An answer to your second question will be found in an opinion rendered by this department on the 6th day of June, 1927, Opinion No. 577, Opinions, Attorney General, 1927, a copy of which I am enclosing herewith.

Respectfully,
EDWARD C. TURNER,
Attorney General.

1447.

BANKS—DIRECTORS—IMPAIRED CAPITAL—METHODS OF RESTORING CAPITAL, DISCUSSED.

SYLLABUS:

1. *A director's note given to make good impaired capital is without valuable consideration unless said impairment was due to lack of proper care on part of director.*
2. *In case of insolvency, director estopped from setting up defense of want of consideration or failure of consideration of note given to make good impaired capital.*
3. *Where director borrows money from outside source to make good impaired capital, bank whose capital was restored would not thereafter be justified in loaning said director funds to take up said note.*
4. *Advancements by directors to make good impairment of capital of bank ordinarily create no legal obligation of bank to repay.*
5. *With approval of stockholders, directors may create contingent liability of bank to repay directors' advances.*
6. *Directors' advances may be paid out of any monies available for dividends upon unanimous approval of stockholders.*
7. *When Superintendent of Banks permits substitution of method prescribed in Section* 710-30, *G. C., he assumes a personal responsibility.*

COLUMBUS, OHIO, December 24, 1927.

HON. ELBERT H. BLAIR, *Superintendent of Banks, Columbus, Ohio.*

DEAR SIR:—This will acknowledge your recent communication as follows:

"Occasionally it becomes necessary for me to advise the board of directors of an incorporated bank or the managing body of an unincorporated bank that losses sustained by said bank must be taken care of.

In such instances these parties are advised of the provisions of Section 710-30 of the General Code of Ohio. It sometimes develops that I am told for me to make an official order for an assessment upon the stockholders or owners of the bank would result in serious difficulties and possible disaster to the institution. When the case is stated in this way it usually follows that the individuals constituting the board of directors of the bank, or, if an unincorporated one, the managing body, volunteer to raise the amount of the deficiency among themselves.

It has always been taken for granted that such individuals may, if they so elect, pay into the bank the amount determined upon to be raised. Where this plan is followed there are some incidental questions regarding which I would like to have you give me your opinion, viz.:

One. May a director or an owner legally place in the assets of a bank his individual promissory note in lieu of cash for his respective contribution to the payment of such a fund?

Two. If question number one is answered in the negative, and such an individual borrows the money from an outside source for a time, would it be lawful for him to repay the original debt so incurred by borrowing funds from the bank in which he is interested and being the same bank that has sustained the losses?

Three. In the event that the individuals connected with either type of banks do contribute or pay the amount of such losses voluntarily, without an official order for an assessment, may they legally be repaid out of the surplus or profits of the bank by the passing of a resolution to that effect by the board of directors or managing body?

Four. If the board of directors or managing body may not legally pass a resolution of the character indicated in question three, may the stockholders or owners of such bank at a regular meeting, or a meeting called for that special purpose, authorize the reimbursement of the contribution or payment of said notes out of the surplus or profits of the bank? If so, what vote is necessary to pass such a resolution?

Five. If this department should discover that the members of the board of directors or managing body of a bank had placed their individual promissory notes in said bank to take care of the charge-outs ordered, or have voluntarily taken care of the losses known to exist, and said board of directors or said managing body has passed a resolution providing for the payment of these notes, or for reimbursing themselves out of the earnings and profits or surplus of the bank, what requirement, if any, should be made by the Superintendent of Banks?

Six. If, after placing promissory notes in a bank as outlined in question five, the signers of the said notes should for any reason desire to take said notes out and rescind the former resolution for payment or reimbursement, by the passage of another resolution, would it be legal for the Superintendent of banks to permit the removal of such notes from the assets of said bank?"

Section 710-30 of the General Code provides, in part, as follows:

"Every bank whose capital stock has not been paid in as required by law, and every bank whose capital shall have become impaired by losses or otherwise, shall within three months after receiving notice from the Superintendent of Banks, cause the deficiency in such capital to be paid in by assessment upon the stockholders pro rata for the amount of capital stock held by each."

As your letter suggests, the exercise of the power therein conferred upon the Superintendent of Banks might often have serious consequences. The fact that an assessment had been made would ordinarily be generally known and would seriously affect public confidence. The result has been that the suggestion of the necessity of an assessment often results in a voluntary contribution of one character or another.

You make certain inquiries concerning specific cases in which voluntary contributions have been made and you ask my advice with respect thereto. You ask that I consider these questions as affecting both an incorporated and an unincorporated bank.

In the case of an incorporated bank, the capital is the amount of money paid in by the stockholders pursuant to their subscriptions to the capital stock of the company. In ordinary bookkeeping practice, the assets of the corporation are upon one side of the balance sheet and the amount thereof is equaled by the sum of the liabilities plus the capital stock, surplus and undivided profits. An impairment of capital exists when there is no surplus nor any undivided profits and the liabilities plus the capital

of the company exceed the assets. The capital, therefore, represents a sort of insurance fund, the integrity of which it is important to preserve. It is a protection to creditors and depositors in that ordinarily it represents the minimum excess of the assets over the liabilities of the corporation. In the case of impairment of capital, the margin of safety is proportionately reduced. For this reason the authority has been given the Superintendent of Banks to require contributions from the stockholders to replace the impaired capital which results from losses sustained in the assets of the bank.

In the case of an unincorporated bank, the situation is very similar. Each such bank is required to state, under Section 710-77 of the General Code, the amount of permanent capital actually paid in and remaining in its possession, bona fide as its property, for the sole purposes of the bank. By the succeeding section it is provided that such capital shall at all times be segregated from all other property or business of the owner or owners of such bank and shall be kept and maintained unimpaired for the security of the creditors of such bank. Thus it will be seen that the capital of an unincorporated bank is just as definite as is that of an incorporated bank. The authority of the Superintendent of Banks extends to the assessment of the owner or owners of an unincorporated bank to make good any deficiency in capital.

Your first question is:

> "May a director or an owner legally place in the assets of a bank his individual promissory note in lieu of cash for his respective contribution to the payment of such a fund?"

My answer to this question is, no; but not without qualification.

Unless the impairment of capital has been brought about or contributed to by some action of the director giving the note, there would be no consideration for his note and he would be able to avoid payment thereof unless there were facts present which would estop him from setting up the defense of want of consideration or failure of consideration.

If the bank to which a director gave his note was found upon liquidation to be insolvent, then the maker of such a note would be estopped from setting up the defense of want of consideration or failure of consideration. This is the effect of the holding in the case of *State, ex rel.* vs. *Hills,* 94 O. S. 171, the first branch of the syllabus of which reads as follows:

> "Where a note is executed to a bank for the purpose of meeting the requirement of the state Superintendent of Banks that deficiency of the assets of said bank be made good, and for the purpose and with the result of enabling such bank to continue its business for some period during which debts are created and new depositors acquired, neither the defense of want of consideration nor failure of consideration for such note is available in an action brought to recover thereon by the state Superintendent of Banks."

However, if such bank were not insolvent, even in case of liquidation, the defense of want of consideration or failure of consideration would be available to the maker of such note unless it appeared that such note had been given to make good some impairment of capital brought about or contributed to by the maker of the note. In this latter event there would have been a valuable consideration for the note. My advice to you, therefore, is that if such a note is offered by a director it should be refused. However, if such a note is in the bank you should not permit it to be withdrawn, returned or cancelled except as hereinafter outlined. So far as the

owner or owners of an unincorporated bank are concerned, the same answer and observations apply.

I have thus given you my legal advice on the general policy that should be adopted. However, there may be instances where it is clear to you that by reason either of his acts or omissions the director in question has become obligated to account to the bank for want of due care in the discharge of his duties, in which event there would be a valuable consideration for the giving of a note. The facts and emergencies surrounding such a case might justify you in taking such a note at least as a temporary expedient but you should be extremely careful as it is your duty to see that the capital is restored before other creditors become such. The lawful way of doing this is, of course, by the assessment plan unless there is a voluntary gift to the bank by the directors or someone else.

My answer to your second question is, no. Your question assumes that the bank in which the director is interested, and being the same bank that had sustained the losses, would know the purpose for which the money was borrowed. Under such circumstances there would always be a debatable question as to the liability of the maker of the note and thus you would have a questionable note in the bank that in good banking practices should not be counted at its face value.

As with the answers to your first two questions, so of the answers to your remaining questions, it may be said that it is difficult to answer them giving general rules. In other words, it would be far more preferable and helpful to you to answer each and all of your questions in the light of the facts and circumstances of each particular case. Situations may be imagined where it could be held legally that in advancing the money or assets to restore a bank's impaired capital and thus permit it to continue doing business, the board of directors or the individual directors were not acting as mere volunteers. There could be situations or conditions arise where the bank would be held to be contingently liable to such directors for the repayment of such advances. This liability would be contingent upon the payment in full of all creditors. In other words, the claims of such directors for reimbursement would be inferior or junior to the claims of creditors but superior or prior to the claims of stockholders. Whether a bank was being liquidated or being continued would make a difference. If the bank were being liquidated, whether it was insolvent or solvent would make a difference. If the bank were being continued, whether the full statutory amount of surplus had been set aside would make a difference.

In answering the remainder of your questions and giving you general rules to follow, I shall assume that the contributions were purely voluntary and were not based upon any valuable consideration which created any obligation on the part of the bank, either direct or contingent.

In your third question you ask whether those contributing toward making good impaired capital may legally be repaid out of the surplus or profits of the bank upon resolution to that effect by the board of directors in case of an incorporated bank or by the managing body of an unincorporated bank. An answer to this question necessitates a discussion of the character of the contribution made.

In order that the capital may be effectually restored, it is absolutely necessary that there be no strings whatsoever attached to the contributions. This is obvious for the reason that were there to exist a liability on the part of the bank to those making the contributions, the liabilities of the bank would be increased in the same amount as the assets, so that no restoration of capital could possibly result. It follows that the contribution must be a *bona fide* gift and consequently there can exist no legal responsibility to the donor. There may, however, be a moral claim to repayment in the event that the bank eventually reaches a sound financial status.

The determination of your question hinges upon the definition of the term "surplus" when used in connection with the banking business. Section 710-1 of the General Code defines surplus as follows:

> "The term 'surplus' means a fund created pursuant to the provisions of Section 130 of this act by a bank or trust company from its net earnings or undivided profits, which to the amount specified and any additions thereof set apart and designated as such is not available for the payment of dividends and cannot be used for the payment of expenses or losses so long as such bank or trust company has undivided profits."

The method of accumulating a surplus is prescribed by Section 710-130, General Code, which is as follows:

> "The board of directors of any bank may declare a dividend of so much of its undivided profits as they deem expedient. Before such dividend is declared, not less than one-tenth of the net earnings of the company for the preceding half-year, or for such period as is covered by the dividend, shall be carried to surplus until such surplus amounts to fifty per cent of its capital stock.
>
> In order to ascertain the undivided profits from which such a dividend may be made, in the account of profit and loss there shall be charged and deducted from the actual profits:
>
> (1) All ordinary and extraordinary expenses, paid or incurred, in managing the affairs and transacting the business of the bank.
>
> (2) Interest paid or then due, on debts which it owes.
>
> (3) All taxes due.
>
> (4) All losses sustained by the corporation. In computing its losses, debts owing to it which have become due and which are not in process of collection and on which interest for one year or more is due and unpaid, unless same are well secured, and debts upon which final judgment has been recovered, but has been for more than one year unsatisfied, and on which also for said period of one year, no interest was paid, unless same are well secured, shall be included."

It is thus apparent that, as an added insurance to those dealing with banks, the statute makes the accumulation of a surplus up to fifty percent of the capital mandatory upon every bank. This is accomplished by requiring the setting aside of one-tenth of the annual profit to the surplus account.

The statute itself evidently makes the surplus unavailable for dividends and it may only be used for the payment of losses in the event that there are no undivided profits to which the losses may be charged. It is therefore important to emphasize again the character of the obligation existing to repay the contributions made for the purpose of restoring impaired capital. In order to be effectual, these contributions must have had no strings tied to them and consequently there exists no legal liability on the part of the bank to make repayment. It necessarily follows, therefore, that there exists no loss after the capital has been replenished and I am therefore of the opinion that the surplus of a bank can not in any event be used to reimburse the contributions made for the restoration of capital. There being no legal liability, any such attempted payment would be nothing more than a donation of money and banks have no such authority. (See *McCrory* vs. *Chambers*, 48 Ill. App. 445.)

It may therefore be assumed that my answer to all of your succeeding questions is that there exists no authority, either in the directors or stockholders of a state bank,

to repay contributions made for the restoration of impaired capital from surplus. The fact that the losses might originally have been paid from surplus, had such a fund existed, is not material since such was not the case. The losses no longer can be said to exist, since the deficiency in capital has been made good.

The undivided profits of a bank, however, stand upon a slightly different footing. After setting aside the statutory proportion of the annual profit to surplus, the board of directors may, in their discretion, either pay out what remains as dividends or place them in an undivided profits fund. No one can be heard to complain in the event that all of this fund is divided among the stockholders. The rights of creditors and depositors are not involved. There is, however, an obligation upon the part of the directors to the stockholders to divide whatever portion of this fund they may see fit to distribute as dividends ratably in proportion to the holding of the stockholders. That is to say, the directors are not authorized to use the profits to make a voluntary contribution any more than they are authorized to use the surplus for this purpose.

The relationship existing between the directors and stockholders of a corporation is of a fiduciary character and the directors would be remiss in their trust if they should pay out the funds of the corporation in an unauthorized manner. I therefore feel that there would be no authority for the directors to repay the contributions in question by the adoption of a mere resolution to that effect.

You next inquire, however, whether the stockholders may authorize such a payment. As I have before stated, no payment in any event can be authorized from surplus. So far as the profits are concerned, however, I am of the opinion that the repayment may be accomplished upon proper authority therefor by the stockholders. The action in this respect must, however, be unanimous. No stockholder may, against his consent, be forced to contribute his proportion of the profits of the corporation to the payment of what I have heretofore described as a mere moral obligation. This being so, I feel that the orderly method of procedure, in the event that the stockholders are unanimous in the desire to repay the contributions theretofore made, would be to have the directors declare a usual dividend out of profits available for that purpose and then secure written assignments of the dividends, executed by the individual stockholders, assigning such dividends to those entitled to reimbursement. In this way the corporate records would be clear. The dividends would be declared in the usual manner, and so long as it was paid out of profits and not from capital or surplus, no creditor or depositor could be heard to complain.

In this connection a situation might arise where the profits available for distribution would not be sufficient to accomplish the purpose. It may be suggested that the stockholders would have the right to take definite action at one time waiving the right to future profits until the entire reimbursement had been accomplished. While this action might possibly be effectual, I have doubts as to its legality. This would especially be true in the case of a stockholder who had originally approved of the assignment of profits *in future* and then subsequently sold his stock to a *bona fide* purchaser for value. I have doubts as to whether the action of the original stockholder would be binding upon his successor unless there was some endorsement of the assignment upon the certificate of stock or some other effectual notice. It is my suggestion, therefore, that, instead of attempting to accomplish the results by the adoption of one resolution with the unanimous consent of the stockholders, the course suggested above be followed, namely, that dividends be declared and assigned as funds are available for such purpose until the reimbursement has been accomplished.

What I have said with respect to corporations is largely applicable in the case of unincorporated banks. In the case of an individual owner, however, where profits permit of repayment, it may be accomplished by the simple action of the owner of transferring the cash or releasing the note, as the case may be. He is the only one interested in the transaction and there is not the relationship existing between directors

and stockholders as in the case of corporations. It must be borne in mind, however, that the unincorporated bank is as much obligated to create and maintain a surplus fund as is a corporation and this fund is no more available for the repayment of contributions than in the case of a corporation. Likewise, in the case of a partnership, effectual action may be taken, where all of the partners have concurred, for reimbursing the original contributions from profits.

If my understanding of your fifth question is correct, you inquire what action you should take in the event that you find that the board of directors of the bank, at the time of placing notes or cash in the bank to restore impaired capital, has passed a resolution providing that such notes shall be paid or such cash reimbursed out of the net earnings or surplus of the bank. From what I have said, it is clear that if the notes or cash, by reason of such resolution, can be regarded as creating an obligation to repay, then there has been no actual replacement. However, as I understand your question, what the directors attempted to do was to create a contingent liability in behalf of themselves payable only out of surplus or profits. From what I have heretofore said it is clear that in no event could any reimbursement be accomplished from surplus except in case of liquidation. If, however, the bank continued and it reached the point where it had money available for the payment of dividends, I am of the opinion that upon the ratification of the action of the directors by the stockholders such reimbursement could be had out of any earnings available for dividends. I think you should require the approval by the stockholders of the directors' resolution for the reason that the directors' resolution confers a benefit.or advantage to themselves in respect of trust funds.

My thought in this connection is that although the directors may attempt to attach qualifications to their contributions to make good impaired capital ,yet if these contributions are shown as a part of the assets of the bank and creditors and depositors have relied thereon, there can be no right of withdrawal or reimbursement at least to the prejudice of such creditors or stockholders. If the bank became insolvent after being permitted to operate with a restored capital, then there would be no possibility of repayment and any notes held by such bank would become in effect assets for the reason that the makers thereof would not be permitted to set up the defense of want of consideration or failure of consideration.

If, however, the bank reaches a satisfactory condition and has a surplus and undivided profits, the reimbursement may be accomplished in either of the manners which I have indicated.

In your sixth question you ask whether, after promissory notes have been placed in the bank it would be legal for you to permit the removal of such notes from the assets of the bank in case the signers thereof desire to take said notes out and do not desire to effect payment thereof out of earnings. My previous discussion has made it clear that these notes, once in the assets of the bank, constitute a part of its assets and there is no authority for the return thereof. The removal of such notes can be accomplished only by their payment in the usual course or by the substitution therefor of assets of like value, or by the sustaining in a court action the defense of want of consideration or failure of consideration of or for a note. A promissory note not based upon a valuable consideration is in effect an unexecuted gift.

As I have heretofore indicated, I have attempted to outline general rules to be followed but with the admonition that there may and probably will be exceptions to these general rules, and it would be for your protection to submit all of the facts in a concrete case whenever such case arose.

Always bear in mind that Section 710-30 of the General Code makes it your duty to require any deficiency in capital to be paid in by assessment upon the stockholders pro rata. When you substitute any other method you are assuming a personal responsibility.

Respectfully,

EDWARD C. TURNER,
Attorney General.