this comment. Before discussing the legal basis underlying the issuance of subordinated debt by commercial banks, however, consideration should be directed both to some of the practical arguments for and against the issuance of capital notes and to the opinions of financial writers. In this manner, legal considerations can be related to the business objectives which prompt boards of directors to look to capital notes as a means of raising additional capital funds.

Development of Subordinated Debt

The development of ab initio subordinated debt was largely the work of sales finance companies. The first public issuance of subordinated debentures, insofar as could be determined, was made in 1936. From that time until the early 1950’s, few institutions other than finance companies showed much interest in this type of capital financing. Due to rapid business expansion after World War II, the large cash accounts which had accumulated during the war became insufficient to meet capital requirements. Retained earnings were inadequate to meet the new capital needs and the sale of common stock alone to raise additional capital became less desirable as taxes rose. Since taxes apply after interest charges and before dividends, it became economically advantageous to secure new funds by incurring debt, within reasonable limits, rather than by selling preferred or common stock. Corporate treasurers were quick to see the advantage in issuing debt instruments to raise additional capital funds and the number of long-term debt

27. Johnson, supra note 4, at 4.
28. From 1941 to 1963, corporate income taxes, for those companies earning over the minimum $25,000 per year base, rose from 31% to 52%. It thus became much more difficult to meet capital needs from retained earnings as these earnings decreased in relation to gross volume. Source of figure: 671 CCH 1966 STAND. FED. TAX REP. ¶ 154.
29. INT. REV. CODE OF 1954, § 163.
issuances increased steadily.\textsuperscript{30} Despite experiencing similar capital squeeze problems,\textsuperscript{31} banks did not follow the trend established by industrial corporations. The banks continued to adhere to the conservative policy of selling only common stock when adding to their capital funds.\textsuperscript{32} In fairness to bank management, it should be noted that bankers may well have thought that there was no choice but to adhere to the more established policies, since regulatory authorities were adamant in opposing the sale of capital notes as a means of raising bank capital. The Comptroller of the Currency was on record publicly as being opposed to such issuances,\textsuperscript{33} and state supervisory authorities generally followed similar policies. An exception to this general rule was found in the policy of the Banking Commissioner of the State of Minnesota. In 1958, he decided to permit banks to issue subordinated debentures under authority of legislation enacted during the depression.

\textit{Bank Issuance of Debentures}

During the 1950's and early 1960's, banks experienced tremendous growth in demand for loanable funds.\textsuperscript{34} At the same time, however, deposits (the primary source of loanable funds) did not increase at a rate comparable to the growth of the gross national product. For the period 1947 to 1962, capital accounts of member banks\textsuperscript{35} grew by 35 percent, while loans expanded 50 percent. The average annual rate of loan expansion was 9 percent, compared to an annual capital growth rate of 6 percent.\textsuperscript{36} The increased profits being realized on this expanded loan demand, lead to increasing pressure by shareholders to pay out larger dividends. These same shareholders were reluctant to approve the sale of common stock. The apparent reason for this phenomenon, at least in the medium and smaller size banks where control is usually a factor, was the concern of shareholders that they might not be financially able to exercise their preemptive rights to purchase a proportionate share of the new stock thereby leading to a dilution of their percentage of control of the bank with each new issuance of common shares.

This pressure on bank capital was recognized by the Commission on

\textsuperscript{30} Corporate bond issues sold in 1947 totaled $5,036,000,000 as compared to new bond offerings in 1944 of $2,669,000,000. During the period 1940-44, the yearly average of new corporate bond issuances was $1,870,000,000, while the average for the 1945-49 period was $5,127,000,000. \textit{Moody, Industrial Manual} a18 (1957).

\textsuperscript{31} W. Kennedy, \textit{Bank Management} 233-36 (3d ed. 1963).

\textsuperscript{32} This, of course, was in addition to the normal procedure of retaining a portion of profits for capital expansion.


\textsuperscript{35} The term used to identify banks which belong to the Federal Reserve System.

\textsuperscript{36} Lindow, \textit{supra} note 34, at 55-56.
Money and Credit\textsuperscript{37} when, in its report to President Kennedy in 1961, it expressed concern about capital adequacy of financial institutions and recommended forms of capital other than common capital stock, surplus, and reserves. "Two suggestions which should be explored," the Commission urged, "are the authorization to issue debentures subordinated to the claims of the depositors and to issue preferred stock."\textsuperscript{38} In 1962, the Advisory Committee on Banking to the Comptroller of the Currency completed its study of the banking structure and the problems confronting the banks. It recommended that the use of preferred stock and debentures should no longer be regarded as emergency measures, but should be recognized as a normal method for obtaining capital funds. Specifically, the Advisory Committee recommended that the attitude of the Comptroller on this subject be liberalized and that flexibility be afforded the banks by permitting the use, in appropriate cases, of various features, such as convertibility or subordination.\textsuperscript{39} Shortly after receipt of this report, the Comptroller published new regulations which permitted national banks to issue preferred stock and capital notes or debentures.\textsuperscript{40}

The only bank experience with subordinated debentures prior to the Advisory Committee's report to the Comptroller was that acquired during the Depression, when preferred stock and capital notes or debentures were sold by state banks\textsuperscript{41} to the Reconstruction Finance Corporation (R.F.C.).\textsuperscript{42} This experience was not wholly satisfactory, since at the time of the bank holiday in 1933, bank stocks were virtually unsalable owing to the distressed financial condition of banks generally and the "double liability" carried on bank common shares.\textsuperscript{43} Banks throughout the country were compelled, by law or by persuasion, to issue capital notes, debentures, or preferred stock to conceal the fact that many needed to do so.\textsuperscript{44} The strongest banks retired these securi-
ties at the earliest permitted date, but the aura of "distress financing" had attached to bank senior securities. With this history in mind, it is not difficult to understand why banks were reluctant to rush forward with the issuance of senior securities, even when confronted with the pressures exerted in the late 50's and early 60's.

Advantages

This psychological barrier was broken, however, when the Franklin National Bank, a large New York institution issued preferred stock in 1962. In the summer of 1963, Franklin National and the state chartered United California Bank sold capital notes to the public. This emerging use of preferred stock and capital notes as a means of raising bank capital caused bankers to re-examine their previous attitudes and to objectively review the relative advantages and disadvantages of these instruments. Some considerations which have been posited to explain the subsequent decision of many banks to issue these instruments are listed below:

(1) The primary function of bank capital is to protect depositors against loss in case of insolvency. Another function is to act to maintain the confidence which a bank must enjoy to continue in business and to prosper, i.e., to provide "staying power" for the bank during difficult periods so that time and earnings can absorb losses. Capital notes, by virtue of their subordination provisions and in view of their generally long-term maturities, meet both of these requirements. (2) A distinct tax advantage is afforded the bank when issuing capital notes, since interest on the notes, unlike dividends, is a tax deductible expense. The effect of this strategic difference is to reduce by approximately 50 percent the effective rate paid on the notes when the bank is incurring the maximum tax levy. Capital notes issued at a coupon rate of five percent in reality cost the bank only about two and one-half percent. (3) Leverage (the ratio of assets to equity investment) is increased, providing increased return on common capital, assuming that the funds derived from the issuance of capital notes are profitably employed. (4) No dilution of control of the corporation occurs, since the holders of the capital notes are normally not entitled to a voice in corporate management. (5) Reserve

50. Exceptions to this general rule do exist. See, e.g., N. Y. Bus. Corp. § 518 (McKinney 1964).
requirements imposed by the Federal Reserve Bank and assessments charged by the F.D.I.C. are not increased, since the notes are not classified as “deposits.” 61 (6) The issuing bank is not required to purchase additional shares of stock of the Federal Reserve Bank, since the required holding of such shares is predicated upon the amount of “capital stock” outstanding. 62 The Fed does not consider capital notes to qualify within the definition of capital stock. 63 (7) The bank’s liquidity needs 64 are not substantially increased, for, by virtue of the fixed term of the capital notes, the bank may plan its investments with a view to the date on which the notes will become due. (8) Bookkeeping costs are reduced, since the capital notes or debentures are normally held by a smaller number of persons than a like amount of common stock. (9) An additional source of funds is made available to the bank through insurance company and pension trust investments. Many states restrict or prohibit investment in corporate stock by these large suppliers of funds. 65 (10) The bank’s lending limit and other statutory limitations based on capitalization are increased since the Comptroller of the Currency considers the proceeds of the notes as a part of capital funds for such purposes. 66 (11) The capacity for relative ease of retirement is achieved. The typical capital note provides for call at the option of the issuing bank subject to certain negotiated terms. If a bank issues common capital which it subsequently finds is not necessary, it is difficult to retire this capital. Prior authority of a supervising agency is necessary in all capital reductions 67 and, even if such permission is obtained, common shareholders are free to ignore requests for tender of their shares for retirement. Even assuming the approval of a supervisory agency for the bank’s purchase of its own shares in the open market, there is no guarantee that the shares will be available for purchase. Thus, the issuance of subordinated notes gives the bank an added degree of flexibility in determining the size of its capital position.

Disadvantages

There are also certain disadvantages associated with bank issuance of capital notes. The first, already mentioned, is the historical association of bank issuance of senior securities with the concept of financial weakness; this aura

54. “Liquidity” refers to the bank’s ability to meet current demands for cash out of available funds. “Solvency” relates to the overall surplus of assets over debt.
55. See, e.g., ILL. ANN. STAT. ch. 73, §§ 737a-737.22a (Smith-Hurd 1966); MASS. ANN. LAWS ch. 175 § 63 (1961).
56. 12 C.F.R. § 7.7 (1967).
of "distress financing" has not completely disappeared.\textsuperscript{58} However, the issuance of capital notes by such notably strong banks as First National City Bank, Chase Manhattan, and Bankers Trust in New York City has gone far to eliminate this negative aspect. A second possible disadvantage is the relative novelty of this type of capital instrument in bank balance sheets and its yet unknown effect upon large, sophisticated depositors. It is possible that banks with relatively large debt capital positions may be subject to deposit withdrawal by large depositors during unstable periods.\textsuperscript{59} Other real considerations for the bank contemplating issuance of subordinated debt are:

(1) The possibility that, at some time in the future, the sinking fund payments or interest payments may become due at a time when it would place the bank in a serious financial squeeze; (2) the possible adverse effect which additional "permanent" debt may have on the price of the bank's common equity; and (3) possible difficulty in refunding at maturity of the notes, either because interest rates may be so high as to render refunding impractical or because business is at such a low ebb that the bank is not producing the earnings coverage to which investors look when appraising the investment qualities of capital notes and debentures. In relation to this, it may be assumed that if business is slow and the bank does not presently need the additional capital, management would likely choose to retire the capital notes.

\textit{Section IV: The Ultra Vires Question}

Throughout the discussion of the legal basis for the issuance of capital notes by national banks, the reader should keep in mind that there are really two questions under discussion: (1) whether national banks can legally issue capital notes or debentures, and (2) whether such debt instruments can validly be considered a part of capital or surplus for the purpose of computing lending limits imposed upon banks. These questions are entirely distinct. The former concerns the power of a bank to borrow money on a long-term basis; the latter revolves around interpretation by the Comptroller of a statute which does not specify whether or not capital notes or debentures may be considered part of a bank's capital base. Neither question has been litigated. The position of the Comptroller as to both has been challenged.

\textit{Comptroller's Regulations}

In December of 1962, subsequent to the report of the Advisory Committee,\textsuperscript{60} the Comptroller issued a regulation stating the position of his office concerning issuance of capital notes or debentures by national banks:

(a) It is the policy of the Comptroller of the Currency to permit

\textsuperscript{59} \textit{Id.} at 1139.

\textsuperscript{60} \textit{See} text \textit{supra} p. 73.
the issuance of convertible or non-convertible capital debentures by national banking associations in accordance with normal business considerations.

(b) Subject to the provisions of 12 U.S.C. 82, the bank may, with the approval of stockholders owning two-thirds of the stock of the bank, entitled to vote, issue convertible or non-convertible capital debentures in such amounts and under such terms and conditions as shall be approved by the Comptroller, provided, however, that the principal amount of capital debentures outstanding at any time, when added to all other outstanding indebtedness of the bank, except those forms of indebtedness exempt from the provision of 12 U.S.C. 82, shall not exceed an amount equal to 100% of the bank's unimpaired paid-in capital stock plus 50% of the amount of its unimpaired surplus fund.61

In December 1963, the Comptroller ruled that capital notes issued by national banks have "all of the protective effect of capital and surplus insofar as depositors are involved" and "may be included as a part of the aggregate amount of unimpaired capital and unimpaired surplus funds for the purpose of computation of the limit on loans to individual borrowers contained in 12 U.S.C. 84."62 His reasoning in reaching this conclusion is illustrated by the following excerpt from the ruling:

An examination of the legislative history of the lending restrictions contained in 12 U.S.C. § 8463 indicated that protection of the depositors is the primary purpose of restricting the amount of loans to any person to a stated percentage of the capital and surplus. Consequently, capital debentures and notes which stand in the same relationship to depositors as traditionally recognized forms of capital and surplus may be included in the loan base. The fact that, as to shareholders, capital notes and debentures would have a preferential position is just as immaterial as is the fact that preferred shareholders take precedence over common shareholders.64

At least one, and possibly both, of the Comptroller's positions were challenged by Chairman Wright Patman of the House Committee on Banking and Currency when, in June of 1965, he presented the Comptroller with a list of 29 charges which purportedly chronicled illegal acts by the Comptroller.65 Charge 24 concerned the issuance of capital notes and debentures and the consideration of such instruments as part of the bank's capital for purposes of the loan limits of 12 U.S.C. 84. It read as follows: "Not provided

62. 12 C.F.R. § 7.7 (1967).
63. Quoted in pertinent part infra p. 90.
64. 12 C.F.R. § 7.7 (1967).
by law and contrary to sound corporate and accounting practice." 66 In addition, the Board of Governors of the Federal Reserve System had previously issued a statement which placed the Board in opposition to the Comptroller. 67 The statement maintained that, for purposes of certain Federal Reserve Act provisions 68 limiting loans and investments of member banks to a specified percentage of their capital stock and surplus, "[c]apital notes or debentures do not constitute 'capital,' 'capital stock,' or 'surplus.'" 69 The Comptroller did not alter his position in the face of this opposition, and many national banks proceeded to issue both convertible and non-convertible capital notes and debentures. 70

The National Bank Act contains no specific authority for the issuance of capital notes or debentures by national banks. In fact, the Act contains no specific authority to borrow. Because of this, those who feel that national banks are acting outside the scope of their authority when issuing capital notes have noted that the Financial Institutions Act of 1957 contained a provision for specific authorization to be given to national banks to issue capital notes and debentures, and that the bill did not pass. 71 This is hardly compelling evidence of the need for such specific statutory authority, however, since failure to pass a specific piece of legislation has no interpretative value in a court. 72 If valuable for any reason, this reference to proposed legislation serves only to illustrate the current state of equilibrium between advocates of expansive and restrictive interpretation of the National Bank Act, since national banks subsequently began to issue these instruments and no statutory expression of congressional disapproval has been forthcoming.

Origin of the National Bank Act Provisions

The Act, as it exists today, provides in pertinent parts: (I) that associations formed under it are for the purpose of "carrying on the business of

66. Id. at 291.
70. For a listing of convertible and non-convertible capital notes and debentures issued by commercial banks since 1963, see THE AMERICAN BANKERS ASSOCIATION, USE OF SENIOR CAPITAL BY COMMERCIAL BANKS 53-70 (1967).
71. Subcommittee draft of S. 1451, 85th Cong., 1st Sess. § 21 (1957), provided for the issue of capital notes or debentures by national banks when so provided in the articles of association and approved by the Comptroller.
72. The Effect of An Unsuccessful Attempt to Amend a Statute, Correspondence between Charles H. Willard and John W. MacDonald, 44 CORNELL L.Q. 336 (1959).
banking”;

(2) that a national bank has the power “... to exercise by its Board of Directors ... all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security; and by obtaining, issuing and circulating notes according to the provisions of this Chapter”; and (3) “No national banking association shall at any time be indebted, or in any way liable, to an amount exceeding the amount of its capital stock at such time actually paid in and remaining undiminished by losses or otherwise, plus fifty percent of the amount of its unimpaired surplus fund, except on account of demands of the nature following....” These provisions are all essentially the same as provisions appearing in the National Currency Act of 1863.

Section 11 of the 1863 Act adopted verbatim (with two irrelevant changes) Section 18 of the New York Free Bank Act of 1838 which provided:

§ 18. Such association shall have power to carry on the business of banking by discounting bills, notes and other evidences of debt; by receiving deposits [sic]; by buying and selling gold and silver bullion, foreign coins, and bills of exchange, in the manner specified in their Articles of Association for the purposes authorized by this Act; by loaning money on real and personal securities; and by exercising such incidental power as shall be necessary to carry on such business....

Section 8 of the National Bank Act of 1864 adopted, with only one relevant change, the terms of the 1863 Act.

Section 8 provided that a national bank might exercise

... all such incidental powers as shall be necessary to carry on the business of banking by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security; by obtaining, issuing, and circulating notes according to the provisions of this Act....

The change mentioned above was a transposition of the clause “... such incidental powers as shall be necessary to carry on such business...” from the end of the recital of powers of the 1863 Act to the beginning, and the con-

77. N. Y. Laws ch. 260 (1838).
sequent elimination of the original beginning clause "power to carry on the business of banking." The transposition has been explained as one

...made primarily to avoid redundancy by the elimination of one of the two clauses as to the 'power to carry on the business of banking' and that it was not the intent of Congress thereby to make a major change in the existing powers of National Banks, namely, to take from all their implied powers to carry on the business of banking which were not necessarily incidental to carry out the specific powers, and which implied powers were granted to them by the 1863 Act.79

Both the debates accompanying passage of the 1863 Act, and a study conducted by the National Monetary Commission in 1909-1910, indicate that the National Bank Act, as enacted in 1863 and amended in 1864, adopted in substance the free banking law of the State of New York.80 It appears that Congress intended to confer upon national banks all powers of New York State banks to carry on the banking business, except as otherwise provided by the National Bank Act.

**Interpretation of the New York Act**

A generally accepted canon of statutory construction is that when Congress enacts a statute in terms that have received a settled interpretation by the courts it in effect adopts that interpretation.81 As previously noted, Congress was aware that it was adopting in substantial form the New York Banking Law of 1838. It seems highly probable, though no authority for the statement can be found, that the leading case of *Curtis v. Leavitt*82 was known to


It is also known that Senator John Sherman of Ohio, one of the authors of the National Currency Act, checked THE BANKS OF NEW YORK, THEIR DEALERS, THE CLEARING-HOUSE, AND THE PANIC OF 1857 (1859) by James Sloan Gibbons out of the Library of Congress. (He had this book in his possession from January 2 to January 21, 1863, during which time the National Currency Act was revised by Senator Sherman). This book describes in detail the duties and responsibilities of the major officers of a bank, the bookkeeping operations of a bank, and clearing house operations. The author's intent is stated as attempting "to give a picture of the banks of New York as they are . . . ." Library of Congress, Miss. Division, Miscellany, Receipt Books L 1861-1863.

81. See J. G. Sutherland, *Statutory Construction* § 5209 (Horace ed. 1943).

82. 15 N.Y. 9 (1857). Some evidence that this case was known to Congressmen can be taken from the fact that the Library of Congress had a book by John Cleaveland on its shelves entitled THE BANKING SYSTEM OF THE STATE OF NEW YORK, WITH NOTES AND REFER-
Congress when the National Bank Act was passed, and that Congress intended National Banks to have the same broad powers to carry on the business of banking as the New York banks had under the decisions of the courts of that state prior to 1863.

In 1857, the Court of Appeals of New York in the Curtis case conclusively settled the New York law as to the implied power of a New York bank to borrow under the above quoted terms of the New York Banking Law of 1838.83 The court based the right to issue bonds described as "payable in large sums, at distant periods of time,"84 in the "incidental power of corporations, and especially in the nature of banking and the incidents and necessities which attend that business."85 In addition, the following broad language on implied powers of banks comes from Curtis:

The implied powers [of a bank] exist by virtue of the grant [to do the banking business], and are not enumerated and defined; because no human sagacity can foresee what implied powers may, in the progress of time, the discovery and perfection of better methods of business, and the ever-varying attitude of human relations, be required to give effect to the express powers. They are, therefore, left to implication.86

This case has been recognized for its valuable consideration of implied powers of banks, especially the power to borrow. Numerous cases decided under the National Bank Act cite it as the leading authority on the question.87

Case Law under the National Bank Act

A considerable body of case law has developed which interprets the provisions of Section 24 (7), and to a more limited extent, those of Section 82 of Title 12 so as to find in national banks an implied power to borrow. The courts have consistently interpreted the National Bank Act as giving national banks an inherent right to borrow money whenever it is reasonably necessary in the proper conduct of the bank's business. In the early case of First National Bank v. National Exchange Bank,88 the Supreme Court stated:

References to Adjudged Cases (1857). This book gives an historical sketch of the New York banking system, banking laws, and includes the General Bank Act of 1838, known as the Free Bank Law, and cases decided by the courts of New York relating to this Act. At page 924 there is a summary of the New York Supreme Court's decision on the case of Curtis v. Leavitt, with a note that the case was now pending in the court of appeals. Furthermore, this case was referred to popularly as the "Million Trust Case," indication that at least it was well enough known to have picked up a slang name.

84. Id. at 73.
85. Ibid.
86. Id. at 157.
88. 92 U.S. 122 (1875).
Authority is thus given [by the National Bank Act] to transact such a banking business as is specified, and all incidental powers necessary to carry it on are granted. These powers are such as are required to meet all the legitimate demands of the authorized business, and to enable a bank to conduct its affairs, within the general scope of its charter, safely and prudently. This necessarily implies the right of a bank to incur liabilities in the regular course of its business, as well as to become the creditor of others.89

In the later case of Western National Bank v. Armstrong,90 a certain amount of doubt was cast upon the implied power of a national bank to borrow. The Court was called upon to determine whether or not the Fidelity National Bank was indebted to the plaintiff bank on account of a loan made by the plaintiff at the request of the vice-president and principal executive officer of Fidelity. Specifically, the question presented was whether this officer, without specific authority from the board of directors, could legally bind Fidelity in its transaction with the plaintiff. Recovery was denied to the plaintiff on the grounds that the transaction was not properly authorized and that the bank did not receive the proceeds of the loan. In his opinion, Mr. Justice Shiras included the following qualifying language:

Nor do we doubt that a bank, in certain circumstances, may become a temporary borrower of money. Yet such transactions would be so much out of the course of ordinary and legitimate banking as to require those making the loan to see to it that the officer or agent acting for the bank had special authority to borrow money.91

It is difficult to find in this case a specific purpose of limiting the authority of national banks to borrow. Rather, it appears that the Court was more concerned with the fact that the bank had derived no benefit whatsoever from the transaction. The overriding concern of the Court seems well stated in the following language of the opinion.

The moneys were appropriated by Harper [the vice-president] to his own use, or, at all events, it does not appear that the bank ever got a penny of the borrowed money or any benefit or advantage whatever by reason of the transaction.92

In any event, the Western case has little, if any, precedent value as a result of subsequent decisions of the Supreme Court limiting the case to its facts.93

In Auten v. United States National Bank,94 the Supreme Court specifically

89. Id. at 127.
90. 152 U.S. 346 (1893).
91. Id. at 351.
92. Id. at 352.
93. See Aldrich v. Chemical Nat'l Bank, 176 U.S. 618, 628 (1900); Auten v. United States Nat'l Bank, 174 U.S. 125 (1899).
94. Supra note 93.
rejected the claim that the *Western* case established the rule that borrowing by a national bank was “out of the usual course of business.” Mr. Justice McKenna noted:

Some of its language [referring to the *Western* case] may seem to do so, but it was used in suggestion of a question which might be raised on the facts of the case, without intending to authoritatively decide it.95

The opinion went on to discuss the business of banking in the following terms:

Banking in much, if not in the greater part of its practice, is in a strict sense borrowing, and we may hesitate to condemn it as illegitimate, or regard it as out of the course of a regular business, and hence suspicious and questionable.

* * *

A banker, Macleod says, is a trader who buys money, or money and debts, by creating other debts, which he does with his credit—exchanging for a debt payable in the future one payable on demand. This, he says, is the essential definition of banking. “The first business of a banker is not to lend money to others but to collect money from others.” (Macleod on Banking, vol. 1, 2d ed. pp. 109, 110.) And Gilbart defines a banker to be “a dealer in capital, or more properly a dealer in money. He is an intermediate party between the borrower and the lender. He borrows of one party and lends to another.” (Gibbart on Banking, vol. 1, p. 2.) (Emphasis in original.)

The very first banking in England was pure borrowing. It consisted in receiving money in exchange for which promissory notes were given payable to the bearer on demand. . . . The relations created are the same as those created by the issue of notes. In both a debt is created—the evidence only is different. In one case it is a credit on the banker’s books; in the other his written promise to pay. In the one case he discharges it by paying the orders (cheques) of his creditor; in the other by redeeming his promises. These are the only differences. . . .

But it may be said these views are elementary and do not help to a solution of the question presented by the record, which is not what relation a bank has or what power its officers may be considered as having in its transactions with the general public, but what is its relation and what power its officers may be considered as having in its transactions with other banks. Indeed, the question may be even narrower—not one of power, but one of evidence. If so, the views expressed are pertinent. They show the basis of credit upon which banks rest, and the necessity of having power to support it; it may be to extend it. Borrowing is borrowing, no matter from

whom. Discounting bills and notes may require rediscounting them; buying bills and notes may require selling them again. Money may not be equally distributed. It is the bank's function to correct the inequality. The very object of banking is to aid the operation of the laws of commerce by serving as a channel for carrying money from place to place, as the rise and fall of supply and demand require, and it may be done by rediscounting the bank's paper or by some other form of borrowing. Curtis v. Leavitt, 15 N. Y. 1; First National Bank v. National Exchange Bank, 92 U.S. 122; Cooper v. Curtis, 30 Maine, 488. (Emphasis added.)

A power so useful cannot be said to be illegitimate, and declared as a matter of law to be out of the usual course of business, and to charge everybody connected with it with knowledge that it may be in excess of authority. It would seem, if doubtful at all, more like a question of fact, to be resolved in the particular case by the usage of the parties or the usage of communities. (Emphasis added.)

This latter language appears to be of particular significance when read with the opinion of the court in Chemical National Bank v. Armstrong,97 where the court was considering facts similar to those presented in the Auten case. In Chemical National Bank, the following language appears:

What is the proper business of a bank, and what incidental powers may be necessary to carry on the business of banking, is not purely a question of law, nor altogether a question of fact. It is a mixed question of law and fact, depending, as to fact, upon circumstances and location. . . . [T]he locality of the bank, the nature of its business, and the time of the transaction, may have much to do with determining what incidental powers are necessary to carry on the business of banking.98

The most recent case in which the Supreme Court has addressed itself to the power of a national bank to borrow is Wyman v. Wallace.99 In that case, the American National Bank did not have sufficient cash to provide for payment of a large amount of its deposits which were shortly to come due. In order to provide the necessary funds to make such payment, it entered into negotiations with the Union National Bank, whereby the latter was to assume all the liabilities of the former, receiving cash and such bills receivable as it was willing to accept at par and without recourse. The difference between the amounts so received and the liabilities assumed was to be represented by three non-negotiable promissory notes of the American Bank, the payment of which was to be secured by a pledge of all its remaining assets. This contract was carried out. Union moved into, and took possession of, the

96. Id. at 141-43.
97. 76 F. 339 (C.C. Ohio 1896).
98. Id. at 343, 344.
99. 201 U.S. 230 (1906).
offices of American. Upon adjustment, the difference was found to be $201,000, for which American executed to Union three non-negotiable promissory notes payable in one, two, and three years, respectively. A suit was brought by the assignee of one of the notes, and one of the issues before the Court was whether the notes executed by American National Bank were valid obligations. The Court, in sustaining the validity of the obligations, stated:

The question, therefore, is, whether a national bank, finding itself embarrassed, with a large amount of assets, much in excess of its obligations, yet without the cash to make payment of those which are due and urgent, can borrow to meet those pressing demands. A very natural answer is, why not? It is not borrowing money to engage in a new business. It simply exchanges one creditor for others. There may be wisdom in consolidating all its debts into the hands of one person. At least such a consolidation cannot be pronounced beyond its powers. When time is obtained by the new indebtedness (in this case a year) it gives the borrowing bank and its officers and stockholders time to consider and determine the wisdom of attempting a further prosecution of business. In the case of an individual it would be a legitimate and often a wise transaction. It is not in terms prohibited by the National Bank Act. [Citing Aldrich v. Chemical National Bank, 176 U.S. 618]100

The lower federal courts have sustained the validity of borrowing by national banks in a similar manner. Weber v. Spokane National Bank,101 was a suit brought against Spokane National and its receiver upon three promissory notes which had been given in payment for bank furniture and fixtures supplied by the plaintiff. As a special defense, the receiver pleaded that at the time of making the notes the bank had already incurred indebtedness and had become liable for amounts aggregating a sum much greater than the amount of its paid up capital stock, so that by virtue of the National Bank Act the bank was prohibited from incurring the indebtedness sued upon. Before reaching the question of the validity of loans which exceed the statutory limit on indebtedness, the court interpreted the debt-limiting provision of the National Bank Act102 as implying a power on the part of a national bank to borrow money, stating:

What is the meaning of the word used? Taken in their ordinary sense and import, we take them to mean that a national banking association is prohibited from contracting debts or liabilities other than within the four classes named,103 except to the extent of its

100. Id. at 245.
101. 64 F. 208 (9th Cir. 1894).
103. At the time this case was decided, there were four exceptions to the general limit on debt imposed by § 82, now there are eleven such exceptions.
paid-up, unimpaired capital stock,\textsuperscript{104} and to that extent there is an implied authority to become indebted upon any contract or transaction which lies within the scope of its power...\textsuperscript{105}

Similar language is found in \textit{Eastern Township Bank v. Vermont National Bank of Saint Albans},\textsuperscript{106} a case in which suit was commenced to enforce a claim against the receiver of a national bank to which the plaintiff had made a loan. The court referred to the statutory limit on indebtedness of a national bank and stated:

That section provides that no association shall at any time be indebted or in any way liable to an amount exceeding the amount of its capital stock actually paid in and undiminished.... This implies that it may become indebted within the limit, even if the power to make contracts generally should be held to apply to something else. Powers impliedly given are as well conferred as those expressly given. [Citing \textit{National Bank v. Graham}, 100 U.S. 699]\textsuperscript{107}

\textbf{Long-Term Subordinated Borrowing}

This review of the legislative history of Sections 24 and 82 of the National Bank Act and the case law decided under these provisions indicates that national banks do have the power to borrow money. But, in a discussion of bank issuance of capital debentures (long-term subordinated debt) the further question arises: Do national banks have the power to engage in this type of borrowing? Reverting to the language of the Court in \textit{Wyman v. Wallace},\textsuperscript{108} "A very natural answer is, why not?" The cases thus far decided have all dealt with relatively short-term unsubordinated borrowing at a time when deposits of national banks were not insured;\textsuperscript{109} the power to borrow was sustained. It is less difficult to come to the conclusion that a national bank whose depositors are insured has the power to borrow on a long-term subordinated basis. The extended term allows management to plan carefully for the eventual repayment or refunding of this debt at a stated maturity and the deposit insurance protects depositors in the event of insolvency.\textsuperscript{110} Add to this an agreement placing certain creditors (the capital note holders) in a position junior to that of depositors and other creditors, and it is difficult to conceive of a court finding insufficiency of authority to incur the debt.

The power to issue capital notes or debentures falls squarely within the

\textsuperscript{104} Now premised on capital stock \textit{and} unimpaired surplus.
\textsuperscript{105} Weber v. Spokane Nat'l Bank, \textit{supra} note 101, at 209.
\textsuperscript{106} 22 F. 186 (C.C. Vt. 1884).
\textsuperscript{107} \textit{Id.} at 188.
\textsuperscript{108} \textit{Supra} note 99.
\textsuperscript{109} See \textit{supra} note 8. Deposit insurance on a national basis did not begin until 1933.
\textsuperscript{110} See 1958 F.D.I.C. ANN. REP. for an excellent discussion of the procedures used by the Corporation in fulfilling its role as insurer.
criteria set out in First National Bank v. National Exchange Bank, in that "[t]hese powers are such as . . . enable a bank to conduct its affairs, within the general scope of its charter, safely and prudently."111 Admittedly, there is language in some of the earlier cases112 to the effect that banks have the power to become only temporary borrowers of money. The courts, however, have never squarely considered the question of whether or not a bank can engage in long-term subordinated borrowing. If any conclusions are to be drawn from the early bank borrowing cases beyond the obvious conclusion that banks do have the right to borrow, it must be that the power should be determined by "the usage of the parties or the usage of communities."113 As noted earlier,114 the issuance of subordinated debentures is a well established, commonly accepted practice of corporations and is generally considered by financial writers and the business community to be a legitimate corporate function. An awareness of this background, together with the fact that banks have wholeheartedly adopted this means of raising additional capital,115 points strongly to the conclusion that issuance of capital notes or debentures is an accepted practice and a common usage.

Comptroller's Authority to Issue Regulations

In addition to the above reasons for sustaining the power of national banks to issue capital debentures, there is a positive ruling of the Comptroller of the Currency that the issuance of these notes is within the power of national banks.116 While the National Bank Act does not specifically empower the Comptroller to interpret its provisions,117 rulings or interpretations by the Comptroller have long been the practice.118 The Supreme Court, in Inland Waterways Corp. v. Young,119 recognized the interpretative function of the Comptroller's office when it stated:

The policy underlying Congressional legislation and reflected in the history of governmental deposits is confirmed by the explicit recognition of that official in whom is centered oversight of the administration of the National Banking Act . . . The Comptroller of the Currency, to be sure, must himself move within the orbit of the

111. 92 U.S. 122, 127 (1875).
112. See Western Nat'l Bank v. Armstrong, supra note 90.
113. Auten v. United States Nat'l Bank, supra note 93, at 143.
114. See text supra pp. 71-72.
115. See figures on bank issuance cited supra note 20.
118. ATTORNEY GEN. COMM. ON AD. PROCEDURES, FEDERAL CONTROL OF BANKING, MONOGRAPH NO. 14, 89-90 (1940); T. KANE, THE ROMANCE AND TRAGEDY OF BANKING 90-91 (1922); Fox, SUPERINTENDENCE OF BANKING BY THE COMPTROLLER OF THE CURRENCY, in REDFORD, PUBLIC ADMINISTRATION AND POLICY FORMATION 155 (1956).
119. 309 U.S. 517 (1940).
National Banking Act. Illegality cannot obtain legitimacy through practice. But when legality itself is in dispute—when Congress has spoken at best with ambiguous silence—a long continued practice pursued with the knowledge of the Comptroller of the Currency is more persuasive than considerations of abstract conflict between such a practice and purposes attributed to Congress. More than half a dozen agencies have thought it their duty to safeguard deposits in nearly a hundred banks by transactions similar to those before us. This practice had the approval of the Comptroller because he believed it within the power of the National Banking Act... When dealing with such necessarily argumentative concepts as those of which the law of *ultra vires* is so largely composed, the responsible and pervasive practice of public officers bent on safeguarding the public interests ought to carry the day even were the issue more in doubt than we believe it to be.\(^{120}\)

The silence of the National Bank Act as to the power of a national bank to issue capital notes, when combined with the positive ruling of the Comptroller that issuance of these notes is within the power of such banks, would appear to fall squarely within the language of the court in *Inland Waterways.*

**Effect of Ultra Vires Finding**

A final question which should be discussed briefly is the possible effect upon notes presently issued and outstanding if a court were to find the issuance of capital notes or debentures to be beyond the power of a national bank. The answer appears to lie in the language of the decision of *Weber v. Spokane National Bank:*\(^ {121}\)

\[
\text{[A]n indebtedness which a national bank incurs in the exercise of any of its authorized powers, and for which it has received and retains the consideration, is not void from the fact that the amount of the debt surpasses the limit prescribed by the statute, or is even incurred in violation of the positive prohibition of the law in that regard.}^{122}\]

This comment, together with the language in *Aldrich v. Chemical National Bank,*\(^ {123}\) would seem to adequately protect a purchaser of national bank capital notes. The Court, in *Aldrich,* spoke as follows:

If the bank’s want of power under the statute to make such a contract of purchase may be pleaded in bar of all claims against it based upon the contract—and we are assuming, for the purposes of this case, that it may be—it is bound upon demand, accompanied by a

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120. *Id.* at page 524, 525; *cf.* Justice Roberts’ dissent at 526, 527.
121. 64 F. 208 (9th Cir. 1894).
122. *Id.* at 211.
123. 176 U.S. 618 (1900).
tender of the price paid, to surrender the bonds to its vendor. The bank, in this case, insisting that it obtained the bonds of the plaintiff in violation of the act of Congress, is bound, upon being made whole, to return them to him. No exemption or immunity from the principle of right or duty is given by the national bank act [sic].

The Court went on to quote from Central Transportation Co. v. Pullman's Palace Car Co., as follows:

A contract *ultra vires* being unlawful and void, not because it is itself immoral, but because the corporation, by the law of its creation, is incapable of making it, the courts, while refusing to maintain any action upon the unlawful contract, have always striven to do justice between the parties, so far as could be done consistently with adherence to law, by permitting property or money, parted with on the faith of the unlawful contract, to be recovered back, or compensation to be made for it. In such case, however, the action is not maintained upon the unlawful contract, nor according to its terms; but on an implied contract of the defendant to return, or, failing to do that, to make compensation for, property or money which it has no right to retain. To maintain such an action is not to affirm, but to disaffirm, the unlawful contract.

The opinion concluded,

Independently therefore, of any question as to the scope of the power of a national bank to borrow money to be used in its business, we hold that the Fidelity Bank became liable to the Chemical Bank by using the money obtained from the latter, under the arrangement made by Harper in his capacity as vice president; consequently, the decree recognizing the claim, of the Chemical Bank for the amount of the loan of March, 1887, was right.

These considerations appear to amply illustrate that national banks do have the power to borrow money and that such power extends to the right to issue capital notes or debentures. Even if this act of the bank should be found to be ultra vires, however, the purchaser would be amply protected in his right to receive the funds which were advanced to the bank.

**Debentures as a Part of the Bank's Capital Base**

As previously noted, there are numerous incentives to issue capital notes or debentures. One such advantage is that the capital notes or debentures may be counted as a part of the bank's capital base for the purpose of computing the bank's lending limit to any one individual. While issuance of cap-

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124. *Id.* at 632.
125. 139 U.S. 24 (1891).
127. *Id.* at 638.
128. See discussion *supra* pp. 74-75.
ital notes might be attractive to national banks, even without this added incentive, this single item is sufficiently important to be considered separately.

The validity of the Comptroller's ruling that capital notes or debentures do constitute a part of the bank's capital base for the purpose of determining Section 84 limitations must, of course, be assessed against the background of the statute. The pertinent language reads as follows:

The total obligations to any national banking association of any person, copartnership, association, or corporation shall at no time exceed 10 per centum of the amount of the capital stock of such corporation actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund.\textsuperscript{129}

As used in this statute, the terms "capital stock" and "unimpaired surplus fund" have never been defined by Congress.\textsuperscript{130}

A reading of the entire 1864 Act,\textsuperscript{131} however, leaves little doubt that the term "capital stock" as used therein meant the basic equity security. This conclusion emanates from a reading of Section 12 of the Act, which specified that "the capital stock of any association formed under this Act shall be divided into shares of one hundred dollars each. . . ." It cannot be said that Congress intended thereby to exclude capital notes as a means of measuring the total allowable credit which a national bank could extend to any one person. Such "debt securities" were not even known at the time of the statute's enactment.

While there is nothing in the legislative history of the 1864 Act to indicate the intent of Congress in setting lending limits by means of percentage of capital stock, an explanation of the provision was supplied in later Congressional debates.\textsuperscript{132} The current loan limit provision of the National Bank Act was enacted in 1906.\textsuperscript{133} The provision derives from Section 29\textsuperscript{134} of the 1864 Act. The new provision increased the base from 10 percent of capital stock to 10 percent of capital stock and 10 percent of unimpaired surplus fund, with an overall limit of 30 percent of capital stock. In the course of debate on the amendment, the rationale of tying lending limits to capital stock was said to be "to prevent the incorporation of banks with a small capital stock and a large paid-in surplus, as under such conditions the security of the de-

\textsuperscript{130} See 48 Stat. 5 (1933), 12 U.S.C. § 51 (c) (1964), for definition of capital stock, not pertinent here.
\textsuperscript{131} 13 Stat. 99 (1864).
\textsuperscript{132} H.R. REP. No. 1835, 59th Cong., 1st Sess. (1906).
\textsuperscript{133} 34 Stat. 451 (1906), 12 U.S.C. § 84 (1964) provides in pertinent part: "The total obligations to any national banking association of any person, copartnership, association, or corporation shall at no time exceed 10 per centum of the amount of the capital stock of such association actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund." (Emphasis added.)
\textsuperscript{134} 13 Stat. 99, 108 (1864).
positors would be limited to the stockholders' liability, which is 'to the extent of the amount of stock owned at par value thereof, in addition to the amount invested.' At the time of the 1906 amendment, bank shareholders were generally subject to double liability based on par value of their shares. By tying loan limits to capital stock, banks were discouraged from setting an initial low par value and large paid-in surplus, thereby limiting shareholder liability while, at the same time, increasing the bank's lending limit. Now, however, double liability no longer characterizes ownership of national bank stock. An interpretive expansion of the "lending limit" measuring stick of "capital stock" would not, therefore, be in derogation of Congressional intent on this issue.

Without the double liability issue, the purpose of the Section 84 limitation appears to be one of diversification of risks. The limitation of individual liability to 10 percent of capital and surplus is intended to protect depositors and shareholders. With the issue thus narrowed to one of protection of these parties, the inclusion of capital notes in the capital base appears sound. Depositors and other senior creditors are protected by the subordination provision of the notes, and the shareholders cannot be heard to complain since they are the parties who initially approve capital note issuance.

The words of the statute do say "capital stock," but the apparent purpose of the provision belies a limitation to the strict semantical interpretation. Not only has Congress never specifically excluded capital debentures from inclusion in the loan base, but on the two occasions when it has legislated concerning these instruments, it has treated them as a part of bank capital. In Section 51 (b)(1) of Title 12 which sets up a method of determining impairment of capital, the liability of capital debentures is ignored. This treatment necessarily results in the debentures being considered not as debt, but as capital. Section 321 of Title 12 is even more explicit. For purposes of this statute, capital notes and debentures issued by the applying bank and purchased by the Reconstruction Finance Corporation (R.F.C.) are specifically designated as included within the terms "capital" and "capital stock." The Fed has taken the position that only those capital notes and debentures purchased by R.F.C. qualify for consideration as capital under this provision.

135. 40 Cong. Rec. 5313 (1906) (Statement of Representative Arsene Pujo).
139. Pursuant to 12 C.F.R. § 14.5 (1967), issuance of capital notes or debentures requires "approval of stockholders owning two-thirds of the stock of the bank, entitled to vote." In the alternative, that provision allows notes or debentures to be issued "without such (specific shareholder) approval if authorized by its (bank's) Articles of Association."
141. 12 C.F.R. § 208.108 (1967).
Be that as it may, the clear recognition by Congress that these instruments possess definite capital characteristics is inescapable. It should be noted that neither of the above statutes applies to national banks. They are presented solely for their value as indicating Congressional recognition that capital notes and debentures partake of the nature of capital. Congress has never addressed itself to the question of who can issue capital debentures.\textsuperscript{142} It has thus far dealt only with the circumstances under which they should be considered "capital stock" for state banks. A plausible reason why these provisions have not been applied to national banks is that Congress already has effective control over these institutions through the Comptroller of the Currency. No such effective control over the capital accounts of state banks is otherwise available to Congress.

Consideration of subordinated notes or debentures as a part of the equity base of non-banking concerns is not unique. They are commonly considered as a part of the capital structure of industrial and financing companies.\textsuperscript{143} In the more analogous context of regulated industries generally, subordinated debentures have become an important financing tool for public utilities. In fact, within the banking field, they are recognized by several states as constituting a part of bank capital.\textsuperscript{144}

In a situation so lacking in Congressional direction as that concerning the power of national banks to issue capital debentures and to include them in capital, a clear ruling by the Comptroller is persuasive evidence of the correctness of his view.\textsuperscript{145} Congress has not spoken clearly on this issue; consideration of subordinated debentures as capital is common practice in many industries and is well recognized by financial writers; and there is precedent for the ruling found in the practice of several states. These factors, when added to the fact that Congress has never specifically defined the term "capital stock" as used in Section 84, go far to support the ruling of the Comptroller. He alone is charged with the responsibility for enforcing this provision and his ruling, based on expertise in the field of banking, should stand unless clearly in error.\textsuperscript{146}

Whatever tenuousness does attach to the position of the Comptroller on this issue could, in the opinion of this writer, be dispelled by an addition to his present ruling. This addition could take the form of a caveat that any bank that desires to include capital notes or debentures as a part of its capital base will not be allowed to retire this "borrowed equity" if repayment would

\textsuperscript{142} See \textit{supra} note 71.

\textsuperscript{143} Johnson, \textit{supra} note 4; see also, Schwartz, \textit{supra} note 15, at 160; J. F. Weston, \textit{Managerial Finance} 226, 356 (1962).

\textsuperscript{144} For a compilation of the provisions of the various state codes, see \textit{The American Bankers Association, Use of Senior Capital by Commercial Banks} 71-75 (1967).

\textsuperscript{145} See Inland Waterways Corp. v. Young, \textit{supra} note 79.

result in impairment of capital or continuation of a previously existing capital impairment. Many of the states which allow inclusion of capital debentures in a bank's capital base have used such a proviso and it apparently has not detracted from the salability of debenture issues by banks under their jurisdiction.

Section V: Enforcement Under the Bankruptcy Act

The subject of enforcement of subordination agreements has been extensively discussed in several recent articles, but none of these has considered the special problems which may arise in a bank receivership situation. Banks may not become either voluntary or involuntary bankrupts within the Bankruptcy Act, the Act under which the case law on subordination agreements has developed. However, a brief consideration of this existing case law should help to establish a background from which to discuss the possible results of similar litigation under the National Bank Act. A determination of the legal rights of capital noteholders vis-a-vis bank depositors, other creditors, and shareholders will hopefully emerge from this inquiry.

Several theories have been put forth to explain the legal basis underlying enforcement of subordination agreements. The courts have spoken of these agreements as creating an "equitable lien" in favor of the senior creditor; they have been thought to create an "equitable assignment" to the senior creditor of the subordinated debt claim in bankruptcy and the dividends payable thereon; the subordinated creditor has been said to hold the dividends received as "constructive trustee" of the holder of the senior debt; and the contract doctrine of "third party beneficiary" has been applied in order to enforce the rights of the senior debt holder as against the subordinated creditor. The most recent case on this issue, In re Credit Industrial Corporation, was decided without recourse to any of the above theories. The court in that case reviewed the note agreement and observed that the lender knew that until CIC [the common debtor] should satisfy "every one of its present or future loans, ... now in existence or

148. Among state banks in California for instance, United California Banks has issued $70,000,000 in debentures, and Wells Fargo Bank has issued $75,300,000.
151. In re Geo. P. Schinzel & Son, Inc., 16 F.2d 289 (2d Cir. 1926).
155. 366 F.2d 402 (2nd Cir. 1966).
hereafter incurred from any bank, finance company, ... or any other institutional organization hereinafter referred to collectively as 'institutional creditors.' CIC would not pay the notes in whole or in part.  

The presence of this provision, together with the provision whereby the note-holders (subordinated creditors) specifically waived all notice of acceptance of the subordination by any institutional creditor or of the reliance by any institutional creditor upon the subordination, caused the court to state:

In bankruptcy, the parties claiming rights to participate in the assets of the bankrupt must do so in accordance with such contractual rights against the debtor as they may have purchased or acquired. Bankruptcy does not provide a forum for the realignment of rights or priorities but serves only as a forum for the recognition of rights already acquired. (Emphasis added.)

The court thus shifted from a position of seeking to find some justification for enforcement of contractual subordination, such as the third party beneficiary theory, to placing the onus upon the subordinated debt holder to show the court some compelling reason for not enforcing the contract as it stands. This logic is appealing.

The Supreme Court has not passed directly on the question of the enforceability of an agreement to subordinate. In Prudence Realization Corp. v. Geist, however, the Court indicated that it would, in a proper case, give effect in a proceeding in bankruptcy or in an arrangement or reorganization proceeding to an agreement to subordinate debt. The Court did not state its rationale for this statement, but it has been said to be that "contract rights acquired pursuant to an agreement enforceable under state law will be honored and given effect in a bankruptcy arrangement or reorganization proceeding under federal law."

The principal contention of the parties opposing enforcement of subordination agreements is that such enforcement would violate the provisions of Section 65(a) of the Bankruptcy Act. This section provides in part that "[d]ividends of an equal percentum shall be declared and paid on all allowed claims, except such as have priority or are secured." This argument has been consistently rejected by the courts. On several occasions they have expressly held that Section 65(a) does not prevent parties from making en-

156. Id. at 407.
157. Ibid.
158. 316 U.S. 89 (1942).
159. Everett, supra note 149, at 963.
161. See In re Associated Gas & Elec. Co., 53 F. Supp. 107 (S.D.N.Y. 1943), aff'd sub nom. Elias v. Clarke, 145 F.2d 64 (2d Cir. 1944), cert. denied, 323 U.S. 778 (1944); In re Aktiebolaget Kreuger & Toll, 96 F.2d 768 (2d Cir. 1938); Bird & Sons Sales Corp. v. Tobin, 78 F.2d 371 (8th Cir. 1935).
forceable subordination agreements, so long as such agreements do not violate public policy or the priorities established by the Bankruptcy Act. 162 Neither the senior debt nor the subordinated debt have been found to have "priority" or to be "secured" within the meaning of the Act. The senior debt and the subordinated debt are proved under the Act on a parity with one another and on a parity with the other debt of the borrower that has neither priority nor is secured within the meaning of the Act. The courts have taken the position that in distributing dividends payable on account of subordination to the holders of the senior debt, they are merely exercising their powers as courts of equity to disburse, in accordance with lawful contracts, dividends that are payable under the Act on account of claims that have been proved under the Act in accordance with the statutory priorities and other applicable statutory provisions.

The cases most often cited as supporting enforcement of subordination agreements are In re Aktiebolaget Kreuger & Toll, 163 Elias v. Clarke, 164 In re National Discount Corp., 165 In re Handy-Andy Community Stores, Inc., 166 Searle v. Mechanics' Loan & Trust Co., 167 Bird & Sons Sales Corp. v. Tobin, 168 and In re Geo. P. Schinzel & Son, Inc. 169 To this list will surely be added the Credit Industrial case mentioned above. 170 A detailed analysis of the facts and holdings of each of these cases will not be attempted here, since this has been ably accomplished elsewhere. 171 Suffice to say that they do support the statement that courts have, with few exceptions, 172 enforced for the benefit of senior creditors the subordination agreements presented to them. Given a situation where the intent to subordinate was clearly expressed, 173 and no element of fraud appears, 174 the only serious question that has recently faced

162. § 64(a) of the Bankruptcy Act, 30 Stat. 563 (1898), 11 U.S.C. 104(a) (1964), sets out five specific categories of debts that will be accorded priority in bankruptcy. This list is exclusive.

163. Supra note 161.
164. Supra note 161.
165. Supra note 154.
166. Supra note 152.
167. 249 F. 942 (9th Cir. 1918).
168. Supra note 161.
169. Supra note 151.
170. Supra note 155.
171. See Everett, supra note 149, at 962-71; Calligar, supra note 149, at 383-92.
173. In the recent case of In re Joe Newcomer Fin. Co., 226 F. Supp. 387 (D. Colo. 1964), the court appears to have been troubled by the question of whether the purchasers really bargained for subordination of the principal of the notes or subordination of the interest on the notes only. See comment on this case in Everett, supra note 149, at 961.
174. In Pioneer-Cafeteria Feeds, Ltd. v. Mack, 340 F.2d 719 (6th Cir. 1965), a peculiarly complex fact situation was presented. Pioneer extended credit to a Canadian corporation (Northland) and obtained from the principal stockholder of Northland (Wyse) an agreement guaranteeing payment of all liabilities of Northland to Pioneer and subordinating all liabilities owing to Wyse from Northland to the prior payment of the debt owed to Pioneer. On September 30, 1959, Wyse filed a voluntary petition in bankruptcy in the district court
the courts is whether or not proof of reliance by the senior creditors upon the subordination is necessary.

In both Kreuger & Toll and Elias, the courts enforced for the benefit of senior creditors a subordination agreement to which they were not a party and upon which they were not alleged to have relied. In Bird & Sons, Searle, and Community Stores, and another leading case, In re Dodge-Freedman Poultry Company, the courts appear to have placed at least some emphasis upon an apparent reliance by senior creditors on the subordination provisions of the loan. A leading commentator in the field of bankruptcy law has opined that “only where subsequent creditors rely on a subordination agreement should a court of equity employ the principle of estoppel to subordinate.” In the Credit Industrial case, the district court considered the lack of proof of reliance by the senior creditors to be determinative and held that such lack of reliance was fatal to enforcement of the subordination provision.

On appeal, the circuit court effectively dispensed with this reliance argument in the following language:

[T]he enforcement of such agreements is not based on any theory of equitable estoppel. In our opinion the district court erroneously relied on the doctrine of equitable estoppel as a basis for its position and failed to recognize the distinction between equitable and consensual subordination in bankruptcy. Equitable subordination, which is founded upon estoppel, is the doctrine invoked by courts to deny equal treatment to creditors based on some inequitable or unconscionable conduct in which they have engaged, or a special position which they occupy vis-à-vis the bankrupt that justifies subordination of their claims. . . . On the other hand, consensual or contractual subordination, of which the debt subordination agreements involved here are prime examples, occurs when a creditor and the bankrupt agree to create priorities among debts. Such

in Ohio and was adjudicated bankrupt. Pioneer continued to advance funds to Northland until the latter filed its voluntary petition in bankruptcy in the bankruptcy court of Ontario, on November 2, 1959. The Canadian court ordered Wyse’s dividends in the Northland bankruptcy to be paid to Pioneer under the subordination clause. Pioneer then filed its proof of claim in the Wyse bankruptcy for the balance due under Wyse’s guarantee of the Northland debt. The referee in the Wyse bankruptcy allowed this claim but ordered that no dividends be paid on the claim until the other creditors of Wyse had received dividends on their claims equal to the per centum of Pioneer’s claim against Wyse which was paid by application of Wyse’s dividends in the Northland bankruptcy, i.e., 26.43%. The court of appeals upheld the ruling of the referee.

In refusing to recognize the subordination in the Canadian court and applying the doctrine of equitable subordination, the circuit court cited Pepper v. Litton, 308 U.S. 295 (1939). This citation, together with the court’s reference to lack of notice to Wyse’s creditors of the existence of the guaranty agreement, may indicate that the court perceived some elements of fraud or overreaching.

175. Supra note 153.
agreements have been uniformly enforced according to their terms by bankruptcy courts. . . . The doctrine of equitable estoppel is clearly irrelevant to a determination of whether a lawful subordination agreement is enforceable in bankruptcy proceedings and the district court erred in invoking it to support its determination that enforcement of such agreements is conditioned on proof of reliance. (Emphasis added.)

The circuit court went on to state its holding as follows:

To conclude, we hold that a senior creditor can enforce in bankruptcy a subordination agreement which was executed for his benefit without alleging or proving that he advanced funds in reliance thereon provided that the agreement does not interfere with the statutory priorities set up by the Bankruptcy Act . . . and the agreement is otherwise lawful. The district court's determination that non-reliance is a defense to the enforcement of such an agreement by a bankruptcy court is reversed. (Emphasis added.)

The current state of the law concerning enforcement of subordination agreements entered into by parties who come under the purview of the Bankruptcy Act thus appears to favor the enforcement of contractual subordination agreements by a court of equity, irrespective of reliance on the part of senior creditors, so long as the agreement is not otherwise unlawful.

After dispensing with the reliance argument in general, the circuit court noted:

When a junior [subordinated] creditor establishes that the subordination agreement is unlawful, it may be reasonable and necessary, if equity is to be done, to require a senior creditor to prove that he relied on the subordination agreement, without actual or constructive knowledge of any infirmity in the agreement, in advancing funds to the bankrupt as a condition to receiving priority in the distribution of the bankrupt's estate. In cases where the underlying subordination agreement is unlawful, a court is not confronted with the problems of enforcing express contractual provisions but, rather, with the entirely separate problem of determining which general creditors should bear a loss caused by the debtor, a problem which may have to be resolved by reference to equitable principles.

The court was here addressing itself to an allegation that the debt instruments had been issued in violation of the Securities Act of 1933, and the case was remanded for further findings on this and other asserted defenses. This language of the court will be of interest when we consider, infra, its possible application to a finding of national bank issuance of subordinated debentures as ultra vires.

178. Id. at 408-09.
179. Id. at 410.
180. Id. at 409.
What Can Be Expected in the Banking Context?

Consideration of the results to be expected if a national bank, having capital debentures outstanding, goes into receivership must be premised on the fact that the decision will be reached under the National Bank Act and not under the Bankruptcy Act. As stated by Mr. Justice Field, speaking for a unanimous court in *Cook County National Bank v. United States*:181

We consider that [National Bank] act as constituting by itself a complete system for the establishment and government of national banks. . . . Everything essential to the formation of the banks, the issue, security, and redemption of their notes, the winding up of the institutions, and the distribution of their effects, are fully provided for, as in a separate code by itself, neither limited nor enlarged by other statutory provisions with respect to the settlement of demands against insolvents or their estates.182

It should be noted, however, that while the provisions of the Bankruptcy Act do not govern, cases decided under that Act have been referred to as helpful guides in the determination of issues arising from the liquidation of a national bank.183

Parties opposing enforcement of the subordination provisions in capital notes or debentures issued by a national bank subsequently placed in liquidation can be expected to contend that enforcement of the subordination agreement violates 12 U.S.C. § 194, which provides in pertinent part:

... [T]he Comptroller shall make a ratable dividend of the money so paid over to him by such receiver on all such claims as may have been proved to his satisfaction or adjudicated in a court of competent jurisdiction, and, as the proceeds of the assets of such association are paid over to him, shall make further dividends on all claims previously proved or adjudicated; and the remainder of the proceeds, if any, shall be paid over to the shareholders of such association, or their legal representatives, in proportion to the stock by them respectively held.

The similarity is striking between Section 194's requirement of a "ratable dividend" and the demand of Section 65 (a) of the Bankruptcy Act for payment of "dividends of an equal percentum." As stated before, the courts have interpreted Section 65 (a) as not creating an inexorable rule for the distribution of dividends,184 but what of the interpretation of Section 194?

In the case of *Merrill v. National Bank of Jacksonville*,185 the Supreme

184. See text supra pp. 94-96, for discussion of this point.
185. 173 U.S. 131 (1899).
Court interpreted this provision in the context of a suit to determine the rights of a secured creditor of a national bank in liquidation. The Court stated:

The requirement of equality of distribution among creditors by the national banking act [sic] involves no invasion of prior contract rights of any such creditors, and ought not to be construed as having, or being intended to have, such a result. (Emphasis added.)

And in another portion of this same opinion, the Court said:

[All] rights, legal or equitable, existing at the time of the commission of the act of insolvency which led to the appointment of the receiver, other than those created by preference forbidden by section 5242, are preserved... Further interpretation of this Section is provided in Chemical National Bank v. Armstrong where the court, speaking through Judge Taft, stated:

The national banking act [sic] was framed to secure equality of distribution among the creditors, so far as is consistent with the previous contract rights of those creditors. (Emphasis added.)

Recall the words of Judge Moore in the Credit Industrial case that “bankruptcy does not provide a forum for the realignment of rights or priorities but serves only as a forum for the recognition of rights already acquired” and an interpretive parallelism consistent with the similarity in wording of the two statutes is seen.

The courts have not as yet had occasion to apply the provisions of Section 194 to the situation of a national bank liquidation which involves outstanding capital notes or debentures. But the analogy between the statutory expression and judicial interpretation of this statute and that of Section 65 (a) of the Bankruptcy Act is so close as to all but compel the conclusion that in a simple liquidation context, the position of a capital noteholder of a national bank would be similar to that of any other subordinated creditor-junior in right of payment to senior creditors. The fact that the F.D.I.C. will be subrogee of all insured depositors (the largest class of senior creditors), to the extent of their insured claims, should not complicate the issue of enforcement of the subordination. In the one case that could be found where such a situation existed, the court had no difficulty in coming to the conclusion that the rights of the F.D.I.C. are no greater and no less than those of the insured depositors. Thus, the court held that when the full principal sum of depositors’ (and other senior creditors’) claims had been paid by the

186. Id. at 147.
187. Id. at 148.
188. 59 F. 372, 376 (6th Cir. 1893).
Receiver, the subordinated creditor (in this case, the R.F.C.) was entitled to repayment of principal before senior creditors' claims for interest payments could be met.

The question of the corporate power of a national bank to issue capital notes or debentures has been considered and the conclusion reached that such issuance is not ultra vires. There remains to be considered, however, the language in the Credit Industrial case concerning reliance and the possible effect which its application could have if a court were to find national bank issuance of capital notes to be unlawful. Recall that Judge Moore felt such a situation would present a court with the problem of determining which general creditors should bear a loss caused by the debtor, "a problem which may have to be resolved by reference to equitable principles." 190

Application of the reliance theory to a bank capital note situation need only be reflected upon momentarily to see the sheer inequity of its result. By far the largest group of senior creditors of a bank is its depositors. Even a relatively small bank has thousands of them. For these senior creditors to shoulder the burden of proving reliance upon the subordination would be an impossibility. None but the largest corporate customers are usually aware of the general financial condition of the bank, let alone possess a more sophisticated understanding of the relative position of the subordinated note-holders to the other creditors of the bank.

Though Judge Moore framed his comment in terms of unlawful subordination agreements, generally it is difficult to rationalize his position without recourse to a finding of fraud or knowledge of fraud on the part of the senior creditor. For without such a finding, what right does the recalcitrant junior creditor have to assert his equality with the senior creditor? If a court were to find that national banks lack the corporate power to issue capital notes or debentures, what possible effect would such a finding have upon the equities governing in a liquidation proceeding? Such a finding would not affect the financial situation which caused the purchaser to subordinate his claim in order to achieve a higher return on his investment. The financial data upon which he premised his decision would not be changed in the least. Why then should he be allowed to seek equality with the senior creditors? Barring reliance on their part, what equity would dictate a dilution of depositors' and other senior creditors' claims against the insolvent bank?

Even assuming that the subordinated creditor was induced by the bank to purchase the notes based on fraudulent financial information, there appears to be no compelling reason to treat the depositors and the capital noteholders alike in the receivership context. Admittedly the noteholder was wronged by the bank, but why should this weigh against the innocent depositor? As

190. *In re Credit Industrial Corp.*, 366 F.2d 402, 409 (2d Cir. 1966).
between the depositor and the noteholder, the latter doubtless had consider-
ably more information upon which to base his decision and he admittedly
purchased the notes as an investment rather than for the purpose of safe-
keeping and convenience. It is submitted that the equities of the situation
would fall on the side of the depositor-senior creditor.

Section VI: Conclusion

This paper has considered at some length the questions which arise with re-
spect to issuance of capital notes or debentures by commercial banks. The
reasons for this lengthy treatment lie both in the fact that this has been a rel-
avely unexplored area of legal writing and that this mode of raising funds
is already of significant importance in banking, and will in all probability
become of even greater importance in the future. As our economy grows
more complex, the tools which the banks need to fulfill their proper role as
a catalyst of economic resources must likewise increase in complexity. The
movement of banks into the area of subordinated debt issuance is only one
manifestation of this necessary evolution.