Office of the Comptroller of the Currency

MOMENTS IN HISTORY

ECONOMIC INSIGHTS FROM THE HISTORY OF THE FEDERAL BANKING SYSTEM

Shareholder Double Liability and Depositor Losses in Failed National Banks: 1865–1935

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From 1865 to 1937, the owners of shares of national banks were subject to double liability, which meant an insolvency would not only extinguish the value of a shareholder's investment in the bank's capital, but would also subject that shareholder to an additional assessment levied by the bank's receiver of an amount equal to that investment (i.e., double the original shareholder liability).[2] OCC receiverships collected $95 million through these assessments during that time, thereby decreasing the losses that would otherwise have been borne by depositors.[3]

Double Liability in the National Bank Act

Before the National Bank Act was signed by President Lincoln in 1863, only the individual states could charter commercial banks, and the state chartering laws varied considerably.[4] Some states (e.g., Vermont and Connecticut) had limited liability, such that investors could lose no more than their investment. In contrast, other states (e.g., New Hampshire and Rhode Island) invoked unlimited liability, in which a receiver could pursue all the assets of a shareholder. Of particular importance were the laws of New York because these became the model for the double liability

[1] The views expressed in this paper do not necessarily reflect the views of the Office of the Comptroller of the Currency, the U.S. Department of the Treasury, or any federal agency.

[2] The 1933 Banking Act permitted the issuance of shares that would not expose the holder to double liability. The 1935 Banking Act permitted banks to drop the double liability associated with their existing shares on July 1, 1937.

[3] Throughout this paper, we used the term "depositor" when referring to uninsured depositors and creditors of the bank. We used data from the agency's annual reports that summarize the completed receiverships of approximately 2,700 national banks between 1865 and 1935.

[4] See Ralph Marquis and Frank Smith, "Double Liability for Bank Stock," *American Economic Review*, vol. 27, September 1937, p. 490–502.

provisions in the National Banking Act. During that state's 1846 constitutional convention, legislators adopted an amendment (later enacted into law) that imposed a liability that was equal to the amount of the investment in the bank's shares, i.e., double liability.

The 1863 Bank Act did not have a double liability clause. Shareholder double liability was included the following year, incorporating language proposed by Sen. John Sherman (R-Ohio):[5] "For all debts contracted by such associations for circulation, deposits or otherwise, each shareholder shall be held to the amount, at their par value, of the shares held by him, in addition to the amount invested in such shares."[6]

Sen. Sherman elaborated on the Senate Finance Committee's motivation for the revision:

> We agreed to it, I believe, unanimously, that the note-holder, the depositor, the creditor of the banks should have something more than the stock to fall back upon; and that if you provide a limited liability to an amount equal to the stock, in addition to the stock, you will make it ample beyond all danger. That principle has been embodied in the laws of a great majority of the States; but the question with us was whether the liability should simply be asserted as it is in this amendment, or whether we should go on and elaborate and provide a remedy to enforce the liability. I have here a very carefully drawn section, specifying and describing the liability more minutely, and also providing for a mode to enforce it; **but, upon reflection, we think it better to simply insert the liability, and leave to future Congresses the difficult task of enforcing the liability or prescribing the remedy.** The laws of the State of New York are very full, very minute, on this subject; but we thought it better not to burden this bill by embodying many provisions that were not necessary. Future Congresses can do it. This will assert the liability of the stockholder to the extent of his stock, and as much more, and future legislation can provide the remedy to enforce it.[7]

Because Sen. Sherman's amendment did not specify how the double liability would be enforced, OCC receivers would have to confront that issue often over the next seven decades. As legal scholars Jonathan Macey and Geoffrey Miller describe in their 1992 article, many Supreme Court cases were needed to clarify the legality of the assessments and subtle operational questions that needed interpretation; several examples of their findings follow.[8]

- Given that receiverships could take several years to complete, the OCC needed the flexibility to levy multiple assessments as the liquidation of the bank proceeded so depositors would not have to wait an unreasonably long time to receive a portion of their deposit.

[5] Sherman was the younger brother of the Civil War general William Tecumseh Sherman.

[6] *Congressional Globe*, 37th Congress, February 9, 1863, p. 824.

[7] Ibid.

[8] Macey, Jonathan R., and Geoffrey P. Miller, "Double Liability of Bank Shareholders: History and Implications," *Wake Forest Law Review*, 1992.

- To offset the effect of shareholders delaying their payment of an assessment as long as possible, courts allowed the OCC to charge interest on the amount owed, calculated from the date of the assessment.
- One question related to how to treat a shareholder who, for example, owned $100 of stock, but also had a $100 deposit at the failed bank. Though such a shareholder would have liked to net those amounts to a zero assessment, the courts said otherwise. The shareholder was required to pay the assessment and, like other depositors, get in line to receive their share of the payments made by the receiver to all the uninsured creditors.
- Even identifying who should be assessed could be complicated. The owner of record in the bank's documents might be different than the actual owner (who might have purchased the stock months earlier from the previous owner, but the bank had not updated its records). Keeping the records current was important so depositors could judge the ability of the owners of record to make good on a receiver's assessment. Thus, the owners of record remained liable, even if they no longer were the actual owner.[9]
- Similarly, there were court cases involving the transfer of shares in advance of a bank's closing. An insider of the bank might "sell" shares to an associate, knowing well that the buyer could not make good on any assessment, and with the understanding that the seller of the stock would remain the de facto owner.[10]
- Or consider an instance when the owner of the shares dies after the receivership has started, but the shares are still in probate. The Supreme Court rejected the argument that the assessment was a personal liability of the deceased individual and upheld the assessment on the heirs. However, the receiver had to pursue the assessment as an unsecured creditor of the estate under the prevailing state laws.
- Finally, if a holding company was the owner of record, the receiver's assessment would flow through to the company's shareholders. This negated the incentive for shareholders to create a holding company for the purpose of insulating themselves from the possible assessments should the subsidiary bank fail.

Voluntary Liquidations Driven by Double Liability

Over the course of the OCC's first 72 years, the agency granted 14,394 national charters. Yet, by 1937 only 5,290 national banks were in existence.[11] Though many had failed or were consolidated with other banks, there also had been 5,907 "voluntary liquidations," which represented more than 40 percent of all the charters granted. Researchers have interpreted this to mean that double liability was very effective in preventing bank failures that would have eventually imposed costs on depositors.[12] Because substantial proportions of the shares were

[9] There was an exception in cases when the original owner made a good-faith effort to inform the bank of the change in ownership, but, owing to the negligence of the bank, the records were incorrect.

[10] Also, transactions involving married individuals or shares purchased in the name of minor children could not escape assessments.

[11] *Seventy-Fifth Annual Report of the Comptroller of the Currency*, 1937, p. 222.

[12] See Eugene N. White, "To Establish a More Effective Supervision of Banking: How the Birth of the Fed Altered Bank Supervision," NBER Working Paper 16825, February 2011, p. 3, and Macey and Miller, p. 34.

often owned by the managers of a bank, those individuals—who likely had the most complete picture of the bank's soundness—had an important interest in anticipating the possible insolvency of the bank and the concomitant double liability assessment. Thus, during the era of double liability, voluntary liquidations were common, with the effect of protecting depositors, who would be paid in full while the bank's assets still exceeded their claims. The topic of when and where voluntary liquidations of national banks occurred is beyond the scope of this paper; we are only analyzing the effect of double liability after a receivership had been initiated.

The Importance of High Levels of Capital Relative to Assets

When a bank failed, recoveries on the assets sold and collections on the double liability assessments were the two principal sources of funds with which the receiver could pay the depositors and reimburse receivership expenses.[13] Simply stated, the larger the shareholder investments relative to assets, the greater the role that would be played by double liability in returning depositors' funds. Mathematically, the protection of depositors that double liability created would be greater when the capital of the bank was 20 percent of assets than if capital were only half that amount. Table 1 shows the distribution of the capital-to-assets ratios for 2,699 national banks between 1865 and 1935 at the time that each failed.[14] The important characteristic of the distribution described by the percentiles in Table 1 is that it highlights the fact that there were very substantial differences in the capital ratios of these banks, and therefore, the importance of double liability in providing a source of funds with which to reimburse depositors. The greater the opportunity for the receiver to collect significant double liability assessments, the more likely an advantageous outcome for depositors.

Table 1: Distribution of Capital to Assets Ratios of 2,699 Failed National Banks

	Percentile				
	10th	25th	Median	75th	90th
Capital ratio	6.16%	8.77%	13.52%	23.96%	43.69%

When these banks were placed into receivership, their aggregate reported assets were $3.337 billion. With their aggregate reported capital at $356.6 million, the aggregate capital ratio for these failed banks was 10.7 percent, somewhat lower than the median value. However, an aggregate capital ratio (i.e., summing over all 2,699 banks) is not a true reflection of the soundness of this group. Our previous Moments in History article described the high levels of assets classified as "doubtful" and "worthless" at the start of these receiverships. For the banks in Table 1, the sum of their assets classified as worthless ($480.0 million) was larger than the sum of those banks' reported capital ($356.6 million). That is, the examiners' estimates of worthless assets in these banks were fully one-third larger than the capital in those same banks. Table 2

[13] In addition, interest might be earned on the assets awaiting liquidation.

[14] The values in the table have a straightforward interpretation. For example, the 10th percentile value of 6.16 percent means that one out of every 10 of the 2,700 failed banks had capital ratios that were less than 6.16 percent at the time of failure. Similarly, the 90th percentile value of 43.69 percent means that another 270 banks (that is, one out of every 10 of the 2,700 failed banks) had capital ratios greater than 43.69 percent. The median value of 13.52 percent means that half of the failed banks had ratios greater than 13.52 percent, and the other half had values lower than 13.52 percent.

shows the distribution of the ratio of each bank's worthless assets to its reported capital-to-assets ratio.

Table 2: Distribution of Ratio of Assets Classified as Worthless to Capital of 2,699 National Banks in Receivership (1865–1935)

	Percentile				
	10th	25th	median	75th	90th
Worthless assets/capital	11.5%	35.8%	81.9%	160.6%	284.7%

Even ignoring assets that the examiners classified as "doubtful," which were also likely to incur losses when sold, the assets classified as worthless were greater than the bank's reported capital in 1,140 of these 2,699 receiverships (or 40 percent of the total count). That statistic about the volume of worthless assets, as evaluated by the examiner, sets the stage for significant depositor losses and the role that double liability might play in tempering those losses.

The Amount by Which Uninsured Claims Exceeded the Realized Value of Assets

In 80 percent of these 2,699 receiverships, the uninsured depositors suffered losses. These losses arose because the realized values of the failed banks' assets were insufficient to meet the various claims on those funds. Claims that were more senior contributed materially to the losses suffered by depositors. Specifically, the following items had a first claim on values realized on the sale of the assets:

- Any collateralized claim on the bank
- The receiver's salary and legal expenses
- Expenses incurred to protect the value of the assets awaiting sale
- After 1933, the interest paid to the Reconstruction Finance Corporation (RFC)[15]

Throughout a receivership, the last three of the four expenses listed above amounted to roughly 7 to 11 percent of the assets placed into receivership. The costs were low relative to the liquidated assets in the early years and increased as the time lengthened and fewer assets remained to be sold.

Recoveries on Assets and Payments to Uninsured Creditors

In 1939 the OCC published the cumulative results for the 2,973 receiverships under its authority for the 76 years of its existence. In aggregate, $1.662 billion in national bank assets had been liquidated. At the end of these receiverships, $593.3 million in payments had been made on "claims proved" of $942.9 million, representing a recovery paid to the uninsured creditors of 63

[15] Authorized by the Banking Act of 1933, the RFC advanced loans to the receivers. These loans were secured by the assets awaiting liquidation. With these loans, receivers could make payments to depositors before realizing the cash value of the assets. The Comptroller's 1935 *Annual Report* (p. 4) estimated that this interest expense added 1.78 percentage points to the receivership costs (expressed as a percent of the realized asset values).

percent. To get a sense of the importance of the double liability assessments, we note that a total of $95 million in shareholder assessments was collected on the $181 million in assessments levied. Thus, the collected assessments were 52 percent of the levied assessment amounts and these collections represented 16 percent of the aggregate payments to depositors.

Bank-level Data on the Collection of Shareholder Assessments as a Proportion of Deposits Paid

Table 3 shows the distribution of the proportion of the double liability assessments the receivers collected from shareholders.

Table 3: Distribution of Proportion of Double Liability Assessment Collected From 2,537 National Banks Where Positive Assessment Were Made Against Shareholders (1865–1935)

	Percentile				
	10th	25th	median	75th	90th
2,537 receiverships	17.8%	32.8%	52.0%	71.1%	85.3%

The percentile values of the distribution in Table 3 are embedded in Figure 1 below. Figure 1 depicts the histogram of the proportion of the double liability assessment collected. The bar chart shows 10 categories of collections, from zero to 10 percent, 11 to 20 percent, etc.

Figure 1: Count of Receiverships by the Proportion of the Double Liability Assessment Collected (2,537 Receiverships)

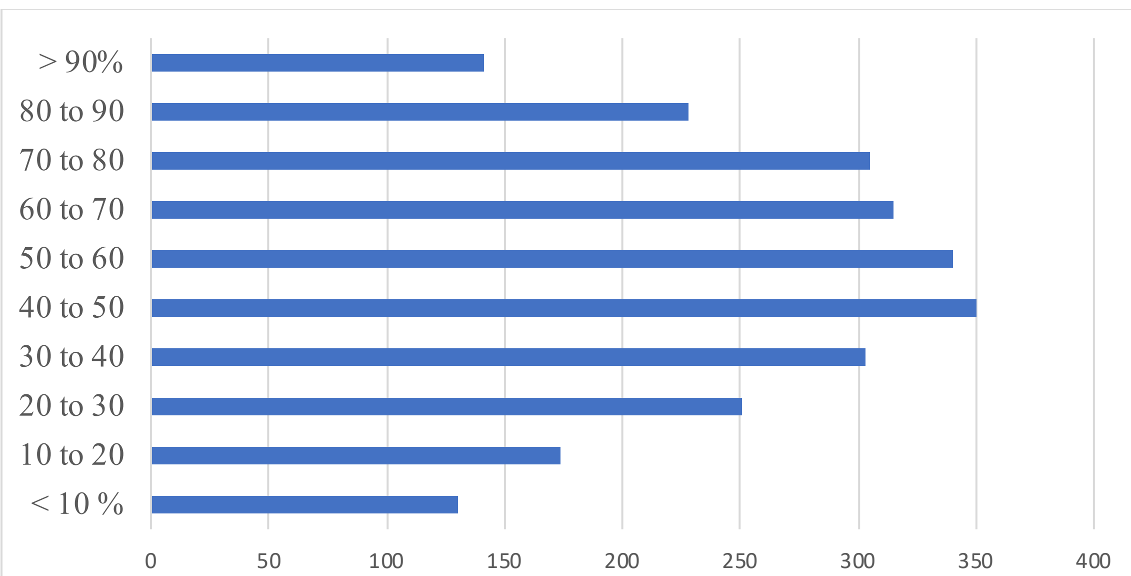
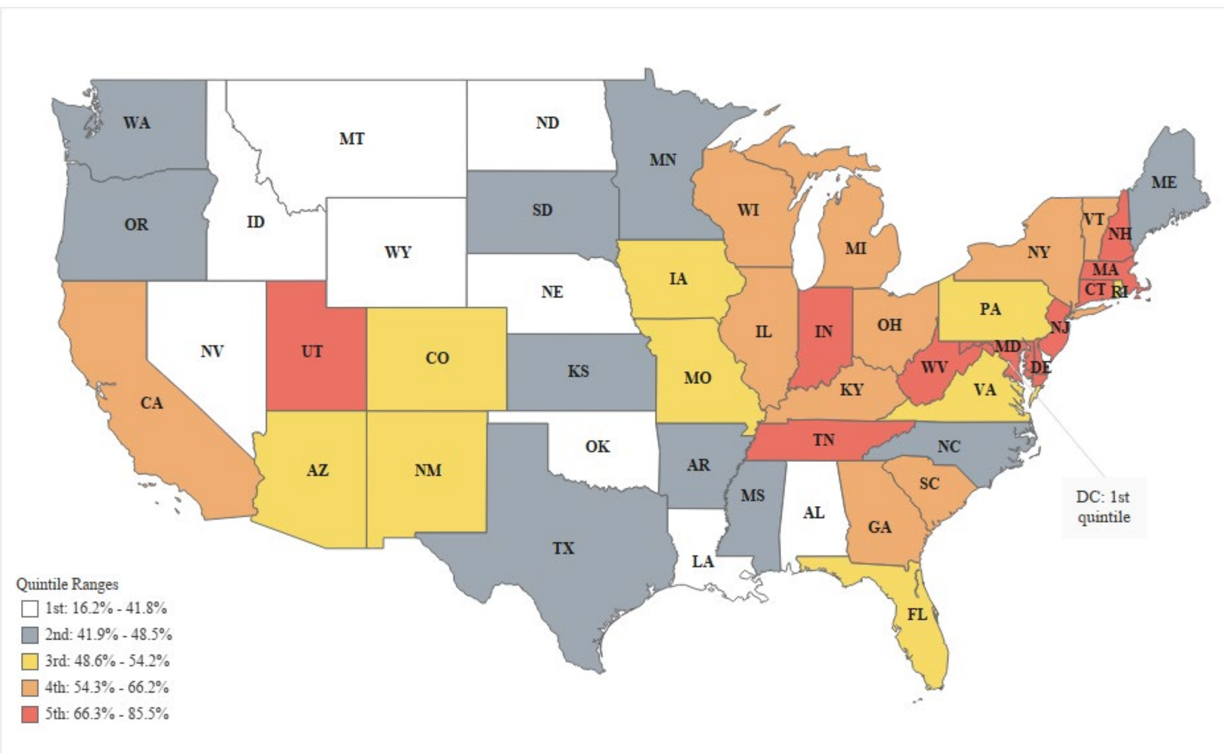


Figure 1 and Table 3 highlight the variability of the receiverships' success in collecting on the assessment levied against shareholders. An interesting feature of these data is that the 75th percentile is 20 percentage points higher than the median, while the 25th percentile is 20 percentage points below the median, suggesting a relatively symmetric distribution on either side of the median. That feature is reflected in the five bars that delineate the 30 to 80 percent range of collections in Figure 1. The pronounced variability in the proportion of the double liability actually collected indicates that the depositors in some failed banks were made better off by the double liability law than other depositors, the shareholders of which the OCC collected only a small proportion of the assessment.[16]

Differences in Double Liability Collections Across States

We found noticeable differences across states in the rate of collection on the double liability assessments. For each of the 48 states and the District of Columbia,[17] we calculated the ratio of the amount of the double liability assessment collected to the total assessments levied against shareholders in that state. For example, receivers in New Hampshire collected $174,000 of $233,000 (or 74.7 percent) in assessments. Figure 2 below shows a map with five colors that represent the quintiles of that statistic.[18] White represents the lowest quintile value of the state-wide assessments collected, light blue the second, yellow the middle, and orange and red for the second highest and highest quintiles, respectively.

Figure 2: Quintiles: Proportion of Double Liability Assessments Collected (1865–1939)



[16] One hundred and sixty-two of the 2,699 receiverships had no assessment levied against the shareholders.

[17] In 1939, Hawaii and Alaska were not states. Though the OCC did not charter banks in the District of Columbia, it did complete the receiverships of failed DC institutions before the FDIC was established.

[18] Quintiles thresholds are the values that split the distribution into five equally sized groups, each containing 20 percent of the population.

Apart from Utah and California, OCC receivers had less success collecting double liability assessments in states west of the Mississippi River. The lowest two rates were 16.3 percent and 25.1 percent for the District of Columbia and Nevada, respectively. The two highest rates were 75.2 percent and 85.4 percent for Massachusetts and Delaware, respectively.

Importance of the Collected Double Liability Assessment

As noted above, 16 percent of the total payments to depositors was attributable to the $95 million in collected assessments. Table 4 shows the distribution of the ratio of the dollar amount of the collected assessments to the sum of the dollar amounts of collected assessments plus realizations on the liquidated assets. That is, the ratio labeled *DLproportion* is a measure of the importance of shareholder double liability collections relative to the realized values of the assets and those collected assessments.

$$DLproportion = \frac{Collected\ Double\ Liability\ Assessment\ (in\ \$)}{Assessment\ Collected (in\ \$) + Liquidation\ Value\ of\ Assets\ (in\ \$)}$$

Table 4: Distribution of Ratio of Double Liability Assessments Collected to Sum of Assessments Collected and Realized Value of Assets for 2,537 National Banks (1865–1935)

	Percentile				
	10th	**25th**	**median**	**75th**	**90th**
Ratio of assessment collected to total collections	3.4%	5.9%	9.6%	16.0%	27.6%

This distribution suggests that in many failures the double liability laws, as implemented by the OCC, were an important component of the dollars available to pay the receivership costs and depositors. The 75th percentile value means that in 25 percent of these receiverships (more than 600 receiverships) the assessments collected from shareholders were at least 16 percent of the total amount of funds available to pay expenses and reimburse depositors. In 10 percent of these receiverships, the assessments were at least 27.6 percent of the funds.

That the double liability assessment was a significant proportion of the values realized by the receivership is not necessarily surprising. Recall that, in Table 1, we saw that the median capital-to-assets ratio was 13.5 percent, while the 75th percentile was 24.0 percent. Therefore, capital that was greater than 24 percent of assets in one-fourth of the population of failed banks implies a large base on which the receiver could pursue double liability recoveries. This is true even though, as seen in Table 3, the receiver typically captured only 52 percent of the assessed amount. Similarly, Table 2 showed that for a large proportion of receiverships, the amount of assets classified as worthless was remarkably large as a percentage of bank assets. For example, the 75th percentile of the proportion of worthless assets was 1.6 times the capital of the bank (i.e., 160.6 percent of capital). These characteristics suggest that (1) with a large base (capital relative to assets) on which to make the double liability assessment, and (2) the fact that in many instances the volume of worthless assets was remarkably large, we should not be surprised to see that the double liability assessment represented a substantial proportion of resources available to the receiver.

Conversely, the 25th percentile value in Table 4 (5.9 percent) suggests that in over 600 receiverships the double liability assessment did not contribute nearly as much as the realization on the failed bank's assets. If, upon liquidation, the assets of the bank yielded a good return compared with other banks, and owing to the circumstances of the state and the shareholders, the receiver could collect only a small amount on the double liability assessment, then the value of the *DLproportion* would be comparatively small.

Conclusion

The available historical data on OCC receiverships from 1865 to 1937 certainly indicate that double liability assessments played an important role in mitigating the losses borne by depositors and in the voluntary liquidations of still-solvent banks. Though Sen. Sherman overstated the case when, in debating the 1864 amendments, he asserted that a double liability regime "will make it ample beyond all danger," his unrealized optimism only partially detracts from the overall positive evaluation of the policy in lessening depositor losses.