Date Issued: May 22, 1985 (AGO 85-21)

Requested by: William L. Strate, City Attorney
Watford City, North Dakota

- QUESTIONS PRESENTED -

I.

Whether it is mandatory that securities pledged by a financial institution as security for the repayment of a deposit of public funds by a public corporation pursuant to N.D.C.C. section 21-04-09 be delivered to a custodian financial institution, other than the depository financial institution, for safekeeping.

II.

Whether securities issued by a political subdivision of a state other than North Dakota are eligible to be pledged by a financial institution as security for the repayment of a deposit of public funds by a public corporation pursuant to N.D.C.C. section 21-04-09.

III.

Whether a financial institution may pledge securities as security for the repayment of a deposit of funds which are not public funds as defined in N.D.C.C. section 21-04-01(5).

- ATTORNEY GENERAL'S OPINION -

I.

It is my opinion that it is not mandatory that securities pledged by a financial institution as security for the repayment of a deposit of public funds by a public corporation pursuant to N.D.C.C. section 21-04-09 be delivered to a custodian financial institution, other than the depository financial institution, for safekeeping.

II.

It is my further opinion that securities issued by a political subdivision of a state other than North Dakota are not eligible to be pledged by a financial institution as security for the repayment of a deposit of public funds by a public corporation pursuant to N.D.C.C. section 21-04-09.

III.

It is my further opinion that a financial institution may not pledge securities as security for the repayment of a deposit of funds which are not public funds as defined in N.D.C.C. section 21-04-01(5).

- ANALYSES -

I.

N.D.C.C. section 21-04-09 allows a public corporation, under certain

circumstances, to accept a pledge of securities from a financial institution as security for the repayment of a deposit of public funds and provides that securities so pledged "may be delivered to and held for safekeeping by any financial institution, other than the depository ›financial institution!. . .which. . .has been approved as a custodian. . .by the state auditor." (Emphasis supplied). The question here is whether the term "may" is permissive or mandatory.

When initially enacted in 1939, N.D.C.C. section 21-04-09 contained this provision:

> Provided, further, that such securities shall be delivered to and held by such trustee as the depository and the public corporation may agree upon, and/or the State Treasurer. It shall be the duty of the State Treasurer to receipt for securities deposited with him and to issue his trust receipt therefor, jointly to the depository and the public corporation. (Emphasis supplied). 1939 N.D. S.L. 102, section 1.

In 1941, the "shall" was replaced with the present "may" and the remainder of the language was amended to read essentially as it reads today. 1941 N.D. S.L. 101, section 1.

The legislative intent is clear. The mandatory requirement that pledged securities be delivered to a custodian for safekeeping lasted only for two years; the first two years during which financial institutions were allowed to pledge securities as security for the deposit of public funds. Two years later, at its first opportunity, the Legislature made the delivery of pledged securities permissive rather than mandatory.

Therefore, it is my opinion that it is not mandatory that securities pledged by a financial institution for the repayment of a deposit of public funds by a public corporation be delivered to a custodian financial institution, other than the depository financial institution, for safekeeping. Rather, it is discretionary with the public corporation making the deposit to require that the pledged securities be delivered to a custodian financial institution by the depository financial institution.

Having expressed this opinion, I would like to comment on the risk to which a public corporation exposes itself if it does not exercise this discretionary authority.

The recent failure of E.S.M. Government Securities, Inc. of Fort Lauderdale, Florida (E.S.M.), offers a vivid example of the opportunity for fraud and the resulting financial harm in a situation where pledged securities are not required to be delivered to a custodian for safekeeping. E.S.M. was primarily involved in doing repurchase agreements which is a form of short-term borrowing where a dealer sells government securities to an investor then buys them back at a later date at a higher price. The difference in price compensates the investor for the use of the money. In theory, the dealer uses the securities to back the loan. In the E.S.M. case, it is estimated that several political subdivisions, banks, and savings and loan institutions stand to lose more than $300 million. It was this situation which led to the temporary closing of the savings and

loan institutions in Ohio just a few months ago. The direct cause of this financial disaster was the failure of these political subdivisions, banks, and savings and loan institutions who were placing their funds with E.S.M. to require that securities which were to be pledged to them be delivered to a custodian for safekeeping and that the delivery be confirmed by the custodian. Consequently, E.S.M. used the same securities for two or more transactions. When E.S.M. was unable to repay the funds placed with it, these political subdivisions, banks, and savings and loan institutions discovered they had no securities to recover against.

Although the above explanation is an oversimplification of the E.S.M. matter, the bottom line is that the political subdivisions, banks, and savings and loan institutions facing these losses could have avoided them simply by requiring that the securities pledged to them be delivered to a custodian for safekeeping and that the custodian issue receipts to them acknowledging their interest in the securities.

N.D.C.C. section 21-04-09 effectively provides public corporations the means to avoid the type of fraud which occurred in the E.S.M. case by giving them the discretionary authority to require delivery of pledged securities to a custodian for safekeeping and also by requiring that the custodian issue a receipt to both the public corporation and the depository financial institution.

II.

N.D.C.C. section 21-04-09 provides, in part, as follows:

> 21-04-09. PLEDGE OF SECURITY IN PLACE OF DEPOSITORY BOND . . . . Securities which shall be eligible for such pledge shall be bills, notes, or bonds issued by the United States government, its agencies or instrumentalities, all bonds and notes guaranteed by the United States government, federal land bank bonds, bonds, notes, warrants, certificates of indebtedness and all other forms of securities issued by the state of North Dakota, its boards, agencies, or instrumentalities, or by any county, city, township, school district, park district, or other political subdivision of the state of North Dakota, whether payable from special revenues or supported by the full faith and credit of the issuing body, and bonds issued by any other state of the United States. . . .

While the above list sets out at length the political subdivisions of the State of North Dakota whose securities are eligible to be pledged under this statute, the political subdivisions of other states are specifically excluded.

I concur with the opinion expressed in 1971 N.D. Attorney General's Opinion 30, that securities issued by a political subdivision of a state other than North Dakota may not be pledged by a financial institution pursuant to N.D.C.C section 21-04-09 as security for the repayment of a deposit of public funds by a public corporation.

III.

"Financial institution" and "public funds" are defined as follows in N.D.C.C. section 21-04-01(3), (5):

> 21-04-01. DEFINITIONS. In this chapter unless the context or subject matter otherwise requires:
>
> * * *
>
> 3. "Financial institutions" includes state and national banks insured by the federal deposit insurance corporation, state chartered or federally chartered savings and loans insured by the federal savings and loan insurance corporation, and state chartered or federally chartered credit unions insured by the national credit union administration.
>
> * * *
>
> 5. "Public funds" shall include all funds derived from taxation, fees, penalties, sale of bonds, or from any other source, which belong to and are the property of a public corporation or of the state, and all sinking funds of such public corporation or of the state, and all funds from whatever source derived and for whatever purpose to be expended of which a public corporation or the state shall have legal custody. They shall include the funds of which any board, bureau, commission, or individual, created or authorized by law, is authorized to have control as the legal custodian for any purpose whatsoever whether such funds were derived from general or special taxation or the assessment of persons or corporations for a specific purpose.

A state bank has the authority to exercise those powers which are expressly given it by statute and such incidental powers which are necessary to carry on the business of banking. Divide County v. Baird 212 N.W. 236, 238 (N.D. 1926).

There is no express authority given to a state bank by statute to pledge its assets to secure a deposit of other than public funds. In Divide County supra the North Dakota Supreme Court held that the pledging of assets to secure a general deposit is not an incidental power which is necessary to carry on the business of banking. Id. at 241. It should be noted that the Divide County decision was issued prior to the enactment of N.D.C.C. section 21-04-09 and was applicable to both public funds and private funds. However, that decision is still applicable to the pledging of assets to secure a deposit of other than public funds.

It is also well settled, for the same reasons that apply to a state bank, that a national bank may not pledge its assets as security for a deposit of other than public funds. Texas and Pacific Ry. v. Pottorff 291 U.S. 245 (1934).

A federal savings and loan association may pledge its assets as security for the deposit of public moneys if required to do so by state law. 12 CFR section 545.16(b)(1). There is no authority for a federal savings and loan association to pledge its assets as security

for the deposit of other than public funds.

Although there is no direct authority for a state savings and loan association to pledge assets as security for the deposit of public funds, N.D.C.C. section 7-02-14 provides that a state savings and loan association may establish any accounts that could be established if it were a federal savings and loan association. There is no authority in state or federal law for a state savings and loan association to pledge assets as security for the deposit of other than public funds. Furthermore, there is no authority for state or federal credit unions to pledge securities as security for the deposit of public or other than public funds.

Therefore, it is my opinion that a financial institution may not pledge securities as security for the repayment of a deposit of funds which are not public funds as defined in N.D.C.C. section 21-04-01(5).

- EFFECT -

This opinion is issued pursuant to N.D.C.C. section 54-12-01. It governs the actions of public officials until the questions presented are decided by the courts.

NICHOLAS J. SPAETH
Attorney General

Assisted by: Thomas B. Tudor
Assistant Attorney General