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PAR CLEARANCE OF CHECKS

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ON MAY 24, 1922, the Supreme Court of North Carolina, in the case of *Farmers & Merchants Bank of Monroe* v. *Federal Reserve Bank of Richmond*,[1] upheld the par clearance policies and practices of the Federal Reserve Bank and pronounced unconstitutional certain state banking laws which had sought to prevent local applications of those policies and practices. A petition for rehearing being granted, the case was subsequently reargued, but with no other result than a reaffirmation by the court, on December 22, 1922, of its former opinion. The case is now pending in the Supreme Court of the United States.

During the year 1922 similar litigation was carried on in the lower federal courts involving the federal reserve banks of Atlanta, Cleveland, and San Francisco. The Atlanta case reached the U. S. Circuit Court of Appeals, and was decided November 2; the other two have not yet been reviewed by appellate courts.

Of the four cases, the North Carolina case, the only one which has pursued its course in the state courts, is the most interesting and significant. It has faced squarely all of the major issues involved in the par clearance controversy, and has kept them free of extraneous and incidental elements which might operate to becloud the true controversy.

Should the North Carolina ruling be upheld in the United States Supreme Court, it is generally believed that it will concentrate the clearance of practically all save local checks within the activities of the federal reserve banks, thus depriving the state banks of certain traditional banking usages and, pending readjustment, seriously reducing their income. The federal reserve banks will assume a much higher degree of banking importance, and become virtually the sole agencies of inter-community and inter-sectional transfers of credit and capital.[2]

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[1] 183 N. C. 546, 112 S. E. 252.

[2] For a detailed and admirable treatment of the economic aspects of exchange, see Cross, *Domestic and Foreign Exchange*, New York, 1923.

The economic consequences of such a development, especially in a section accustomed to highly individualized and decentralized banking machinery, therefore gives to the litigation under way much more than passing significance.

Except in isolated communities, one of the chief functions of a commercial bank is to attend to the business of receiving checks drawn on other banks and to secure from the drawee banks payment therefor. While engaged in the process of collecting checks from other banks, it is also being steadily collected from by other banks. In the long run the amount of the checks which a bank is called upon to collect from other banks is roughly equal to that which other banks collect from it. Therefore settlements from one bank to another theoretically can be made by the simple process of swapping debits and credits, rather than through the shipment of cash.

But in actual practice, even this swapping process is attended by difficulties. In the first place there is seemingly no end to the number of places to which depositors of a given bank send their checks, one will send his check to Chicago, another will send it to Los Angeles, another to Akron, and so on *ad infinitum.* For the banks in each of these distant localities to collect directly from the North Carolina bank would be impracticable because of the cost of correspondence for so small a number of items and because of the expense of shipping the cash necessary for settlement.

It is therefore essential that specialized devices be brought into play in order that the use of the check may not be restricted. There has grown up in consequence the use of correspondent banks and of clearing house associations. The clearing house takes care of the exchange process between banks in a given city. But when there are checks to be collected from distant points or from country banks, the correspondent is called into play. Outgoing checks to be collected are sent in batches to the appropriate correspondent. Incoming checks to be paid arrive through the correspondent. The correspondent debits one set of items and credits the other. If the outward flow and the inward flow equalize, all well and good. They pay for each other. If not there must be a shifting of balances from one correspondent to another. Lacking this, cash or borrowing must be resorted to for settlement.

The correspondent in turn has its correspondents with which the process is repeated, and hence it can readily be seen that if banking connections were ideally made interbank settlements would be effected almost automatically without the necessity of shipping cash. Such an ideal system would assume that every bank has one or more correspondents which are also correspondents either directly or indirectly of all the other banks. In our decentralized banking system no such ideal has ever been realized or even approached on a national scale until the inauguration of the Federal Reserve System. Only within limited areas has banking coördination in the matter of exchange been worked out. In consequence the country as a whole has been served by an indefinite number of what might be termed community clearing systems, each one overlapping more or less the neighboring ones, through the instrumentality of the larger banks which with a longer

radius of activity than the average, maintain correspondents in distant areas. Such unity as has obtained was gained chiefly through the wide use of New York as a clearing centre. Practically every bank either had a correspondent in New York or else a correspondent that had a correspondent in New York.[3] New York exchange came to be a universal medium of interbank settlements, which to a large extent solved the problem of making remittances, but which owing to the vastness of our geographical distances, could not solve the problem of the speedy and economical homeward routing of checks which had strayed a great way from the drawee bank. Hence when a check on a Carolina bank was deposited in Santa Fe, the Santa Fe bank having no bank in common with the bank of Carolina, would probably send the check for collection to a St. Louis correspondent, from which place it might go to Philadelphia, thence to Richmond, thence to Winston-Salem and finally to the home bank, the circuitous trip possibly consuming weeks of time, and of course involving frequent handling and recording. This is a typical and not an extreme sample. The total of checks thus outstanding was termed the "float," and the daily volume ran into many millions.[4]

Not the least of the accompanying evils was the great expense. Even worse was the practice of banks in counting the mass of checks in transit for collection purposes as reserves immediately upon despatching them, perhaps days or even weeks prior to their actual collection. At any given time, considerable portions of the reserve funds of many banks would be of this imaginary character.

Larger banking institutions found that efficiency of operation necessitated the carrying of a multitude of reciprocal accounts with correspondents which not only added to the overhead expense of the bank but which called for constant shifting of bank balances and often the shipments of large quantities of cash. Also such scattering of the liquid resources of a bank was not conducive to their most efficient use. Unusual or unexpected transfers of capital and credit to satisfy the cyclical ebb and flow of business or to meet the changing seasonal demands of business were effected in most cases only with great difficulty.

Another logical outcome of this unwieldly machinery of interbank clearance and collection was the imposition in many localities of the long familiar, but now celebrated, exchange charge. Where checks had to be collected and paid through the medium of correspondents, it was but natural for the drawee bank to regard the remittance of funds as a costly service to the holders of checks which justified the imposition of an exchange charge to cover the attendant inconvenience and expense. For these reasons exchange charges were until comparatively recent years practically universal.

However, the rapid growth of the trade volume in the great industrial centres of the country has so enlarged the volume of clearances in those localities in proportion to the number of clearing agencies required that the law of diminishing cost has functioned with remarkable success. The average cost of handling each item has been steadily reduced until at present it is virtually negligible in respect

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[3] See Johnson, *Money and Currency*, ch. 5.
[4] See Willis and Edwards, *Banking and Business*, New York, 1922, ch. 17.

to all checks save those originating in the more or less isolated communities. Where such developments have occurred par clearance has logically and naturally followed, merely as a matter of good business policy.[5]

It would seem then that a universal application of the principle of par clearance awaits merely, first, the appearance in the more isolated communities of a sufficient volume of clearing items to permit the operation of the quantity principle, and, second, the concentration of the clearance functions within a relatively smaller group of correspondents. Stated in another way, par clearance follows the routing of transit items through fewer, larger, and more direct channels, which afford greater ease, more speed, and less cost in transmission, and at the same time entail the use of fewer, larger, and more self-sustaining credit balances from which to make the requisite payments to collecting banks.

Left to the usual evolutionary processes, these developments would eventually come of their own accord, perhaps all but unnoticed, and probably without protest from any quarter. But the evolutionary process would require many years to arrive at completion. Wherefore the conscious, organized effort of the federal reserve banks for its immediate achievement.

It must not be assumed that the sole or chief purpose of the federal reserve banks is to eliminate as between the banks the exaction of the exchange charge. That is but part of a larger scheme which contemplates a general rehabilitation of the entire system of bank clearance and collection. It is only through this broader view that one comes to recognize the full significance of what is termed the par clearance controversy.

It should be noted that the United States is divided into twelve geographical areas for federal reserve purposes. In each of these areas, called federal reserve districts, there is one federal reserve bank which is exclusively a bankers' bank and which has for its members all national banks within that district, and, in addition, such state banks as meet certain banking requirements and express a desire for membership.

Now the plan of the federal reserve banks is to serve as common clearing agents and correspondents for the banks in their respective districts, both members and non-members. The federal reserve banks might therefore be properly pictured as converging points where are brought together all of the outward flowing currents of transit items and likewise all of the inward flowing items, thus meeting the ideal of quantity handling and standardized routing. At the same time the resultant concentration of accounts would mean that the interbank settlements could be effected merely by the simple process of debit and credit entries upon receipt of the appropriate items, thus avoiding the delay and expense incident to the distance, shifting of balances and shipments of cash. To accord still more closely with the ideal the federal reserve bank stands ready to advance such credits as may be necessary from time to time to take care of customers' balances.

Just as each of the federal reserve banks serves as a common clearance and collection centre for its district, so does the Federal Reserve Board serve as the

[5] See Cross, note 2, *supra*, pp. 38-44.

common clearance and collection agency for the federal reserve banks of the country as a whole. Each of the federal reserve banks, in the course of a day's business, comes into possession of items drawn upon banks in other districts which it must collect, and likewise it receives from other districts a great volume of items which it must pay. Thus, in relation to the other federal reserve banks, it stands exactly where its individual member banks formerly stood in their relationships to each other. Therefore the federal reserve banks must in their turn have a common correspondent, and a common keeper of accounts. In practice each of the banks maintains a deposit with the Federal Reserve Board in the form of gold, and the fund thus created is known as the gold settlement fund. The Federal Reserve Board does not actually handle the items to be cleared, as no time would be gained thereby. Rather, each federal reserve bank routes directly to the other reserve banks in large batches the checks to be collected from the drawee banks in their respective districts. Such operations are reported by wire to the Federal Reserve Board which credits in the gold settlement fund to each bank the amount of the collection items which it has sent to the other banks, and enters offsetting debits for the items to be charged.

Thus with lightning-like speed and automatic precision the tremendous volumes of inter-district clearings are cared for, and at an average cost per item which is but a minute fraction of a cent. As one example of what is being done, the Federal Reserve Bank of Richmond, which does only about five per cent of the business of the Federal Reserve System, in 1922 paid out for items received from other federal reserve districts about $5,138,000,000, and received in payment for items sent to other federal reserve districts $5,193,000,000. This tremendous volume of clearings was taken care of through the gold settlement fund without the actual shipment to or from other districts of a single dollar in cash. It collected for the banks within the district about 43 million checks in the year, aggregating in amount $8,762,000,000, and at a cost per item of less than one one-hundredth of a cent. Moreover as compared with the traditional methods of collection, the average time for collecting a check has been reduced by at least two-thirds.

As part of the general plan of exchange the federal reserve banks make available, for the benefit of individuals or banks, telegraphic transfers of money to meet specific payments. John Smith, in Raleigh, desiring to pay a debt of $5000 in New York may step into his bank, pay down the necessary sum and ask for its immediate transfer to Jones in New York. The Raleigh bank will wire to the Richmond Federal Reserve Bank, which in turn will direct the Federal Reserve Bank of New York to make available in Jones' designated bank to his order the sum of $5000. Proper entries in the accounts of the individual banks and in the gold settlement fund effect a quick settlement. The whole business is accomplished in a few minutes, and without charge so far as the federal reserve banks are concerned. A transfer of $10,000,000 is made as easily as a transfer of $5000.[6]

[6] *The Gold Settlement Fund*, letter No. 7, Federal Reserve Bank of Richmond.

This in brief constitutes the structure and operation of the federal reserve clearance plan. It promises to revolutionize, and in many places has already done so, the traditional antiquated system of exchange. Yet this particular aspect of the Federal Reserve System, though a valuable economic end in itself, is but the means through which even more important duties are performed by the federal reserve banks. In their capacity as reserve depositories for all member banks, as banks of discount and issue, as sources of credit for member banks, and as collection agents for maturing notes, drafts, and bills of exchange, and as fiscal agents for the United States government, they are faced with duties the efficient and economical performance of which is conditioned upon the unrestricted use by the federal reserve banks of all customary banking paper, and the unquestioned convertibility of such paper without charge and at par value.[7]

This lengthy prelude to the legalistic aspects of par clearance has been ventured in the belief that no adequate understanding of the cases at bar could be had without a knowledge of the economic background.

As originally enacted, the law providing for the establishment of the federal reserve banks,[8] specifically authorized them to receive for collection only such items as were drawn upon member banks. This, together with certain additional handicaps of a technical nature, held in abeyance the collection function of the Federal Reserve System for about two years. Not until May, 1915, was the gold settlement fund established. Thereupon, member banks were invited to use the collection machinery of the reserve banks, but the limited nature of the paper eligible for handling in this way discouraged general use of the plan.

In July, 1916, the plan was made compulsory for member banks,[9] and on September 7, following, Congress passed an amendment to section 13 of the Federal Reserve Act authorizing the federal reserve banks to receive for collection checks drawn upon non-member as well as member banks. In order to encourage still further the use of the federal clearance machinery, another amendment was enacted authorizing non-member banks to open exchange accounts with the federal reserve banks. A further amendment, known as the Hardwick amendment, prohibited the charging of exchange by any bank as against the federal reserve banks.

Section 13 of the Federal Reserve Act, the legal basis of the federal clearing activities, in its amended form, is as follows:

"Any federal reserve bank may receive from any of its member banks, and from the United States deposits of current funds in lawful money, national bank notes, federal reserve notes, or checks, and drafts payable upon presentation, and also for collection, maturing notes and bills; or, solely for purposes of exchange or of collection, may receive from other federal reserve banks deposits of current funds in lawful money, national bank notes, or checks upon other federal reserve banks, and checks and drafts payable upon presentation within its district, and maturing notes and bills payable within its district; or, solely for

[7] See Reed, *Federal Reserve Policy*, New York, 1922, ch. 2; an able treatment of the broader aspects of par clearance.

[8] Federal Reserve Act, 38 Stat. at L. 251, U. S. Comp. Stat. sec. 9785 *et seq.*, Fed. Stat. Ann., Supp. 1914, 260.

[9] *Annual Report*, 1916, Federal Reserve Board.

purposes of exchange or of collection, may receive from any non-member bank or trust company deposits of current funds in lawful money, national bank notes, federal reserve notes, checks and drafts payable upon presentation, or maturing notes and bills; provided, such non-member bank or trust company maintains with the federal reserve bank of its district a balance sufficient to offset the items in transit held for its account by the federal reserve bank; provided, further, that nothing in this or any other section of this act shall be construed as prohibiting a member or non-member bank from making reasonable charges, to be determined and regulated by the Federal Reserve Board, but in no case to exceed 10 cents per $100 or fraction thereof, based on the total of checks and drafts presented at any one time, for collection, or payment of checks and drafts and remission therefor by exchange or otherwise; but no such charges shall be made against the federal reserve banks."[10]

It is to be noted that this section specifically authorizes a federal reserve bank to receive from its member banks checks and drafts subject to no other limitation than that they be payable upon presentation. Checks and drafts payable upon presentation are also receivable directly from non-member banks provided the latter maintain the proper credit balances.

Also worthy of especial note is the concluding proviso to the effect that while the Federal Reserve Board shall not prohibit the exaction of certain charges as between banks and individuals, or as between any member or non-member bank, "no such charges shall be made against the federal reserve banks."

Believing, after these amendatory enactments, that they possessed all the requisite powers and facilities for an efficient and universal system of clearance and collection, the federal reserve banks lost no time in exercising them. Campaigns of education and persuasion were generally inaugurated in order to gain the full coöperation of the state banks. The task was a big one, as the aggregate of member banks comprised less than one-third of the nation's total.

However, in certain of the federal reserve districts, the principle of par clearance had already been fairly well established, particularly in the Boston and New York districts; and here no considerable difficulty was experienced in securing almost complete adoption of the federal reserve plan. By the end of 1918, about 20,000 banks, member and non-member, were on the par lists. In 1919 the number of banks clearing at par was increased to 25,486, while the number of non-par banks was reduced to 4,015. Of the latter, the great majority were to be found in the southern states, although much opposition to par clearance was also evident in Washington, Oregon, Arizona, South Dakota, Minnesota, and Wisconsin. The rest of the states either voluntarily or under pressure, had become practically all-par.[11]

The Federal Reserve Bank of Richmond entered the aggressive stage of its campaign for par clearance in 1919, with its efforts confined at first to the state of Maryland. September 10 was fixed as the day when the state should be declared all-par. The five banks still remaining outside the pale on that day were speedily brought in by threats to collect on them at the counter for cash.

[10] U. S. Comp. Stat., see 9796 (1).

[11] *Development of Par Collections by Federal Reserve Banks*, letters 5 and 6, Federal Reserve Bank of Richmond.

On February 1, 1920, West Virginia was declared on the par list, although personal presentation of checks was necessary in some cases to make par collections. The same procedure of education, persuasion, and threat of collection at the counter, resulted in placing Virginia on the all-par list April 1, 1920. In 24 cases actual presentation of checks at the counters had to be resorted to.

November 15, 1920, was named as the date when the federal reserve bank would undertake the collection at par of all checks drawn on North Carolina banks. On that date 478 banks were added to the par list, and in 24 cases personal presentation had to be resorted to.

It appeared that the state banks were utterly unable to contend with the chief weapon used by the federal reserve bank in enforcing par collection, namely, personal presentation of checks. The traditional method of making payment for checks sent in for collection by other banks was of course the use of exchange drafts, as previously pointed out. It will be recalled that these exchange drafts were drawn on credit balances in correspondent banks which were usually maintained through payments received from other banks in settlement of collection items sent to them. Now, the action of the federal reserve bank in presenting at the counter for payment in cash those items usually received in the mails and paid for in exchange drafts, had the effect of depriving exchange balances of their main function. If drafts could no longer be drawn upon them for exchange purposes, the only alternative was to draw them in to the home bank in the form of cash, in order that funds might be available to meet the greatly increased volume of checks clamoring for cash at the counter.

Such a situation was not only fraught with great expense; it also meant the conversion of more than the usual proportion of the bank's resources into cash in vault, which is equivalent to a diminution of its income-producing assets. Assuming that the major proportion of the checks drawn upon a bank should be collected and presented by the federal reserve bank for cash payment over the counter, it would, obviously, be impossible for the drawee bank to continue in business except at a loss.[12]

Hence, the history of the par clearance struggle in North Carolina would probably have become a closed chapter in November 1920, had not the state legislature, espousing the cause of the state banks, enacted on February 5, 1921, a law authorizing the state banks (1) to make an exchange charge not in excess of one-eighth of one per cent on remittances covering checks, or a minimum charge of 10 cents; and (2) in the event a federal reserve bank, post office, or express company, should make presentation of checks at the counters of the drawee banks and demand payment in cash, the drawee banks should be permitted to pay by means of a draft on a correspondent bank deposit, excepting of course checks payable to the government. state or federal, and checks on which the drawer had specifically ordered payment in cash.[13]

[12] Transcript of record, *Farmers and Merchants Bank* v. *Federal Reserve Bank of Richmond*, note 1, *supra*, pp. 101, 114, 120.

[13] P. L., 1921, ch. 20. It is understood that similar laws have since been enacted in other states.

In compliance with the provisions of this law certain state banks refused further to remit at par to the federal reserve bank for checks sent through the mail. The federal reserve bank, believing that the law was unconstitutional, persisted in its former course, and upon failure to collect at par through the ordinary procedure, presented the checks for payment at the counters of the drawee banks. In such case, the drawee banks offered to pay at par, provided drafts on exchange deposits were acceptable. But the federal reserve bank, in retaliation for being compelled to present checks at the counter in order to secure full payment, refused under such conditions to accept any form of payment except cash.[14]

Where an impassé of this type arose the federal reserve bank made a practice of returning the uncollected checks as dishonored to the former holders, but with the reasons given for the dishonor. The return of checks as dishonored to bank depositors at once created disaffection among their ranks, and the state banks were hard put to explain satisfactorily to their customers why checks were not honored. The evidence supports the conclusion that some depositors under such circumstances transferred their accounts to member banks, in order to make sure that henceforth their checks would circulate anywhere at par value.[15]

To make use of the protection presumably offered by the state law, the Farmers and Merchants Bank of Monroe, with twelve other state banks and trust companies, later increased to over 250 in number, instituted injunction proceedings in the Superior Court of Union County, and were awarded a temporary restraining order on February 29, 1921. An attempt by defendant to remove the case to the U. S. District Court for the western district of North Carolina failed because of inability to establish that a sum in excess of $3000 was involved. On March 29, 1922, after trial, Judge James L. Webb entered the final order making the temporary injunction permanent. In substance, the Federal Reserve Bank of Richmond was enjoined from refusing to accept exchange drafts drawn by the plaintiffs in payment of checks presented at the counters of the plaintiff banks, and was also enjoined from returning as dishonored those checks which had been presented for payment and for which payment had been tendered in the form of the above mentioned exchange drafts.

The defendant bank appealed to the Supreme Court of North Carolina, which tribunal rendered its decision on May 24, 1922,[16] reversing the lower court, and declaring invalid the North Carolina statute upon which the injunction was based. The opinion was rendered by Chief Justice Clark.

In its decision, the court reasoned in substance as follows: If the federal reserve bank was to perform its function of a reserve depository for member banks it must be in a position to collect their checks and other instruments which are the ordinary means of making settlements and transmitting funds. Since a large portion of the checks handled by member banks are drawn upon non-member banks, obviously the federal reserve bank must accept such checks without

[14] For defendant bank's account of its procedure see transcript of record, note 12, *supra*, p. 163 *et seq.*, evidence of Chas. A. Peple.

[15] *Development of Par Collections by Federal Reserve Banks*, note 11, *supra*, letter 6, p. 65.

[16] Note 1, *supra*.

discrimination, else the resultant uneven flow of checks would put the member banks at great disadvantage in the maintenance of their reserves and the establishment of credits through which to cover debit items returned for collection through the federal reserve bank. Therefore, the reasonable interpretation of section 13 of the Federal Reserve Act, is that "checks and drafts payable upon presentation within the district" has reference to the instruments drawn upon member and non-member banks alike. But the Hardwick amendment specifically prohibits the payment of exchange charges by the federal reserve bank. Hence the conclusion is obvious that the federal reserve bank is obligated to handle for its members at par all checks and drafts whatsoever payable on presentation within the district.

The North Carolina law, however, as the court indicated, directed the state banks to charge exchange to all alike. As the federal reserve bank is prohibited from paying such exchange, there arises either an inevitable conflict of law, or else the necessity that the federal reserve banks cease trying to handle the checks of state banks. The court refused to accept the latter alternative as it would in effect greatly reduce the efficiency of such service as the federal reserve bank under the federal law is impelled to grant to its members. Therefore, the only reasonable interpretation of the matter, as viewed by the court, was to regard the provisions of the two laws as in direct conflict. And the court held that the state law must yield.[17]

Moreover, that portion of the North Carolina law denying to federal reserve banks the privilege of returning as dishonored checks, payment for which had been tendered by the drawee banks in the form of exchange drafts, was regarded as being in conflict with the U. S. Constitution. The court evidently accepted the view presented by counsel for the Federal Reserve Bank of Richmond, that such a law imputed to bank checks legal tender characteristics clearly beyond the powers of the state to grant.

The following passages reveal the attitude of the court as regards the major issue:

"The federal reserve bank, under the provisions of the federal statute, has the right to receive for collection, a check drawn upon a non-member bank, or upon any other person within its district under the clear unmistakable terms of the act.

"The amendment made June 21, 1917, to section 13 of the Federal Reserve Act provides that no charge for the payment of the checks and drafts and the remission therefor for exchange or otherwise shall be made against the federal reserve banks.

"The real question therefore presented for us is whether the legislature of North Carolina can, by the act above mentioned, chapter 20, laws 1921, interfere with this provision or regulation of the federal corporation by a valid act of Congress, by providing that a state bank need not pay its obligations in lawful money when checks, which upon their face are unconditional orders for the payment of money, are presented by federal reserve banks."

In a subsequent paragraph the court states a part of its answer to this question as follows:

"No act of this state can authorize the paying bank to pay less than the face amount of the check drawn upon it by its depositor or to remit its check in payment or pay it otherwise than in legal tender money."

[17] U. S. Const., Art. 6, sec. 2.

The Federal Reserve Bank of Richmond, although wholly successful in the litigation, has shown no disposition to profit from the favorable outcome, and is withholding further attempts to impose par collections upon the state banks, until disposition of the case is made by the Supreme Court of the United States, to which appeal has been taken by friendly action of all the parties.

Since, therefore, some measure of doubt still remains as to the final outcome, a further examination of the cause as viewed by the state banks may not be amiss.

The state banks have, not without reason, expressed much doubt as to the proper scope of those clauses in section 13 of the Federal Reserve Act which empower a federal reserve bank to receive "checks and drafts payable upon presentation within its district," but which prohibit it from paying exchange charges on such checks. In the absence of a Supreme Court decision it is fairly debatable whether Congress intended these provisions to apply to banks which were not in any way affiliating with the Federal Reserve System. Attorney General Gregory, in an opinion given on March 21, 1918, thought that the state banks would be only indirectly affected by becoming possibly less desirable as banks of deposit in the eyes of the public at a time when member banks were handling checks at par for their depositors.[18] He stated that:

"If the state banks refuse to comply with the conditions by insisting upon making charges against the federal reserve banks, the result will simply be, so far as the Federal Reserve Act is concerned, that since the federal reserve banks cannot pay these charges they cannot clear or collect checks on banks demanding such payment from them . . . in my opinion the limitations contained in section 13 relating to charges for the collection and payment of checks do not apply to state banks not connected with the federal reserve system as members or depositors. Checks on banks making such charges cannot, however, be cleared or collected through federal reserve banks."

Advancing this interpretation as the proper one, the state banks of course follow it up by the claim that the economics of the situation is not such as to render it morally obligatory on the part of the federal reserve banks to clear for their members checks and drafts on all banks in the district.

Relative to the validity of the state law in question, counsel for the state banks argued that the statute authorizing drawee banks to make payments to federal reserve banks in the form of exchange drafts, unless otherwise directed by the drawers of checks in writing on the face of checks, did not contravene the legal tender provisions of the Constitution, as it did not remove the obligation of the bank to pay legal tender on the order of the depositor. Furthermore payments by draft were represented as being in the nature of immemorial custom, and in fact an admitted necessity in the efficient and economical transfer of bank funds.

They also emphasized that it was not their purpose to compel the acceptance of such drafts by the federal reserve banks. On the other hand, they admitted the right of the federal reserve bank to refuse such drafts, but denied that the federal reserve bank had the right to return as dishonored those checks payment

[18] 31 Opinions of the Attorney General (1918) 245.

for which had been tendered in the form of drafts. This reasoning of course depends for its validity upon the assumption that the federal reserve bank in the normal course of its business is not of economic necessity called upon to handle the checks of state banks generally.

In fact this assumption is insisted upon by the state banks. They claim that the federal reserve bank exclusively by its own action in advertising that it would undertake the collection of checks on non-member banks, comes into the possession of such checks. In the absence of such advertisements these checks would normally follow other channels, and would not impose upon the federal reserve bank the duty of collecting them.[19]

It will at once be seen that the soundness of this reasoning as compared with the reasoning of Mr. Chief Justice Clark, is conditioned not so much upon legal as upon economic considerations. The Chief Justice in his opinion took pains to show that inability to collect at par all checks on non-member as well as member banks seriously impairs the efficiency of the federal reserve bank in the performance of those duties which, under a valid act of Congress, it is obliged to perform for its members.

Certain economic aspects of the question are also regarded by the state banks as favoring their cause. They regard the exchange operation as a service rendered to the holders of the checks, involving on the part of the drawee bank trouble, expense, and risk. The charge is regarded as wholly economic and not disproportionate to the service rendered, wherefore it should justly be termed a valid source of income, just as loan and discount operations. Further, it is urged that the elimination of this source of income would seriously embarrass many banks and undoubtedly force an appreciable number out of business to the inconvenience and injury of the businesses and communities which they serve.

Aggravation of this hardship is caused, they assert, by the nature of the collection process which the federal reserve bank has chosen to adopt. Payment for checks must not only be at par, but must in addition take the form either of cash or of drafts which are convertible into cash within one day of receipt. This, in practice, means checks on Richmond, New York, or Philadelphia. State banks have feared that this requirement would necessitate the maintenance of larger deposits in those centers to the consequent diminution of North Carolina balances, when in many cases such a redistribution of funds would not be to the best interests generally of the banks.[20] They have therefore urged that the federal reserve bank accept for immediate credit, in payment for checks collected, drafts on North Carolina members. At present such drafts are credited only when collected: that is, three days after receipt.

In reply to these objections, the federal reserve bank points out that to give immediate credit for exchange drafts on distant banks is but to mistake the

[19] See Judge James L. Webb's findings of fact, transcript of record, note 12, *supra*, pp. 54-65, and testimony of Page, Covington, Seawell, Jenkins, Weskett, Collins, and Herring, pp. 97 127. See also brief for appellees on appeal of defendant on rehearing, *Farmers and Merchants Bank* v. *Federal Reserve Bank of Richmond*, note 1, *supra*, pp. 1-40, for a restatement of the case for the state banks.

[20] See transcript of record, note 12, *supra*, pp. 105, 124, 139. For the time or "availibility" schedule of the federal reserve banks, see Cross, note 2, *supra*, p. 42.

shadow for the substance. Since the funds received by the federal reserve bank from paying banks must be made available at once to the order of the collecting banks, obviously for its own protection the federal reserve bank must be within one day's reach of the actual cash. Also it has been the practice of many banks to draw checks upon correspondents in order to make settlement for collections when perhaps it had on deposit with the correspondent insufficient funds to cover the check, in such case trusting to its ability subsequently to build up its deposit before the check arrived for payment. In this connection the practice of "kiting" checks was developed by many individuals and banks under the old banking system. In the interest of sound banking, therefore, the federal reserve banks are determined to retain the practice of giving credit for remittances only when the credits can be realized on.[21]

Regardless of this conclusion, it yet remains an unfortunate fact, that as compared with banks in closer proximity to Richmond, the North Carolina banks are at some slight disadvantage. It seems wholly reasonable that in the future some device should be worked out by means of which this handicap of distance may be overcome. So far some progress toward its alleviation has been made through the use of the so-called "immediate credit symbol." A non-member state bank, not desirous of maintaining a Richmond or New York balance of the necessary proportions, but desirous of receiving immediate credit for its remittances to cover check collections, may arrange with one of its correspondents which is a member of the federal reserve bank, for the use of a special form of check which immediately upon its receipt in Richmond becomes chargeable to the account of the member bank. Such checks bear the immediate credit symbol, and the privilege of their use is presumably extended by member banks to such of their non-member correspondents as maintain with them balances large enough to compensate for the slightly larger balance which the member must maintain in Richmond. Unfortunately many state banks cannot provide their member correspondents with deposits profitable enough to enable the member bank to accord the use of its immediate credit symbol. However, officials of the federal reserve bank claim that a general use of this method of payment would not necessitate appreciably larger balances in Richmond to the account of member banks.

By way of supplementing the broader legal and economic basis of the antagonism to federal reserve banks, certain state banks have taken exception to the specific methods followed by the federal reserve banks in promoting the par collection principle. They regard as nothing short of high handed the placing on the par list of banks which never gave their consent to being so placed. Some termed as piratical the method pursued by the federal reserve bank of compelling acquiescence to par collection by presenting checks at the counter for payment in cash rather than in the customary exchange drafts. And there has been bitter resentment to the practice of returning as dishonored those checks which were presented for payment, but payment for which was unavailingly tendered in the

[21] Transcript of record, note 12, *supra*, evidence of Chas. A. Peple, pp. 163-173.

form of drafts on exchange deposits. Fortunately, the major issues of the present litigation were not obscured by such minor and transient considerations as the specific methods followed by the federal reserve banks in gaining their ends. In other districts, in somewhat similar cases, the disputants did not act so wisely, occasioning in consequence what may prove to be indefinite postponement of the adjudication of the really important issues.[22]

In its opinion, the North Carolina court makes special reference to only one other case directly involving par clearance, the Atlanta case. This case was inaugurated in the Superior Court of Fulton County, Georgia, on June 20, 1920, when a number of non-member banks filed a petition for an injunction to restrain the Federal Reserve Bank of Atlanta from collecting checks drawn on the plaintiff banks in any other manner than through the mails. It was alleged in the petition that the defendant bank, in presenting checks for par collection over the counters of the drawee banks was following unusual and oppressive tactics designed either to force the state banks into opening accounts with the federal reserve bank or to ruin their business. It was also alleged that the federal reserve bank in some instances accumulated checks until they reached a large amount before presenting them for payment at the counters of the country banks, an allegation which, if established, might go far toward indicating ulterior motives on the part of the federal reserve bank.

On petition of defendant, the case was removed to the U. S. District Court for the northern district of Georgia, where the bill was dismissed, on demurrer, for want of equity, the decree being affirmed on November 19, 1920, by the U. S. Circuit of Appeals for the fifth district.[23] The state banks appealed, setting up want of jurisdiction in the District Court and error in the final decree.

The decision of the U. S. Supreme Court, written by Mr. Justice Holmes, and handed down May 16, 1921,[24] was therefore a judgment rendered on the basis of the facts as alleged in the bill of complaint, and not on the basis of facts as established in a trial. The jurisdiction of the lower court was sustained, but its decree as to want of equity was reversed, the case being remanded for trial on its merits.

"The question at this stage," said Mr. Justice Holmes, "is not what the plaintiffs may be able to prove, or what may be the reasonable interpretation of the defendants' acts, but whether the plaintiffs have shown a ground for relief if they can prove what they allege. We lay on one side as not necessary to our decision the question of the defendants' powers, and assuming that they act within them consider only whether the use that according to the bill they intend to make of them will infringe the plaintiffs' rights."

Restating the familiar principle that most rights are qualified, and that in cases of conflict, lines have to be drawn that limit both, the Justice points out that:

"If without a word of falsehood but acting from what we have called disinterested malevolence, a man by persuasion should organize and carry into effect a run upon a bank and ruin it, we cannot doubt that an action would lie. A similar result, even if less com-

[22] See the Oregon and Kentucky cases, cited *post*, notes 27 and 28.

[23] *American Bank and Trust Co.* v. *Federal Reserve Bank of Atlanta* (1920) 269 Fed. 4, commented upon in 92 Cent. L. J. 243.

[24] S. c. (1921) 256 U. S. 350, 41 Sup. Ct. 499, 65 L. Ed. 983.

plete in its effect, is to be expected from the course that the defendants are alleged to intend, and to determine whether they are authorized to follow that course it is not enough to refer to the general right of a holder of checks to present them, but it is necessary to consider whether the collection of checks and presenting them in a body for the purpose of breaking down the petitioners' business as now conducted is justified by the ulterior purpose in view."

The concluding words have an ominous rumble:

"The policy of the federal reserve banks is governed by the policy of the United States with regard to them and to these relatively feeble competitors. We do not need aid from the debates upon the statute under which the reserve banks exist to assume that the United States did not intend by that statute to sanction this sort of warfare upon legitimate creations of the states."

In the trial that followed the lower federal court found that those allegations in the bill which had moved Mr. Justice Holmes to refer to the alleged practices of the federal reserve banks as "warfare," were not substantiated by the facts as proved.[25] In the conclusion of an opinion, remarkable for its conciseness, District Judge Beverly D. Evans, states "I find the evidence insufficient to sustain any charge in the bill that the federal reserve bank was acting illegally, or exercising any right it had so as to oppress or injure the plaintiff banks." Specifically, the court found that the charge that the Federal Reserve Bank of Atlanta had accumulated checks upon non-member banks until they reached a large amount, and then presented them for payment over the counter, so as to compel the plaintiffs to maintain so much cash in their vaults as to drive them out of business, was not sustained by the evidence. In a word, the alleged ulterior motives of the reserve bank in inaugurating its par clearance system, were not substantiated.

The reasoning of Judge Evans, in his statement of the legal rights of the federal reserve bank is in substantial agreement with the later opinion of Mr. Chief Justice Clark. It was held that under sections 13 and 16 of the Federal Reserve Act the federal reserve banks are empowered to accept any and all checks payable on presentation, when deposited with them for collection. Checks thus received must be collected at par. In the discharge of their clearance and collection duties, the federal reserve banks are empowered to adopt any reasonable measure to accomplish these purposes. If the drawee bank refuse to remit at par for checks sent through the mails, "it is in the power of the several federal reserve banks to employ any proper instrumentality or agency to collect the checks from the drawee bank, and they may legitimately pay the necessary cost of this service."

However, the finding of the Georgia Federal Court did not constitute an unqualified victory for the reserve bank. In one respect the state banks gained relief, the federal reserve bank being enjoined from publishing on the par list the names of institutions whose consent thereto had not been gained. Nevertheless, an appeal was taken by the state banks to the U. S. Circuit Court of Appeals, with the result that the judgment of the lower court was in all respects affirmed, November 2, 1922.[26] The case is now pending with the North Carolina case, in the Supreme Court of the United States.

[25] S. c. (1922) 280 Fed. 940.
[26] S. c. (1922) 284 Fed. 424.

Between the time of the filing of the North Carolina Supreme Court decision and the time of its subsequent reaffirmation after rehearing, two U. S. District Courts handed down decisions in somewhat similar cases, both of which were unfavorable to the cause of the federal reserve banks. On June 26, 1922, in the Federal District Court for Oregon, Judge Wolverton held that a federal reserve bank is under no obligation to make collections of checks upon non-member banks which refuse to remit at par, that non-member state banks have the right to charge exchange on remittances and that this right is not impaired by the Federal Reserve Act.[27] The court was guided in its legal findings by the opinion of Attorney General Gregory alluded to above, interpreting the power of the federal reserve bank as regards the clearance and collection of checks on non-member banks as being permissive and not mandatory.

Briefly, the facts in the Oregon case were that the Federal Reserve Bank of San Francisco, in order to make par collections from the Brookings state bank, had maintained an agent at Brookings for about a year, whose business it was to present checks to the bank over the counter for payment in cash. The agent was then withdrawn, and the federal reserve bank thereafter forwarded checks on the state bank to it by mail, with the request that payment be made at par and in the form of exchange drafts on Portland or San Francisco. Checks thus sent for collection were endorsed: "Pay to Brookings State Bank for collection only and remittance in full without deduction for exchange or collection charges." The checks were returned to the federal reserve bank without payment on the ground that the state bank was not called upon to act as agent for the reserve bank and to make such collections on the terms imposed. Thereupon the reserve bank returned the checks to its correspondents, advising them in effect that the Brookings bank refused to pay without protesting the paper, and that they must look to the Brookings bank for their protection.

An injunction was sought and obtained restraining the reserve bank from sending letters to its clients advising them to the effect that they must look for protection to the Brookings state bank which upon request to remit at par had returned the checks without protest. The court, pointing out that such return of checks was not tantamount to dishonor, quoted approvingly from a portion of its own opinion given in certain preliminary proceedings:

"While, under the prevailing custom, the defendant bank could rightfully remit checks and drafts drawn against the plaintiff bank direct to the latter for collection, and could thereby exact payment of them, it could not impose conditions upon which such payment should be made; much less could it make the plaintiff bank its agent for causing protest to be made for non-payment. The idea of requiring that a maker or drawee shall have protested his own paper is so inconsistent with the functions of an agent that it can hardly receive the sanction of law."

The significance of this case is somewhat diminished in that the main issue before the court was a very narrow and technical one, being confined to a single and very unusual method of collection. However, it is entirely possible that the

[27] *Brookings State Bank v. Federal Reserve Bank of San Francisco* (1921) 277 Fed. 430, commented upon in 6 Minn. L. Rev. 517.

interpretation therein made of section 13 of the Federal Reserve Act, to the effect that the act imposes upon the reserve banks no legal obligation to collect checks on non-members may be portentous of a similar future attitude on the part of the final court of appeal. Yet careful study of the opinion in its entirety leaves one with the distinct feeling that Judge Wolverton leaned backward in his effort to conform *a priori* with the doctrines laid down by Mr. Justice Holmes in the Atlanta case. He took it for granted that an attempt to coerce a state bank into paying the full amount of its checks to the federal reserve bank is wrong *per se,* without going to the trouble to ascertain if the effect of par clearance was unduly oppressive to the particular state bank, or if the failure of par clearance was injurious to the banking system as a whole. Perhaps it is attributable to the peculiar nature of the facts involved that the court in this case reveals no recognition whatsoever of the economic significance of the par clearance controversy.

The remaining case to be noted is one from the Federal District Court of Kentucky. It involved the Federal Reserve Bank of Cleveland,[28] which, in its campaign for par clearance, resorted through its agents to methods in and of themselves likely to be unlawful, thereby causing the charges in the bill of complaint to be of such a nature as to make impossible an adjudication of the fundamental questions underlying par clearance. The federal reserve bank in collecting checks from the Farmers and Merchants Bank of Cattlettsburg, attempted at first by persuasion to enter into an agreement with the state bank for par clearance. Failing in this, checks were for some time collected through the express company at the counter for cash. The express company finally gave up the practice, and a special agent was then maintained in Cattlettsburg by the reserve bank. As stated by the court, this agent so conducted himself as to injure the business of the bank, and unjustifiably to cause annoyance to the bank's customers. Finally, the reserve bank went so far as to refuse to handle any checks bearing the endorsement of the Cattlettsburg bank, even when such checks were on member banks and presented by member banks for collection. These and other acts gave color to the allegation that the reserve bank was more intent upon destroying the business of the recalcitrant bank than in collecting checks in a lawful and proper way, thereby bringing itself easily within the range of the severe condemnation meted out by Mr. Justice Holmes to those possessed of ulterior motives in the exercise of alleged rights.

Hence Judge Cochran, in the Kentucky case, granted a preliminary injunction restraining the Federal Reserve Bank of Cleveland from the collection of checks in the manner described in the affidavits, and from publishing the name of the plaintiff on its par list. In his enunciation of principles he followed closely the suggestions of Mr. Justice Holmes in the Atlanta case, and referred approvingly to the findings of Judge Wolverton in the Oregon case.

By way of summary, it is to be noted that the North Carolina and Georgia cases are closely similar in that the issues in each case are such as to force without

[28] *Farmers and Merchants Bank of Cattlettsburg* v. *Federal Reserve Bank of Cleveland* (1922) 283 Fed. —, Federal Reserve Bulletin, Dec. 1922, p. 1409.

complicating elements a delineation of the clearance and collection powers of the federal reserve banks and at the same time put to a test the rights of the state banks in the matter of charging exchange and tendering exchange drafts to federal reserve banks. Action in the Georgia case was brought in the light of federal law whereas action in the North Carolina case was based mainly on state law. Both cases were argued on their merits in courts of appeal, and the resultant decisions were practically identical in effect, the only substantial point of disagreement being the question of the right of the federal reserve bank to publish on the par list the names of unwilling non-member banks.

It is of importance also to note that both of these decisions were subsequent to the filing of the U. S. Supreme Court decision in the Atlanta case. The influence of this decision, while perhaps not directly prejudicial to the cause of the defendent banks, as it was rendered merely upon a demurrer, yet could not have failed in the trials which later took place to cause a more searching and critical examination of the methods and motives of the federal reserve banks, a fact which makes more significant the success of the latter.

The Oregon and Kentucky decisions, while they have not been subjected to appellate review, strongly emphasize the fact that the battle for universal par clearance is still far from won. These decisions, also subsequent to the U. S. Supreme Court's pronouncements in the Atlanta case, were unfavorable to the federal reserve banks, but as above pointed out, they are not readily comparable with the North Carolina and Georgia cases, in that they had to do with facts of a substantially different order. The federal reserve banks of San Francisco and Cleveland were guilty of methods and motives not proved in the other cases, and which, in and of themselves, were subject to Mr. Justice Holmes' condemnation.

In one respect Judge Wolverton is in entire accord with Judge Evans in the Georgia case and with Chief Justice Clark, when he states in his opinion that "the reserve bank may at its option receive paper against such banks [non-member] for collection. Having that power it may collect it, *if it can find a way of doing so without the payment of exchange,* [italics mine] which it is prohibited from paying by the act." Continuing, the Judge takes the position that the state banks have the power to charge exchange on remittances, and that they should not be coerced into giving up that power. Obviously, then, his opinion as to the legality of any method of par clearance would rest upon his definition of coercion. He regarded as coercion the particular methods followed by the federal reserve bank in the Oregon case. Would he regard as coercion the orderly presentation of checks at the counter for payment in cash, assuming that there is no massing or accumulation of such checks, and that the agent of the federal reserve bank comported himself in a way not differentiated from that of the bank's regular customers?

Judge Cochran, in the Kentucky case, does not even make reference to the Federal Reserve Act, much less make an attempt to analyze its appropriate sections to ascertain its powers express and implied, and to understand what constitutes

the functions essential to an efficient centralized banking system. Without worrying as to what it was all about, he merely took one of the leads thrown out by Mr. Justice Holmes. The state banks have the right to charge exchange. The federal reserve bank attempts to destroy that right. The federal reserve bank should be restrained. What could be simpler? "It is one of the inalienable rights of a person to be unprogressive, selfish, and even mean," states the Judge. "No other person has the right to coerce him into being otherwise." And with this application of Aurelian philosophy, par clearance in the fourth federal reserve district is firmly put to sleep.

Assuming an understanding of banking principles and practices, an examination into the merits of the present par clearance controversy should begin with the Federal Reserve Act. Considerations of state law and of so-called inherent rights of state banks are valid only in so far as they do not come into direct conflict with this valid act of Congress. The Federal Reserve Act specifically empowers the federal reserve banks, in section 13, to receive from member banks "for purpose of exchange or collection" checks and drafts payable upon presentation. No distinction is made between checks on member and checks on non-member banks, provided they are received from member banks. Receipt of such checks regardless of origin is also permitted directly from non-member banks provided the latter maintains an open account with the federal reserve bank.

Now some have professed to see in the above authorizations what is termed permissive rather than mandatory power. Settlement of the questions thus raised can be arrived at only through a process of inference. This process necessitates a careful study of all the powers and duties of the federal reserve banks. Such a study reveals that these banks are compelled to act as reserve depositories for their members, which comprise all national and many state banks. They also must serve as banks of issue, as banks of deposit, as banks of loan and discount, and in general perform all functions incumbent upon bankers' banks, not to mention those arising from their duties as depositories and fiscal agents of the United States government, which again involve a veritable complex of additional relationships with state and member banks. It requires no expert in banking to recognize that an efficient performance of these various mandatory duties can be accomplished only by according to the federal reserve banks unrestricted use of those instruments of banking which are in general and customary use. To argue that the controversial clause in section 13, because of the presence of the word "may," renders the power invested permissive rather than mandatory, becomes therefore mere quibbling. What as a matter of language may be claimed in this case to be permissive, is, as a matter of sound banking practice, clearly obligatory. Should the federal reserve bank fail to receive and collect at par checks on all banks payable upon presentation within the district, a thing which is indisputably permitted if not required by the act, and the performance of which is essential to the fulfillment of its expressly delegated functions, such failure might justly be regarded as a violation of its statutory obligations.