Can a Bank Issue a Loan Secured by Its Own Stock?

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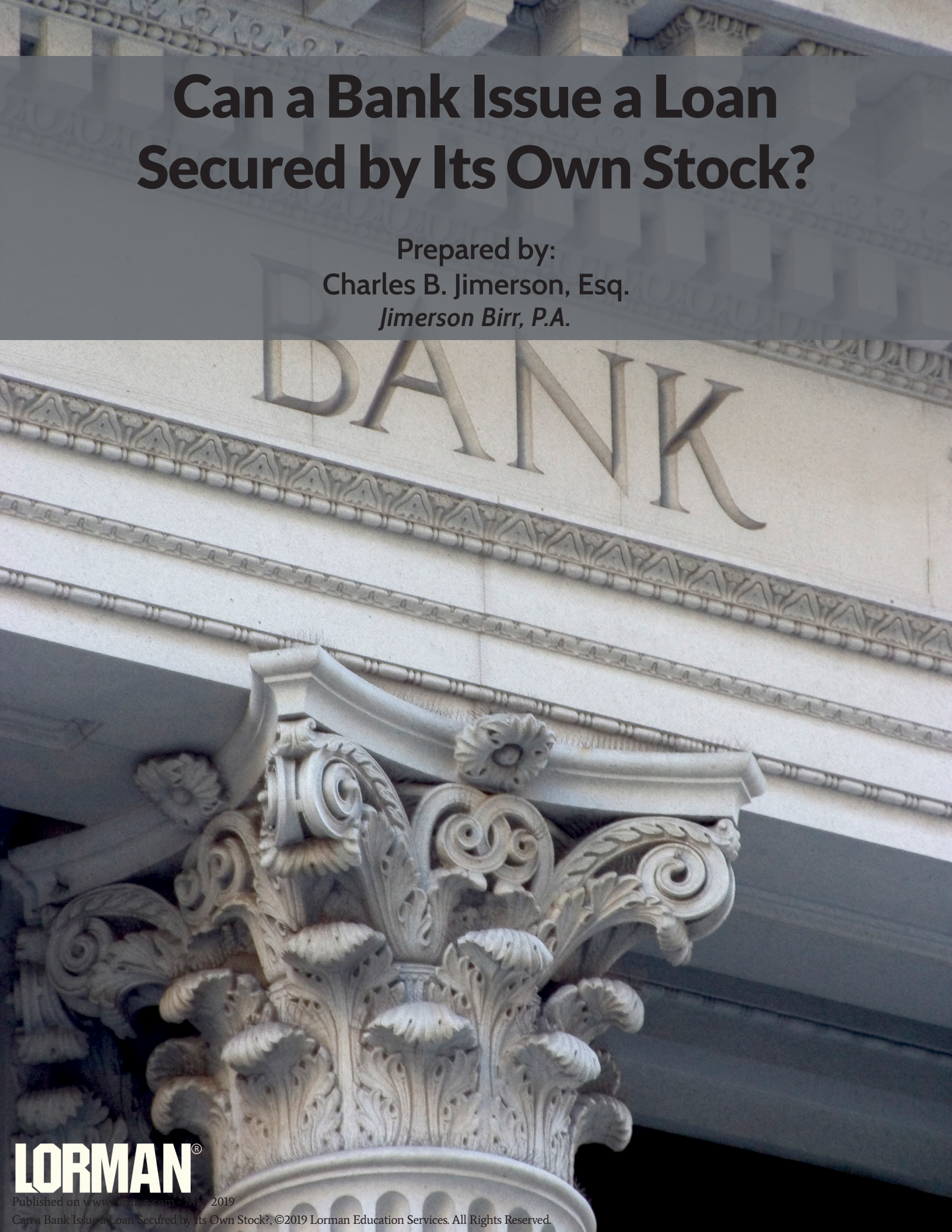

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CAN A BANK ISSUE A LOAN SECURED BY ITS OWN STOCK?

Written by Charles B. Jimerson, Esq. – 4/10/19

On occasion a lender is confronted with a complicated question of whether it can lend based on collateral in the form of its own stock. Unfortunately, this is not legally acceptable collateral, as neither a national, nor a local Florida bank may issue a loan and secure that loan with its own stock. Both federal and Florida law expressly prohibit these practices for loan securitization, but for one exception as set forth below. Additionally, a bank may set conditions on the transferal of its own stock by borrowers.

Federal Prohibition

At the federal level, national banks were prohibited from issuing loans secured by their own stock by the National Banking Act of 1864. This prohibition is now codified under 12 U.S.C. § 83, which establishes "[t]hat no association shall make any loan or discount on the security of the shares of its own capital stock."

The Supreme Court declared that the above language expressly prohibits lending with bank-stock as collateral in *First Nat. Bank v. Lanier, 78 U.S. 369 (1870)*. This SCOTUS opinion explains the policy reasoning behind § 83's prohibition. First off, if it is important to note that the reason for prohibiting the use of bank-stock as collateral is an extension of the logic behind the

prohibition against a bank owning its own stock. Thus, not only can banks not issue bank-loans secured by their own bank-stock, banks cannot own their own bank-stock. The Court explains:

> [Banks] were created to subserve public purposes, and not the mere private interests of their stockholders. And in no better way could this object be attained than by placing shareholders, in their pecuniary dealings with the bank, on the same footing with other customers. Besides, how could the capital of the bank be kept available for active use, if the shareholder, who had pledged his stock for borrowed money, should be unable to meet his obligation? To the extent of the debt the capital would be withdrawn, and it is hardly possible that this could be the case for any length of time, were the debt secured outside of the shares of the bank.

It is also worth reiterating that the above explanation was considered "unnecessary," given the express prohibition contained in § 83. Nevertheless, the Court's reasoning appears to support the general notion, as dictated by another Circuit Court, that lending on a bank's own shares would violate public policy.

Federal Exceptions

The text of § 83 itself provides one exception to the general prohibition on securing bank-loans with bank-stock. Specifically,

a bank-loan may be secured with bank-stock only if it is "necessary to prevent loss upon a debt previously contracted in good faith." This exception may only apply for six months.

Additionally, Chapter 12 of the Code of Federal Regulations lists other instances in which a bank may set conditions on the transfer of its own stock by borrowers. 12 C.F.R. § 7.2019 provides that a national bank may require a borrower holding shares of the bank to execute agreements: (1) not to pledge, give away, transfer, or otherwise assign such shares; (2) to pledge such shares at the request of the bank when necessary to prevent loss; and (3) to leave such shares in the bank's custody. This section also provides that a national bank may not make loans secured by a pledge of the bank's own capital notes and debentures. Such notes and debentures must be subordinated to the claims of depositors and other creditors of the issuing bank, and are, therefore, capital instruments within the purview of 12 U.S.C. § 83.

For additional material on the federal prohibition, *See* 51 A.L.R. 346, *Construction, application, and effect of provision of Federal statute forbidding national banks to loan on security of, or be purchaser or holder of, its own shares* (1927).

State Prohibitions

Similar to § 83, Florida Statute § 658.48(4)(c) provides that a loan may not be made by a bank: (1) on the security of the shares of its own capital stock or of its obligations subordinate to deposits; (2) on an unsecured basis for the purpose of

purchasing shares of its own capital stock or its obligations subordinate to deposits; and (3) on a secured or unsecured basis for the purpose of purchasing shares of the stock of its one-bank holding company. A bank under this section is defined as any person having a subsisting charter or other lawful authorization, under the laws of Florida or any other jurisdiction, authorizing such person to conduct a general commercial banking business. Fla. Stat. § 658.12(2).

Florida Courts have explained how the general prohibition at issue is meant to address shareholder-creditor conflict. In *Taylor v. Spurway, 16 F.Supp. 566 (SD FL 1936)*, the Southern District of Florida maintained that "[c]ourts of equity are astute to detect and defeat any scheme or device which is calculated to withdraw the capital or other assets of a corporation for the benefit of stockholders to the prejudice of creditors." *Id*. This language sounds of the public policy pronouncements of the Supreme Court in *Lanier*. No surprise, however, since the Southern District of Florida was interpreting state statutory language almost identical to that of 12 U.S.C. § 83.

Conclusion On Bank Stock Collateral For Loan Securitization

All of this is to say that the issue at hand—whether a bank can issue a loan secured by its own stock—has been settled law at both the state and federal levels for decades. The reason for this is to keep creditors on an equal footing with shareholders, where a creditor is often the average Joe that keeps money in a

checking or savings account. Exceptions to the general prohibition against securing bank-loans with bank-stock are extremely limited.

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