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# Bailment Ailment: An Analysis of the Legal Status Of Ordinary Demand Deposits in the Shadow of the Financial Crisis of 2008

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Cover Page Footnote

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# BAILMENT AILMENT: AN ANALYSIS OF THE LEGAL STATUS OF ORDINARY DEMAND DEPOSITS IN THE SHADOW OF THE FINANCIAL CRISIS OF 2008

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# BAILMENT AILMENT: AN ANALYSIS OF THE LEGAL STATUS OF ORDINARY DEMAND DEPOSITS IN THE SHADOW OF THE FINANCIAL CRISIS OF 2008

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## ABSTRACT

The vast majority of case law establishes that, in the absence of a specific agreement to the contrary, the deposit of funds into a bank creates a debtor-creditor relationship, pursuant to which depositors are deemed creditors of their respective banks. In effect, depositors loan their deposits to banks, which may then use such deposits for ordinary banking activities, including investment and lending, speculative or otherwise. This Article examines the case history pertaining to this legal classification and proposes that such case history does not comport with depositor intent, is not supported by purportedly relevant legal premises (as illustrated by an analogy to deposits of commodities in the agricultural context), and does not justify the conclusion that bank deposits give rise to debtor-creditor relationships. The Article proceeds to explore the practical consequences of the anomalous legal classification of bank deposits as loans instead of the natural and obvious alternative—bailments.

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## Introduction

A client walks into a bank with the intention of depositing personal or business funds. The bank's teller gladly accepts the deposit, credits the client's account accordingly, and the client departs content that what transpired was an ordinary-course banking transaction. Simultaneously, however, a curious phenomenon occurs, one which effectively transforms the legal nature of the transaction into something very different from that which our unwary depositor intends. That curious phenomenon, which willfully ignores the nature of the deposit as understood by *both* parties, subverts the intentions of only *one* party. What the depositor intends to be in the nature of a bailment, the law transforms into a loan; where ordinary people expect a bailor-bailee relationship, the law creates a creditor and a debtor. Title to the deposited funds passes from the depositor to the bank, and usually only the bank knows it. Upon this legal transformation is built the leviathan that is the global banking system.

This Article evaluates the reasons for the anomalous legal classification of ordinary bank deposits as loans instead of bailments, the reasons for treating depositors as creditors to banks, and the consequences of classifying banks as debtors to depositors. This Article concludes that (i) there is no legal justification for treating ordinary bank deposits as loans, depositors as creditors, or banks as debtors in the ordinary deposit context; (ii) the default legal relationship that exists between a depositor and a bank should be that of bailor and bailee—a loan arising only by express agreement, in accordance with depositors' expectations; (iii) the fungible nature of deposits, and the fact of commingling, pose no legal or practical obstacles for the robust law of bailments and its application to the deposit context; and (iv) the classification of ordinary deposits as loans pursuant to which banks acquire title to deposited funds has costly social, economic, and legal consequences.

Part I of this Article describes the relevant terminology and then proceeds to examine the case history pertaining to the legal nature of deposits in the banking context, particularly during the 19th century. Part I also illustrates that the precedent established by applicable 19th-century case law, a precedent codified during the 20th century by many states through their respective banking regulations, is essential to the modern banking system, but conflicts with depositors' intentions and creates an inherent discrepancy between the practical relationship, on the one hand, and the legal relationship, on the other, between depositors and banks.

Part II examines the historical reasons underlying the case law classifying an ordinary bank deposit as a loan instead of a bailment in the absence of an agreement to the contrary and proceeds to evaluate the relative merits of the myriad legal justifications for this classification proffered by various state and federal courts.

Part III provides a legal justification for treating deposits as bailments. In particular, Part III explores the nature of deposits of agricultural goods in the commodity warehouse context and shows that such transactions are analogous to the deposit of money in the banking context. The part then examines the history of agricultural transactions and the legal relationship that exists between farmers (or similarly situated parties) and warehouse operators pursuant to case law and applicable statutory law. Part III concludes by arguing that there is no *legal* justification for differentiating between money deposits in the banking context and commodity deposits in the agricultural context.

Part IV introduces the ubiquitous practice of fractional reserve banking and explains that its existence depends on the default legal classification of an ordinary deposit as a loan. Part IV should be understood as the crux of the article that explains the connection between the legal classification of ordinary demand deposits as loans (as described in Parts I, II, and III) and the consequences of such classification (as described in Parts V, and VI). In particular, Part IV hypothesizes that the primary *intended* purpose of the default legal classification was the retroactive legitimization of the widespread but legally dubious use of deposited funds by banks for investment and lending purposes.

Part V employs Aesop's fable of the Ant and the Grasshopper to illustrate that, in the banking context, the prudence of 100% reserve banks is undermined by the existence of fractional reserve banks. Part V proceeds to show that the rise of deposit insurance marginalizes 100% reserve banks by rendering them superfluous, leaving fractional reserve banks as the only practical banking alternative.

Part VI concludes this Article by discussing some of the consequences of the anomalous classification of ordinary demand deposits as loans instead of bailments together with the implementation of systematic deposit insurance. The discussion addresses bank insolvency, speculative and excessive banking activity (i.e., lending and investment), inflation, moral hazard, systemic financial instability, and other ramifications for deposit insurance, disguised social policy, and economic and social disruption.

## I. RELEVANT TERMINOLOGY AND ORIGIN OF DEFAULT LEGAL RULE

In the ordinary deposit context and in the absence of express agreement to the contrary, title to deposited funds automatically passes from the depositor to the bank in what is typically called a "general deposit." In the case of general deposits, a bank assumes the legal obligations of a debtor to the depositor in respect of the deposited funds, and undertakes a contractual or legal obligation to return the deposited funds "on demand" or, in the case of "time deposits," subject to certain restrictions identified in Part IV below. Prior to the return of deposited funds, however, the bank in the general deposit context may use the available funds for its general business purposes including lending and investment, subject to applicable federal and state banking regulations. Conversely, if a depositor and a bank agree explicitly to establish a bailment, a "special deposit" arises where title to the deposited funds remains with the depositor, and the bank assumes the legal obligations of a bailee. For example, under New York law a "bailment of money is created . . . when a *special* or *specific* bank account is created, title to the funds remains with the account holder, and the funds are separated from other deposits."[1] In the special deposit context, the bank is not permitted to use deposited funds for its general business purposes. The *process* by which these ordinary deposits came to be classified as loans instead of bailments is of critical importance. In the 1864 case *Marine Bank v. Fulton*, the Supreme Court observed:

> All deposits made with bankers may be divided into two classes, namely, those in which the bank becomes a bailee of the depositor, the title of the thing deposited remaining with the latter; and that other kind of deposit of money peculiar to the banking business, in which the depositor, for his own convenience, parts with the title to his money, and loans it to the banker; and the latter, in consideration of the loan of the money and the right to use it for his own profit, agrees to refund the same amount, or any part thereof, on demand.[2]

Most jurisdictions now use the "special deposit" / "general deposit" framework to make the substantive distinction between a bailment and a loan, respectively; and, since the particular terminology used is not crucial to the central thesis, this Article will use the terms "special deposit" and "bailment" interchangeably, and the terms "general deposit" and "loan" interchangeably.[3]

Having established the possible alternatives, subsequent courts set forth to explain the procedure for determining whether "a deposit was made without condition or special agreement"; i.e., whether it was special or general, a bailment or a loan.[4] In the Second and Sixth Circuits, that procedure amounts to an evaluation of depositor intent: "[w]hether a deposit in a bank is general or special depends upon the mutual understanding and intention of the parties at the time such deposit is made."[5] By supposition, however, the steps thus far

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1. Rozsa v. May Davis Grp., Inc., 152 F. Supp. 2d 526, 532 (S.D.N.Y. 2001) (emphasis added); *see also* Warren v. Nix, 135 S.W. 896 (Ark. 1911), Woodhouse v. Crandall, 64 N.E. 292 (Ill. 1902), Kimmel v. Dickson, 58 N.W. 561 (S.D. 1894).

2. Marine Bank v. Fulton Bank, 69 U.S. 252, 256 (1864).

3. *But see Nix*, 135 S.W. at 898 ("But we think there is a clear distinction between a loan and a general deposit. When a loan is made, the money is borrowed for a fixed time, and the borrower promises to repay such amount at a fixed future date. But a general deposit is payable upon demand; in effect, the money thus deposited is kept under the control of the depositor, because it must be kept at all times subject to be paid upon his check. The money so deposited or its actual equivalent is returned to the depositor upon demand.").

4. Thompson v. Riggs, 72 U.S. 663, 678 (1866).

5. Peoples Westchester Sav. Bank v. F.D.I.C., 961 F.2d 327, 330 (2d Cir. 1992) (quoting Keyes v. Paducah & I.R. Co., 61 F.2d 611, 613 (6th Cir. 1932)).

elaborated do not result in a definitive legal classification of the nature of the deposit, precisely because the depositor and the bank do not have a mutual understanding or intent.[6] What is needed (at least from the bank's perspective) is a default rule that classifies the deposit as general, not specific. Courts nationwide eagerly obliged: the Second,[7] Ninth,[8] and Tenth[9] Circuits cite the Sixth Circuit for the proposition that "a deposit made in the ordinary course of business is presumed to be general."[10] District and state courts followed suit: in New York, "[a]bsent evidence of intent, New York law presumes that deposits are general rather than specific";[11] under Florida law, "[a] bank becomes the absolute owner of money deposited with it . . . in the absence of any special agreement importing a different character into the transaction, and the relationship between the parties is simply that of debtor and creditor";[12] under South Carolina law, "[i]t is an important part of the business of banking to receive deposits; but when they are received, unless there are stipulations to the contrary, they belong to the bank, become a part of its general funds, and can be loaned by it as other moneys [sic]";[13] in Arkansas, "the general rule [is], that where money . . . is deposited with a bank . . . the law presumes it to be a general deposit, until the contrary appears";[14] in Texas, "[w]hen money . . . is deposited in a bank without any special agreement . . . the relation of debtor and creditor is created between the bank and the depositor, and the deposit is

6. To be precise, I assume the depositor believes her deposit to be a bailment and that the bank understands it to be a loan. I add that the bank likely understands that the depositor is subject to a mistaken belief regarding the legal classification of her deposit. *See, e.g.*, *Nix*, 135 S.W. at 898–99 ("Certainly, the thousands who daily deliver money to banks for safekeeping and return in corresponding currency do not regard the transaction as a loan, nor do they so speak of it.") (quoting Allibone v. Ames, 68 N.W. 165, 166 (S.D. 1896)).

7. *Peoples Westchester Sav. Bank*, 961 F.2d at 330.

8. Thompson v. Beitia, 69 F.2d 356, 358 (9th Cir. 1934) (quoting N. Sugar Corp. v. Thompson, 13 F.2d 829, 831 (8th Cir. 1926)).

9. Dean Witter Reynolds Inc. v. Variable Life Annuity Life Ins. Co., 373 F.3d 1100, 1107 (10th Cir. 2004).

10. *Keyes*, 61 F.2d at 613.

11. Rozsa v. May Davis Grp., Inc., 152 F. Supp. 2d 526, 532 (S.D.N.Y. 2001).

12. City of Miami v. Shutts, 51 So. 929, 931 (Fla. 1910) (quoting Camp v. First Nat'l Bank of Ocala, 33 So. 241, 243 (Fla. 1902)).

13. Leaphart v. Commercial Bank of Columbia, 23 S.E. 939, 941 (S.C. 1896).

14. Dawson v. Real Estate Bank, 5 Ark. 283, 297 (1843).

general";[15] and in California, "[i]t is unquestionably true that one making a general deposit with a bank in the usual course of business parts with title to the moneys deposited."[16]

Further, in order that the legal presumption inhere with practical substance, courts drove the point home: again in the Second and Ninth Circuits, "the burden of proof is on the depositor to overcome such presumption by proving that the deposit was . . . a special deposit, or a deposit for a specific purpose, as distinguished from a general deposit";[17] in the Southern District of New York "[w]here there is no written contract, the party asserting a bailment must establish, in light of all the circumstances, that the parties agreed to a contract with definite terms";[18] and, in the Eighth Circuit, "a deposit made in the ordinary course of business is presumed to be general, and the burden of proof is upon the depositor to overcome such presumption by proving that the deposit was made upon such terms and conditions as to constitute it [sic] a special deposit or a deposit for a specific purpose, as distinguished from a general deposit."[19] Perhaps tellingly, the Third Circuit sidestepped the perfunctory evaluation of depositor intent, and straightforwardly declared "money deposited in a bank becomes the property of the bank in the sense that the bank may use it as its own."[20]

In effect, the above case law and the ensuing state legislation ensures that in the absence of an agreement between the parties, a deposit is subject to a legal presumption that determines the respective rights of each party in connection with their deposits. More specifically, the process of (i) distinguishing between possible classifications, (ii) assessing the mutual intent of the parties, and (iii) establishing a default rule that classifies deposits as general in the absence of evidence of the parties' intent, effectively renders into loans the vast majority of deposits made in the nation's banks precisely by ignoring depositors' intentions, notwithstanding the self-evident observation that most

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15. McBride v. Am. Ry. & Lighting Co., 127 S.W. 229, 232 (Tex. Civ. App. 1910).

16. Anderson v. Pac. Bank, 44 P. 1063 (Cal. 1896).

17. Peoples Westchester Sav. Bank v. F.D.I.C., 961 F.2d 327, 330 (2d Cir. 1992) (quoting Keyes v. Paducah & I.R. Co., 61 F.2d 611, 613 (6th Cir. 1932)); Thompson v. Beitia, 69 F.2d 356, 358 (9th Cir. 1934) (quoting *Keyes*, 61 F.2d at 613)).

18. Rozsa v. May Davis Grp., Inc., 152 F. Supp. 2d 526, 532 (S.D.N.Y. 2001).

19. N. Sugar Corp. v. Thompson, 13 F.2d 829, 831 (8th Cir. 1926).

20. *In re* Erie Forge & Steel Corp., 456 F.2d 801, 804 (3d Cir. 1972).

depositors do not intend to be creditors to their respective banks.[21] Thus, under most circumstances, the first two steps of the above-described process constitute perfunctory gestures that suggest a lawful basis exists for classifying a deposit in a manner that conflicts with the intentions and understanding of ordinary depositors. Accordingly, what ultimately matters is the third step—the default legal conclusion that deposited funds are general deposits (i.e., loans from depositors to banks) coupled with the requirement that depositors bear the burden of disproving such conclusion by proffering explicit evidence of agreement to the contrary. That step seems to be an aberration of the common law, unjustified by recourse to the mutual understanding of both parties as illustrated by the legal relationship recognized to exist between warehouse operators and those who deposit fungible commodities into such warehouses, as described in Part III *infra*.

The perfunctory nature of the process is evidenced by the Supreme Court's 1866 observation, only two years after *Marine Bank*, that it was "well settled" law that if a deposit was "made without condition or special agreement of any kind . . . the depositor parts with the title to his money, and loans it to the bank."[22] Two years is apparently ample time to gloss over extant precedent in an otherwise analogous field of law; i.e., the law of bailments in the context of deposits of fungible agricultural goods, and to ordain that an anomalous legal conclusion is "well settled." Indeed, most observers would probably not agree that it "is axiomatic that the relationship between a bank and its depositor arising out of a general deposit is that of a debtor and creditor."[23] To argue as much is to boot-strap the "axiom," without which the reasonably presumed legal relationship between a depositor and a bank is that of bailor to bailee, not creditor to debtor.[24] Having established the genesis of the default legal rule that renders ordinary deposits into

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21. Warren v. Nix, 97 Ark. 374, 381 (1911) ("Ordinarily the depositor understands that he is leaving his money for safekeeping, to be returned upon his order upon demand, and not that the identical pieces of money left with the bank will be returned, but only its equivalent. He does not ordinarily understand that he is making a loan to the bank when he makes a deposit therein.").

22. Thompson v. Riggs, 72 U.S. 663, 678 (1866).

23. Morse v. Crocker Nat'l Bank, 142 Cal. App. 3d 228, 232 (Ct. App. 1983).

24. The Supreme Court's 1966 statement that "[t]he relationship of bank and depositor is that of debtor and creditor, founded upon contract" is instructive to the extent it fails even to mention the intent of the parties. Bank of Marin v. England, 385 U.S. 99, 101 (1966).

loans, and by corollary renders ordinary depositors into lenders, we're left wondering why. Subsequent courts attempted to answer this question. But, as Part II demonstrates, these attempts did little more than restate the conclusion.

## II. HISTORICAL REASONS FOR DEFAULT LEGAL RULE

Historically, courts classified deposits as loans in part because they possessed a narrow understanding of bailments as applied exclusively to fungible goods. For example, well more than a century ago, an Illinois appeals court in *Mutual Accident Association of the Northwest v. Jacobs*, stated that if "there is no obligation to restore the specific article, and the receiver is at liberty to return another thing of equal value, the contract is not that of bailment."[25] Seventy years later, using the terminology from Part I, the Third Circuit applied similar reasoning to define bailor-bailee relationships in the banking context: "A 'special' deposit or account is one where the identical money or thing deposited is to be kept safe and returned as deposited. The relation of debtor and creditor is not created, but that of bailor and bailee is, title remaining in the bailor."[26]

In 1866, twenty-five years before *Jacobs*, the Supreme Court in *Thompson v. Riggs* lent its weight to a narrow definition of bailments: deposits, the Court stated in *dicta*, "may be made under circumstances where the legal conclusion would be that the title to the thing deposited remained with the depositor, and in that case the bank would become the bailee of the depositor, *and the latter might rightfully demand the identical money deposited as his property*."[27] The supposition is, of course, that if a bailment exists, the bailor *must* have the right to demand that the identical money deposited be returned.[28] By implication, no commingling of the funds can occur, a conclusion that courts have acknowledged: "We also approve the principle . . . that where a depositor gives the bank the right to commingle his deposit with other

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25. Mut. Accident Ass'n of Nw. v. Jacobs, 43 Ill. App. Ct. 340, 343 (1891) (quoting Mallory v. Willis, 4 N.Y. 76 (N.Y. 1850)).

26. *In re* A.M. Townson & Co., 283 F.2d 449, 453 (3d Cir. 1960).

27. *Riggs*, 72 U.S. at 678 (emphasis added).

28. *See, e.g.*, Mystic Color Lab, Inc. v. Auctions Worldwide, LLC, 284 Conn. 408, 420 (2007) (stating that if a putative bailee is not required to return the identical deposited items, but may instead deliver any items of equal value, there is no bailment); *see also*, State v. Deutsch, 77 N.J.L. 292, 297 (Sup. Ct. 1909); Woodhouse v. Crandall, 197 Ill. 104, 109 (1902).

funds owned by the bank, he creates only a general deposit whose funds the bank is authorized to use and disburse as it sees fit."[29]

The reasoning in *Jacobs* comports with the Supreme Court's statement in *Thompson*, as illustrated by the *Jacobs* Court's explanation that because a $6,000 deposit was not a bailment (since the specific funds were not to be returned), it was therefore "more in the nature of a loan" and that "the relation of debtor and creditor [was] created by the transaction."[30] This reasoning is correct, as far as it goes—a deposit must be either a bailment or a loan, and it cannot be both. That conclusion also comports with the Supreme Court's earlier holding in *Marine Bank*.[31] But the reasoning also presupposes incorrectly that if the identical units of deposited currency are not to be returned (or cannot be returned, for practical reasons) then the deposit must not be a bailment. As explained below, this conclusion does not follow from the premise that a deposit must be either a bailment or a loan, but not both, and the Court provides no explanation for this logical leap. Thus, observers are left to wonder whether a definition of "bailments" that fails to account for fungible goods is sufficiently robust in a modern economy.

To that end, the *Jacobs* Court's description of the subject deposit suggests the possibility that it was aware of the logical leap, but, having determined that the deposit was not a bailment, had no alternative other than to use ambiguous language to conclude that the deposit was "*in the nature of a loan*"; but, apparently not *a loan*.[32] Such equivocation is more than merely semantic and reflects the essence of the underlying dilemma; namely, everybody knows that depositors believe their deposits to be *in the nature* of a bailment, but all banks operate as though such deposits are loans. Thus, phrases like "in the nature of" seem to be thinly-veiled attempts to skirt an essential legal issue. Other courts have wrestled with the same difficulty. For example, the Third Circuit in *In re Erie Forge & Steel Corp.* stated that "money deposited in a bank becomes the property of the bank in the sense that the bank may use it as its own."[33] This is consistent with the creditor-debtor

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29. Hudnall v. Tyler Bank & Trust Co., 458 S.W.2d 183, 186 (Tex. 1970).

30. *Jacobs*, 43 Ill. App. Ct. at 346.

31. Marine Bank v. Fulton Bank, 69 U.S. 252, 256 (N.Y. 1864).

32. *Jacobs*, 43 Ill. App. Ct. at 346; s*ee also*, Downes v. Phoenix Bank, 6 Hill 297, 300 (1844) (acknowledging some difficulty in denying that an ordinary bank deposit appears to be a bailment).

33. *In re* Erie Forge & Steel Corp., 456 F.2d 801, 804 (3d Cir. 1972).

relationship, pursuant to which title to deposited funds changes hands, subject to an explicit or tacit contract to return such funds on demand. However, only one sentence later, the Third Circuit elaborated that "the mere deposit of money in a bank does not amount to a transfer of property."[34] This is exactly the crux of the issue, and the Court's second point can't be reconciled with the simultaneous conclusion that a depositor is a creditor and not a bailor, as exemplified by the first point. Either title to deposited funds remains with the depositor, as in the bailment context, or it passes to the bank, as in the creditor context. Indeed, this dilemma has been swept under the rug by the largest broom in the land. At the beginning of the 20th century, the Supreme Court stated:

> A deposit of money to one's credit in a bank . . . creates at the same time, on the part of the bank, an obligation to pay the amount of the deposit as soon as the depositor may see fit to draw a check against it. It is not a transfer of property as a payment, pledge, mortgage, gift, or security. It is true that it creates a debt . . . .[35]

Dissecting the Court's statements unveils a semantic and logical quagmire. The first sentence is ambiguous, and it is not clear whether title to deposited funds changes hands. The ambiguity is apparently resolved in the second sentence, as the Court states that deposits are not transfers of property. This implies that the deposit must be a bailment, since no property is transferred; i.e., title to the property remains with the depositor. But, alas, appearances are deceiving, as evidenced by the Court's confusing final statement that the deposit "creates a debt," notwithstanding the fact that there is no transfer of title to the property.

This confusion is reminiscent of *Jacobs*. Recall that in *Jacobs*, an Illinois appeals court held that a deposit was a loan because there was no agreement to return the *specific* deposited money. But, the *Jacobs* Court made its task unnecessarily difficult, at least to the extent that buried in its opinion are facts that substantiate independently its holding: "it was the manifest intention of the parties that the $6,000 was not to be kept as a special deposit . . . and to remain unused in the [bank] . . . , but that it was to be . . . used in the regular . . . business" of the bank.[36] If the intention of the parties regarding the status of the deposit was "manifest," the Court's legal gymnastics presumably were gratuitous.

34. *Id*.
35. New York Cnty. Nat. Bank v. Massey, 192 U.S. 138, 147 (1904).
36. *Jacobs*, 43 Ill. App. Ct. at 345–46.

Such intention would be established by facts that, at the appellate level, were presumed true, and would be sufficient to reach the conclusion that the deposit constituted a loan without resort to a default rule classifying them as such. In other words, the ultimate issue is precisely whether a depositor intends that the bank use deposited funds for its business purposes. If so, the deposit is a loan; if not, the deposit is a bailment. Creditors intend that debtors use credited funds, bailors do not.

In effect, the assumption that it is practically untenable to require banks to return identical deposits of currency leads to the reasonable conclusion that banks need only return currency deposits of equal value.[37] That is, once courts concluded that depositors were indifferent to the return of identical units of currency (as opposed to units of equal value), a conveniently narrow conception of bailments induced these courts unnecessarily to conclude that title to deposited funds must pass from depositors to banks. Thereafter, courts assumed that deposits of currency must be classified as general deposits as opposed to specific deposits.[38] After all, if a bailment requires that the specific article deposited also be returned, and banks are commingling literally billions of homogenous deposits,[39] then there is no practical way to conclude that such deposits constitute bailments, if only because banks cannot really track title. Banking would grind to a halt as managers attempted to account for each depositor's legal title to specific bills. This explains the conclusion that title to deposited funds must pass from depositors to banks. Such reasoning reduces to the following form: (i) initially, depositors have title to their specific deposits; (ii) then, bankers commingle these deposits *en masse*, and in the process lose track of title; therefore, (iii) courts concluded that depositors must lose title to their specific deposits. With time, clause (i) is forgotten and the affirming-the-consequent nature of the above logical structure is resolved.

But the issue needn't be nearly so messy, and bailments are far more flexible as legal devices than courts suppose or banks prefer. Indeed, the practical inability to return the specific fungible deposit (i.e.,

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37. Part VI, *infra*, explains that although returned deposits will have the same nominal or "face" value, they usually will not possess the same "real" value as that which inhered in the funds at the time of deposit.

38. *See, e.g.*, Hossain v. Rauscher Pierce Refsnes, Inc., 15 F. App'x 745, 748 (10th Cir. 2001) (quoting Bloomheart v. Foster, 221 P. 279, 281 (Kan. 1923)).

39. Homogenous for all practical purposes, of course, each bill is distinct at least to the extent that it has a unique serial number.

the dollar bill with the same serial number) poses no conceptual difficulty for the law of bailments. Part III, *infra*, practically and legally debunks the notion that bailments require bailees to independently track title to fungible, commingled deposits, and sets the stage for a restoration of the reasonable and widely-held understanding that ordinary deposits are bailments, not loans.

## III. Deposits of Fungible, Commingled Goods in the Agricultural Context

The *practical* relationship that exists between the depositors of fungible agricultural goods[40] and the warehouses that store such goods is analogous to the *practical* relationship that exists between monetary depositors and banks. During normal economic circumstances, a bank depositor may operate without interruption under the incorrect belief that the bank holds all deposits in the form of cash reserves; for example, she may write checks that draw upon her available balance and expect that such checks will be honored by the bank when presented for payment, and she may otherwise engage in ordinary banking activities without concern for the security of her deposits. She may *act* as if her deposit were a bailment. Similarly, for all practical purposes, the warehouse depositor transacts his business with the correct understanding that his deposit constitutes a bailment.[41] However, the default *legal* relationship that exists in the bank deposit context is the antithesis of that which exists in the warehouse deposit context. When a grain producer deposits his fungible goods with a warehouse, "the general rule is that a bailment is created by such a deposit . . . even though [the] grain belonging to the warehouse and various other owners

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40. E.g., grain or wheat.

41. *See, e.g.*, N.D. CENT. CODE § 60-02-25 (2013) ("[w]henever any grain shall be delivered to any public warehouse . . . such delivery shall be a bailment . . . ."); and 78 AM. JUR. 2D *Warehouses* § 23 (2014), citing O'Keefe v. Equitable Trust Co., 103 F.2d 904 (3d Cir. 1939); *In re* Ellis' Estate, 24 Del. Ch. 393, 6 A.2d 602, 612 (Del. Orph. 1939); Bonnett v. Farmers' & Growers' Shipping Ass'n, 105 Kan. 121, 181 P. 634, 635–36 (1919); Moses v. Teetors, 64 Kan. 149, 67 P. 526, 527 (1902); New Domain Oil & Gas Co. v. Hayes, 259 S.W. 715, 716–17 (Ky. 1924) (recognizing rule); State v. Cowdery, 79 Minn. 94, 81 N.W. 750, 751 (1900); State v. Colonial Club, 154 N.C. 177, 69 S.E. 771, 775 (1910); St. Anthony & Dakota Elevator Co. v. Dawson & Byfield, 20 N.D. 18, 126 N.W. 1013, 1015 (1910); Savage v. Salem Mills Co., 48 Or. 1, 85 P. 69, 74–75 (1906); Robertson v. Ramsey, 17 Tenn. App. 248, 66 S.W.2d 1022, 1035 (Ct. App. 1933) (recognizing rule); Barnes v. Patrick, 176 Wash. 142, 28 P.2d 293, 295 (1934); and State v. Oakley, 129 Wash. 553, 225 P. 425, 427 (1924).

is from time to time added to the common mass, and sales and deliveries are made therefrom."[42]

Under ordinary economic circumstances, the distinction between the *legal* relationship and the *practical* relationship in the bank deposit context is of little relevance, at least from the perspective of the depositor. However, during extraordinary economic circumstances, the actual legal relationship that exists is of particular importance, because the depositor will ordinarily act as though her deposit constitutes a bailment, whereas the bank will act as though it is a loan. During a recession, banks suffer financial losses that bring into sharp focus the fact that such banks used deposits to make investments and loans that depositors did not authorize, and for which they will be liable.[43] Before discussing extraordinary economic circumstances, however, an analysis of the similarities between a bank deposit and warehouse deposit help to illustrate that there do not appear to be any legal or practical reasons to classify the former as a loan and the latter as a bailment, absent express agreement to the contrary.

For example, warehouse depositors can and do undertake transactions using warehouse receipts that in many respects parallel ordinary bank checking transactions. The Uniform Commercial Code ("UCC") specifically contemplates the existence of such transactions in the warehouse deposit context: "a document of title [such as a warehouse receipt] is negotiable if by its terms the goods are to be delivered to *bearer* or to the *order* of a named person."[44] Similarly, the UCC contemplates equivalent transactions in the banking context: commercial paper, such as a certified or bank check, is a negotiable instrument if, among other things, it is "payable to *bearer* or to *order*."[45] The analogy in this context is, of course, not to an ordinary personal check, but to a bank or certified check; however, the emphasized language will undoubtedly sound familiar to anybody who has handled a personal check, and who understands that signing a blank check or failing to identify the payee could result in losses to the drawer. Highly

42. 78 AM. JUR. 2D *Warehouses* § 23 (2014).

43. Deposit insurance, as discussed in Part V, *infra*, only appears to mitigate these losses.

44. U.C.C. § 7-104(a) (2012) (emphasis added). See U.C.C. § 1-201(b)(16) (2012) for the definition of "document of title," which includes "warehouse receipt"; and U.C.C. § 1-201(b)(42) for "warehouse receipt" defined as "a receipt issued by a person engaged in the business of storing goods for hire."

45. U.C.C. § 3-104(a)(1) (2012) (emphasis added).

complex economic transactions occur in the financial *and* commodity context. Accordingly, the need to engage in complex financial transactions using monetary deposits is apparently not sufficient to warrant the default loan classification in the warehouse deposit context even though it is sufficient to warrant that conclusion in the bank deposit context: the justification for treating deposits in the former context as loans and in the latter context as bailments cannot be found here.

The similarities between a warehouse deposit and a bank deposit extend to the physical characteristics of the deposited item, at least to the extent that a warehouse deposit consists of a fungible commodity, such as grain, wheat, fuels, or base metals. Given the fungible nature of commodities, economies of scale result from the commingling of stored and transported deposits of like kind—it is in the interest of the warehouse and depositors that fungible goods be commingled for storage or transportation purposes. Indeed, perhaps the apotheosis of homogenous, fungible commodities exists in the energy industry. In its purest form, natural gas is almost 100% methane. Methane is a chemical compound of indistinguishable carbon and hydrogen particles. This atomic homogeneity posed no problem for the Third Circuit when it recognized the Federal Power Commission's point that "the mere physical commingling of [one party's] gas in [another's] lines . . . does not compel rejection of historic notions of bailments . . . ."[46]

Similarly, the fungible nature of grain means that economies of scale result from the commingling of stored deposits of like quality—it is also in the interests of grain warehouses and depositors that equal quality grain be commingled for storage purposes. Dollars are also fungible goods; indeed, the very concept of "money" presupposes perfect homogeneity. And, as most depositors likely understand, dollar deposits are commingled within the bank. As above, the degree to which deposits are fungible or commingled is not relevant for purposes of the bailment/loan dilemma, as is sufficiently well-illustrated in the grain deposit context, notwithstanding the apparent widespread belief that commingling is critical to the bailment/loan determination in the banking context.[47] This point is understood by the numerous state

46. Public Serv. Elec. & Gas Co. v. Fed. Power Comm'n, 371 F.2d 1, 4 (3d Cir. 1967).

47. *See, e.g.*, *In re* Nat Warren Contracting Co., 905 F.2d 716, 718 (4th Cir. 1990); Hossain v. Rauscher Pierce Refsnes, Inc., 15 F. App'x 745, 748 (10th Cir. 2001); and United States v. $3,000 In Cash, 906 F.Supp. 1061, 1070 (E.D. Va. 1995).

legislatures[48] that have enacted the general UCC principle that "fungible goods [that] are commingled . . . are owned in common by the persons entitled thereto."[49] The fact of commingling poses no practical difficulty for the law of bailments, whether in the commodity or monetary context, and the need for banks to commingle monetary deposits is insufficient to warrant the default loan classification.[50]

Further, in the event that the amount of a particular fungible good actually stored does not reconcile with the sum of the amount purportedly stored as indicated by all outstanding warehouse receipts, something untoward must have occurred—i.e., natural decay or disaster, or something more nefarious such as conversion, embezzlement, or fraud by the warehouse operator or its agents.[51] In the first case, depending upon the nature of the agreement apportioning the risk of loss as between the parties, the individual grain depositors may be liable to bear the loss *pro rata*;[52] but, in the latter case, the warehouse operator or somebody else would have committed a crime.[53] As such, the law of bailments is well-suited to apportion liability for loss in the commingling context, regardless of whether such commingled items are

48. *See, e.g.*, COLO. REV. STAT. ANN. § 4-7-207(b) (West 2006); N.D. CENT. CODE ANN. § 60-02-25 (West 2013); WIS. STAT ANN. § 407.207(2) (West 2012); and MO. ANN. STAT. § 400.7-207(2) (West 2013), among others.

49. U.C.C. § 7-207(b) (2012), among others.

50. *See, e.g.*, 7 U.S.C. § 248 (2012) ("In general [a] warehouse operator may commingle agricultural products. . . . A warehouse operator shall be severally liable to each depositor . . . to the same extent and under the same circumstances as if the agricultural products had been stored separately.").

51. *See, e.g.*, Preston v. United States, 696 F.2d 528, 540 (7th Cir. 1982) (finding that conversion is an appropriate remedy where a grain elevator wrongfully took property owned by the plaintiff bailors).

52. *See, e.g.*, United States v. Luther, 225 F.2d 499, 505 (10th Cir. 1955) (storage claimants that are tenants in common are entitled to their *pro rata* share of the remaining grain in storage); Dole v. Olmstead, 36 Ill. 150, 154–55 (1864) (where an undifferentiated mass of fungible goods is totally or partially lost or destroyed, all depositors are liable to sustain *pro rata* any loss which may occur by diminution or decay).

53. *See, e.g.*, TEX. AGRIC. CODE ANN. § 14.073(a)(1) (West 2013) ("A person commits an offense if [he]: . . . (1) issues or aids in issuing a receipt or scale weight ticket knowing that the grain covered by the receipt or scale weight ticket has not been actually received at the grain warehouse."); *see also*, State v. Deutsch, 77 N.J.L. 292, 298 (Sup. Ct. 1909) (stating that "[i]n order to sustain a conviction it was necessary to prove not only that [the defendant] was a bailee of [plaintiff], and that he converted [plaintiff's] money to his own use, but that he did it fraudulently").

agricultural goods, industrial goods, or money. Here again, the fungible nature of money and the need for banks to commingle dollars are insufficient to warrant the default classification of ordinary monetary deposits as loans.

The above analysis touches on the similarities between bank deposits and the deposit of fungible goods. However, the nuances of the legal relationship that exists between a depositor of fungible goods and a warehouse operator, as well as the rights of third parties to whom instruments such as warehouse receipts may have been negotiated, are well explored and thoroughly understood by all parties involved. To be sure, such established law simply and accurately reflects the understanding that any reasonable party could be expected to have.

Ultimately, the commercial and economic similarities between a deposit of dollars in a bank and a deposit of fungible commodities in a warehouse yield the conclusion that there is no apparent legal or practical justification for a default rule treating the former as a loan and the latter as a bailment. In all practical regards, the nature of each transaction is the same. Indeed, innumerable commodities have served as "money" in many historical contexts, thus pre-empting the red-herring argument that there is a meaningful difference between "money" and such commodities that serves as a justification for the default legal classification of dollar deposits as loans.

## IV. Fractional Reserve Banking

Part I illustrated the confusion inherent in the 19th and early 20th century case law that dealt with the legal status of ordinary bank deposits. That part also demonstrated that by the 20th century, most courts and state legislatures had settled the bailment-loan dilemma by declaring deposits to be loans, in the absence of an agreement to the contrary. Part II explained that such courts and legislatures reached the conclusions set forth in Part I based upon a deficient understanding of the legal nature of bailments. In effect, courts and legislatures concluded that *because* currency deposits were commingled, they could not legally be bailments. But, Part III demonstrated that the law of bailments is capable of handling the legal and property issues that arise in the context of commingled goods deposits, belying the ostensible justifications for the juridical and legislative conclusions described in Part II. In summary, by the early 20th century, courts and legislatures across the nation concluded that currency deposits must be loans because they could not legally be bailments; but, as shown above, a simple analysis of the law of bailments rebuts this legal conclusion. Thus, if the conclusion obviously cannot be justified on legal grounds, why were such courts and legislatures intent on reaching it? One way of explaining the conclusion is to examine the realities of modern banking both at present and in the late 19th and early 20th centuries.

Generally, modern banking techniques classify deposited funds (already, for the most part, classified as "general deposits," i.e., loans to the bank, as opposed to "special deposits," i.e., bailments) as "time deposits" or "demand deposits." The distinction defines the legal and contractual restrictions on depositors' withdrawal rights. Demand deposits, for example, impose virtually no restrictions on depositors, and must be repaid promptly following receipt of notice of demand for repayment.[54] Time deposits, conversely, frequently include savings accounts, certificates of deposit, and other deposits payable after a specified period of time.[55] Time deposits may be repaid more promptly than specified by law; however, banks may postpone repayment for a statutorily-defined (or contractually-defined) period of time. Specific, general, demand, and time deposits encompass different legal and practical relationships that define the respective rights and obligations of depositors and banks in connection with deposited funds.[56] But both demand deposits and time deposits are (or, in the case of time deposits, were) subject to fractional reserve requirements; i.e., regulations imposed by the Federal Reserve Act in the case of nationally chartered banks, and applicable state law in the case of all other banks, that require banks to maintain a percentage of demand deposits and a lesser percentage (or no percentage) of time deposits in the form of reserves.[57]

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54. For example, in Delaware repayment must be made within thirty days. DEL. CODE ANN. tit. 5, § 907(a) (West 2014). In New York, repayment must be made within fourteen days. N.Y. BANKING LAW § 2(13) (McKinney 2014). For practical purposes, demand deposits are usually paid immediately, although they need not be.

55. *See, e.g.*, DEL. CODE ANN. tit. 5, § 907(a) (2013).

56. This Article deals primarily with ordinary "demand deposits," but the essence of the analysis applies in any context in which a bank retains only a fraction of a type of deposits.

57. 12 C.F.R. § 204.5(a)(1) (2013); *see also,* BOARD OF GOVERNORS OF THE FEDERAL RESERVE, DIVISION OF CONSUMER AND COMMUNITY AFFAIRS, *Regulation D: Reserve Requirements*, *in* CONSUMER COMPLIANCE HANDBOOK 1 & n.2 (2011), *available at* http://www.federalreserve.gov/boarddocs/SupManual/default.htm ("All depository institutions, including commercial banks [and] savings banks . . . are subject to reserve requirements. Institutions must satisfy reserve requirements by holding cash

More specifically, modern banking techniques depend critically upon the classification of ordinary consumer and corporate deposits as loans, and the money supply depends critically upon these modern banking techniques.[58] Stated otherwise, modern banks are in the business of making loans using, *inter alia*, money deposited by ordinary depositors, and these loans augment the money supply. To a certain extent, this is an oversimplification since banks can obtain the funds they need to make loans from a variety of sources, ordinary bank deposits among them, and the Federal Reserve also can alter the money supply through open market operations and the federal funds rate.[59] In any event, the money supply can be expanded at a rate roughly inverse to the portion of all deposits that are *not* subsequently used to make new loans—at a rate inverse to the fractional reserve requirements imposed by law.[60] For purposes of this Article, however, the fraction of deposits that a bank is legally required to maintain in the form of reserves is irrelevant. Rather, the very concept of legal reserve requirements presupposes that a certain supplementary fraction of each bank's deposits will *not* be held in reserve, and that such fraction of deposits will be used by banks in their discretion and possibly contrary to the intentions of a substantial portion of depositors. This process, known as fractional reserve banking, is the *de facto* standard for all modern banks.

Thus, the growth of the money supply depends in part upon the ability of banks to make loans, which, in turn, depends in no small part on the availability of deposited funds for such purposes; and, if deposited funds were treated as bailments, then they would be wholly-unavailable to banks for lending purposes. Surely, such obvious practical difficulties weighed heavily on courts and legislatures during the late 19th and early 20th centuries when the default legal classification of bank deposits began to emerge. We can presume that

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in their vaults or, if vault cash is insufficient, as a balance in account at a Federal Reserve Bank.").

58. *See generally* JOSHUA N. FEINMAN, RESERVE REQUIREMENTS: HISTORY, CURRENT PRACTICE, AND POTENTIAL REFORM (1993), *available at* http://www.federalreserve.gov/monetarypolicy/0693lead.pdf.

59. *See generally* BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM PURPOSES AND FUNCTIONS 27–50 (9th ed. 2005) [hereinafter THE FEDERAL RESERVE SYSTEM PURPOSES AND FUNCTIONS], *available at* http://www.federalreserve.gov/pf/pdf/pf_complete.pdf.

60. *But see* PAUL SHEARD, STANDARD & POOR'S ECONOMIC RESEARCH, REPEAT AFTER ME: BANKS CANNOT AND DO NOT "LEND OUT" RESERVES 7 (2013) (arguing that deposits are created by loans, not the other way around).

courts and legislatures near the dawn of the 20th century were well aware that any holding or legislation that classified ordinary bank deposits as bailments would profoundly disrupt the banking system that already treated them as loans.

## V. RESERVE REQUIREMENTS, DEPOSIT INSURANCE, AND THE RACE TO THE BOTTOM

Part IV argued that 19th and 20th century banking practices, both local and national, were the actual impetus for courts and legislatures to fashion a *de jure* justification for a *de facto* business practice. The result was the creation of the legal framework essential to the modern fractional reserve banking system, and, arguably, the beginning of the end of sound money. Economic consequences aside, however, the default legal classification of deposits as bailments had an enormous practical consequence: it eliminated categorically the market for 100% reserve banks and for banks that maintained any reserves substantially in excess of legal requirements. Minimum reserve requirements established by applicable law do not *prohibit* banks from maintaining all of their demand deposits in the form of reserves; however, as a practical matter, no bank will maintain 100% reserves if any competing banks operate with less than full reserves *and* are the beneficiaries of a deposit insurance system subsidized by all banks. The essence of this point is essential to the Article and thus an example is appropriate.

Suppose "Ant Bank" agrees to maintain 100% of its demand deposits in the form of reserves, and that "Grasshopper Bank" agrees to maintain only 50% of its demand deposits in the form of reserves; i.e., Grasshopper Bank is a fractional reserve bank. Suppose further that Grasshopper Bank, in order to induce depositors to make demand deposits, uses the half of its demand deposits not maintained as reserves to lend, invest, or speculate, and that the interest payments, dividends, and profits earned from such lending, investing, or speculating are used in part to pay interest to depositors on their demand deposits. Note that, without the opportunity to earn interest on demand deposit balances, no rational actor would deposit funds with Grasshopper Bank as long as Ant Bank remains a viable alternative.[61] The interest payments are

61. Today, as a result of deposit insurance, Ant Bank is no longer a viable alternative since no depositor actually bears any risk of loss (at least up to the $250,000 per account insurable limit). Ironically, deposit insurance relieves Grasshopper Bank of

compensation to Grasshopper Bank's depositors for their assumption of the risk that Grasshopper Bank may fail to repay all or a portion of its demand deposits (either as a consequence of a mismatch between deposit withdrawal requests, on the one hand, and available cash reserves plus liquidity from underlying loans and investments, on the other; or, worse, a default or loss on such loans or investments).[62] Assume that Ant Bank and Grasshopper Bank are identical in all other respects.

In this simple hypothetical, some portion of depositors would choose to deposit their funds in Ant Bank and others would choose to deposit their funds in Grasshopper Bank. Much would depend on the rate of interest paid by Grasshopper Bank on demand deposit balances, and it is not unreasonable to assume that many depositors would maintain demand deposit balances at both banks, in accordance with each depositor's respective appetite for savings versus investment.[63] However, if we further suppose that government-sponsored deposit "insurance" exists—insurance provided by the Federal Deposit Insurance Corporation ("FDIC")—the outcome of the above hypothetical changes dramatically.[64] If the entirety of Ant Bank's and Grasshopper Bank's demand deposits are insured, and assuming that each bank complies with the insuring entity's reserve requirements, then interest payments to Grasshopper Bank's depositors constitute a windfall, i.e., a reward without the corresponding assumption of counterparty risk. Further, if each bank pays a "premium" to the insuring entity in exchange for deposit "insurance," then Ant Bank's depositors are subsidizing the risk-seeking behavior of Grasshopper Bank's depositors, assuming that each bank passes the cost of insurance

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the obligation to pay interest on its deposits, at least to the extent that interest payments compensate depositors for assuming the risk of loss.

62. Ant Bank's depositors, conversely, are not subject to any counterparty risk because Ant Bank is not a fractional reserve bank; i.e., there is no possibility of an uncovered bank run, tautologically. Accordingly, Ant Bank would not have any incentive to pay, and Ant Bank's depositors would not have any reason to require, interest on demand deposit balances. This comports, of course, with the theory that interest payments partially constitute compensation for foregoing current consumption—demand deposits can be demanded at any time, and thus do not constitute the sacrifice of current consumption in any substantive sense.

63. By hypothesis, all of the demand deposits deposited in Ant Bank constitute savings; whereas 50% of the demand deposits deposited in Grasshopper Bank constitute savings, the other half constituting indirect investment.

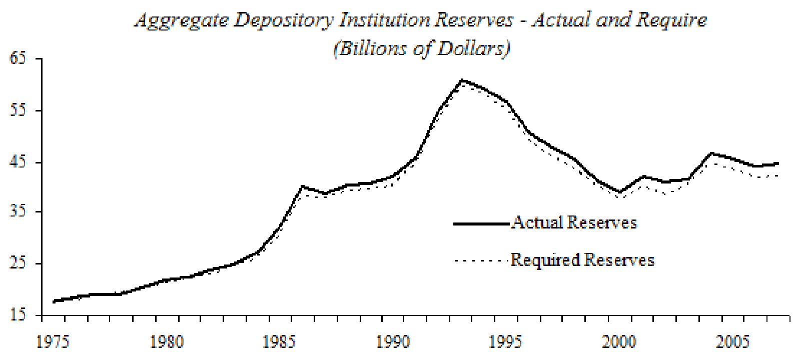
64. See Part VI below for a discussion regarding deposit insurance.

premiums to its respective depositors.[65] In effect, the insuring entity guarantees the demand deposit balances of both banks, but only Grasshopper Bank pays its depositors interest on their demand deposit balances. The obvious result is that depositors will remove their funds from Ant Bank and deposit them in Grasshopper Bank, or that Ant Bank will begin paying interest on its demand deposit balances, which would require it to engage in lending, investment, or speculation (i.e., to cease operating as a 100% reserve bank).

Additionally, because the insuring entity guarantees deposit balances, all insured banks have an incentive to invest or lend *all* (or a substantial majority of) demand deposits not legally required to be held as reserves, irrespective of the quality of the underlying investments or loans. In effect, every interest payment received or dividend earned by a bank constitutes a net gain to the bank's managers and shareholders whether or not the underlying borrower defaults or the underlying investment declines. A portion of such gains are passed on to depositors in the form of interest in exchange for providing the capital (deposits) for these loans and investments, wittingly or otherwise. The above dynamic results in a situation in which all banks strive to maintain no more than that fraction of demand deposits required to be held as reserves pursuant to applicable law. The result is, in normal economic circumstances, a race to lend or invest as quickly and haphazardly as possible. The data bear this out, as illustrated by Figure 1. Figure 1 compares aggregate reserves actually maintained by insured depository institutions relative to reserves required to be maintained by these institutions pursuant to applicable laws and regulations.

65. If the cost of deposit insurance premiums is not passed on to depositors, then Ant Bank's managers (or shareholders) are effectively subsidizing Grasshopper Bank's managers (or shareholders).

Figure 1[66]




Four relevant conclusions follow. First, assuming the absence of deposit insurance, all banks will operate either as 100%-reserve banks or as fractional reserve banks. The former are in effect money warehouses and presumably would provide ordinary banking services such as checking and ATM access, etc., for which depositors would be assessed a small periodic fee. Additionally, depositors would not earn interest on their deposit balances, and would not be exposed to the possibility of default by the bank.[67] Fractional reserve banks, conversely, would pay interest on demand deposit balances as a form of compensation for the use of a fraction of such deposits for investment or lending purposes and the risks associated therewith; also, they likely would provide the above-mentioned ordinary banking services. Second, assuming the existence of system-wide deposit insurance, all banks will operate as fractional reserve banks, and the assumption that all deposit balances will yield interest no longer obtains, since depositors do not bear the risk of loss of their deposits. Third, absent some exogenous variable, all banks will maintain only those reserves that they are required by law to maintain (as evidenced by the nearly parallel lines in Figure 1).[68] Fourth, fractional reserve banking implies the bank-as-debtor and depositor-as-

66. Board of Governors of the Federal Reserve System, *Aggregate Reserves of Depository Institutions and the Monetary Base*, *available at* https://www.federalreserve.gov/datadownload/default.htm, (last visited Nov. 5, 2013).

67. Assuming the bank was operating lawfully; i.e., actually maintaining 100% of its deposits in the form of reserves (or, more to the point, acting as a lawful bailee).

68. Data from 2008 through the present show a dramatic increase in actual reserves relative to required reserves (not depicted in Figure 1). The discrepancy is the result of various economic stimulus programs designed to increase bank assets coupled with the resulting reluctance of such banks to increase lending, the original intent of such economic stimulus programs notwithstanding. *See supra* Figure 1.

creditor relationship; whereas 100% reserve banking implies that depositors are bailors and banks are bailees of deposits.

With these conclusions in mind, note that the hypothesis that depositors will patronize fractional reserve banks only if they are compensated for the risk of loss[69] presupposes that the there is an alternative—that 100% reserve banks will not lend or invest any portion of their deposit balances, as would be expected in a bailor-bailee relationship. This is the logical equivalent of supposing that there exists a realistic option to bank pursuant to a debtor-creditor relationship *or* pursuant to a bailor-bailee relationship. But, in today's economy, bailor-bailee banking relationships and 100% reserve banks do not exist.[70] This comports with the explanation that deposit insurance excludes 100% reserve banks from the market. In effect, why not enter into a debtor-creditor relationship if the government guarantees the debt? Thus, the default legal classification of ordinary deposits as loans instead of bailments established the legal framework for the modern fractional reserve banking system. Subsequently, the creation of systematic deposit insurance drove 100% reserve banks from the market.

## VI. SOCIAL, POLITICAL, AND ECONOMIC CONSEQUENCES

To summarize, the default legal classification of ordinary bank deposits as loans, as described in Part I, was based on the erroneous legal conclusion that commingled bank deposits could not be bailments, as described in Part II. Part III debunked this erroneous legal conclusion; and Part IV illustrated that prevailing banking practices in the 19th and 20th centuries were the actual impetus for courts and legislatures to fashion the default legal classification. A primary consequence of this legal framework was the rapid expansion of fractional reserve banking together with the development of systematic deposit insurance, as detailed in Part V. Thus, the legal classification of ordinary bank deposits as loans instead of bailments resulted in the universal expansion of fractional reserve banking together with its

69. I.e., only if their deposit balances earn interest.

70. Depositing money in a safe deposit box would be a clear example of a bailment between a depositor and a bank, but this relationship does not share any of the characteristics of banking, *per se*.

crucial governmental support, deposit insurance. This Part discusses several possible consequences of these developments

Specifically, several adverse social, political, and economic consequences are reasonably attributable to the misclassification of ordinary demand deposits as loans instead of bailments. These consequences include: (i) the mischaracterization of deposit guarantees as "insurance" instead of transfer payments; (ii) bank runs that, but-for fractional reserve banking, *could not* occur; (iii) suboptimal lending and investment through surreptitious social policy masquerading as private enterprise; (iv) moral hazard and subsidization of risky lending and investment; and (v) the devaluation of money through inflation.

### A. DEPOSIT GUARANTEES: INSURANCE OR TRANSFER PAYMENTS?

The true legal nature of the depositor-bank relationship is of critical importance in the event of bank insolvency. Under such circumstances, depositors are confronted with the startling reality that, as unintended creditors of the bank, the law places the full risk of loss on them. In this context, as in many normal debtor-creditor relationships, depositors may be forced to bear the full cost of investment failure by their respective banks; i.e., they bear the risk of default. The extent of depositors' participation in the realized gains of the bank takes the form of interest payments on deposits, which if paid at all, are only loosely correlated with the performance of the bank's underlying loan and investment portfolio and the bank's risk of default.[71] Viewed in this light, the risk and cost of insolvency of a particular bank might be justified in the case of an *informed* depositor in light of the countervailing interest earned on her deposit; but it is not clear how to justify subjecting an ordinary depositor to the risk of financial loss if such depositor is not even aware that she is a creditor.[72] This helps to explain the creation of federal deposit insurance, which arose as a direct consequence of the anomalous legal classification of an ordinary demand deposit as a loan.

In order to perpetuate the widespread but inaccurate belief that depositors retain title to deposited funds, such funds must be available for withdrawal on demand. When such funds are not available for immediate withdrawal, the FDIC steps in as a receiver for the bank,

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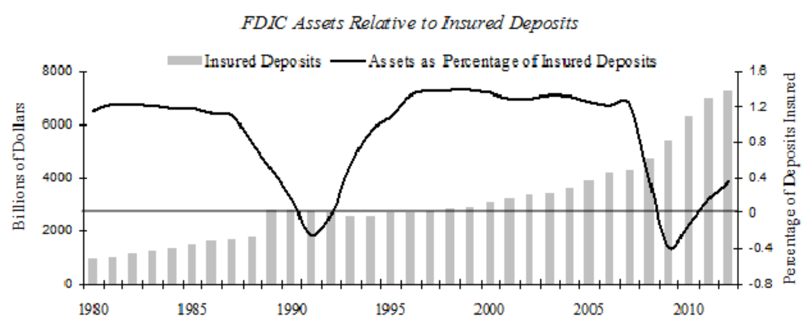
71. *See* JOHN H. MALKIN, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH: WHAT DETERMINES INTEREST RATES (2005), *available at* http://www.aei.org/files/2005/01/01/20041222_17755graphics.pdf.

72. Even ignoring the existence of deposit insurance.

liquidates its assets, and returns deposited funds to depositors. However, the history of the FDIC illustrates that too frequently its assets are insufficient to bail out insured institutions. This fact—that the cumulative total of premiums paid by functional banks is frequently insufficient to cover insured deposits of failed banks (particularly during a recession)—is a reflection of an underlying possibility: bank losses that accrue as a result of loans or investments made on misclassified deposits may be caused by such legal misclassification and, as such, are not insurable events. Figure 2, *infra,* depicts historical FDIC asset balances (reserve fund amounts available to cover insured deposit losses) as a percent of corresponding aggregate insured deposits.

Figure 2[73]




The shortfalls in 1991 and again between 2008 and 2010 suggest that losses on loans and investments made using misclassified deposits are not insurable events.[74] Alarmingly, negative values represent periods during which the FDIC lacked sufficient assets to cover *actual* losses on insured deposits. Thus, then-FDIC Chairwoman Sheila Bair's statement, in a November 17, 2009 press release, that "[t]he FDIC was created specifically for times like these. Our resources are strong,"[75] is

73. FEDERAL DEPOSIT INSURANCE CORPORATION, ANNUAL REPORT 2012, 114 (2013), *available at* http://www.fdic.gov/about/strategic/report/2012annualreport/AR12final.pdf.

74. *Id.* Since 2008, the FDIC has fallen well short of its designated reserve ratios of 1.25% through 2010 and 2% thereafter. *Deposit Insurance Management Fund*, FDIC, http://www.fdic.gov/deposit/insurance/fund.html (last updated June 17, 2013).

75. Press release, FDIC, *No Safer Place for Your Money: Why the FDIC's Resources Are Strong and Insured Deposits Are "Absolutely Safe"* (Nov. 17, 2009), *available at* http://www.fdic.gov/news/news/press/2009/pr09210.html [hereinafter *No Safer Place for Your Money*].

difficult to reconcile with the FDIC's almost $21 billion deficit at the end of 2009.[76] Of course, to perpetuate the conflict between depositors' unconditional demand for immediate access to deposited funds and the default legal classification that such deposits are loans, depositors cannot be required to bear the consequences of such insurance fund deficiencies.[77] Along those lines, then-Chairwoman Bair in the same press release stated that the "FDIC fully guarantees [depositors'] insured deposits and provides them with seamless access to their money. For the insured depositor, a bank failure is a non-event."[78]

However, with banks continuing to fail and the FDIC suffering substantial deficits, the FDIC had no choice but to replenish its reserve fund to ensure that such bank failures would actually be "non-events" for depositors. Supporting the conclusion that deposit insurance is not actually insurance, the FDIC amended "its assessment regulations to require insured [banks] to prepay" regular risk-based assessments three years in advance, effective as of December 30, 2009.[79] At the time, the FDIC expected that its mandatory prepayment program would add $45 billion to its reserve fund.[80] For purposes of this Article, however, the relevant consideration is whether an economic transaction that requires the prepayment of *future* premiums in order to compensate for *past* losses (as distinguished from current premiums to cover expected future losses) properly can be classified as insurance.[81] It cannot.[82] At the risk

76. FDIC, STATISTICS AT A GLANCE: HISTORICAL TRENDS (2013), *available at* www.fdic.gov/bank/statistical/stats/2013jun/fdic.pdf.

77. As should be obvious, the reason this situation is a conflict is because creditors cannot require the repayment of a loan "on demand." By definition, an economic transaction in which a creditor can demand the return of "credited" goods immediately is a bailment, not a loan. This point is not harmed by conditions within a borrower's ostensible control (or at least outside of creditors' control) the occurrence of which may require the immediate repayment of credited funds, such as the failure to make periodic payments or to reach certain milestones (as in the construction lending industry).

78. *See No Safer Place for Your Money*, *supra* note 75.

79. 12 C.F.R. § 327.12 (2013).

80. Press release, FDIC, *FDIC Board Approves Final Rule on Prepaid Assessments* (Nov. 12, 2009), *available at* http://www.fdic.gov/news/news/press/2009/pr09203.html (last visited Nov. 5, 2013). Approximately $46 billion ultimately was paid. Memorandum from Arthur J. Murton (Director of Division of Insurance and Research) to FDIC Board of Directors, 2 (June 8, 2010), *available at* www.fdic.gov/deposit/insurance/memo3.pdf (last visited Nov. 5, 2013).

81. The FDIC apparently viewed mandatory "prepayment [as] preferable to borrowing from [the] Treasury," which "could risk diminishing public confidence in the FDIC and in insured [banks]." FDIC, 12 C.F.R. PART 327: PREPAID ASSESSMENTS 20 (2009), *available at* http://www.fdic.gov/news/board/2009nov12no4.pdf (last visited

of belaboring the point, the fact that FDIC assets are frequently insufficient to cover bank losses is likely not a failure of actuarial calculations. The FDIC's actuaries, much to their credit, try futilely to calculate insurance premiums for seemingly uninsurable events: losses that may be caused proximately by the legal misclassification of ordinary deposits as loans instead of bailments.[83]

All of this illustrates the critical role played by deposit insurance in maintaining the illusion that a deposit is a loan and simultaneously a bailment, an illusion that the law resolves unequivocally in favor of banks—an ordinary deposit is a loan, absent agreement to the contrary.[84] However, in order to preserve the quantity of deposited funds available to banks for lending and investment, depositors must believe they always have access to deposited funds on demand. If depositors assumed the risk of loss (if they might not have access to deposited funds on demand), they would not deposit their funds in fractional reserve banks, or else, as explained above, would demand substantially higher interest payments to compensate for their assumption of the risk of loss (i.e., to compensate them for the risk of the real economic transaction into which they enter—lending). Deposit insurance perpetuates this illusion by providing depositors with access to their funds even though such depositors' banks have lost the deposited funds via bad loans or investments.

### B. BANK RUNS, DEPOSIT INSURANCE, AND CIRCULAR REASONING

If case law (and statutory law) paralleled the understanding held by ordinary depositors regarding the status of their ordinary deposits, bank runs could not occur and, as a consequence, deposit insurance would

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Nov. 5, 2013). It's not clear to this author how the FDIC's decision to *require* its regulated counterparts to pre-pay arbitrary fees in order to balance the FDIC's books is more or less dubious—from a public confidence perspective—than borrowing the same amount from the Treasury. *Id.*

82. *See infra* Part VI.

83. "The FDIC has already increased annual assessment rates uniformly by 3 basis points beginning in 2011, based on the FDIC's long term projections for the DIF and liquidity needs and to ensure that the fund reserve ratio returns to 1.15 percent within the statutorily mandated eight years." FDIC, 12 C.F.R. PART 327: PREPAID ASSESSMENTS, 24 (Nov. 12, 2009), *available at* http://www.fdic.gov/news/board/2009nov12no4.pdf (last visited Nov. 5, 2013).

84. Thompson v. Riggs, 72 U.S. 663, 678 (1866).

serve no purpose. If banks properly classified deposits according to the intentions of their depositors, then each deposit would consist of two explicit components: special deposits and the complementary portion consisting of general deposits. The sum of the amount classified as special deposits plus the sum of the amount classified as general deposits would, by definition, equal 100% of the amounts deposited. Under this system, by classifying a deposit as a general deposit available to the bank for subsequent lending, the purchase of securities, or otherwise (and not as a special deposit to be stored securely as a bailment), the depositor would necessarily understand that such deposit is exposed to possible losses.[85] By implication, the depositor's intentions with respect to the remainder of the deposit (i.e., the amount classified as a special deposit) would be honored. To be sure, the fraction of special deposits "matched" by reserves would always be 100%.[86] The essential point is that the depositor would make the distinction as to the fraction of the deposit that is "savings" (and, thus, to be entrusted to the bank's vault) and the fraction of the deposit that is not "savings" (and which may be loaned or invested by the bank or otherwise used in the bank's discretion).

Accordingly, the very reason for deposit insurance (the establishment of a pool of assets funded by premiums[87] paid by banks and available to compensate depositors in the event of a bank run) would be eliminated. There *could not be* any bank runs, at least not any for which the bank did not have adequate corresponding reserves on hand. The proposition is quite simple: if courts enforce the property rights and contractual rights of depositors as commonly understood by depositors, uncovered bank runs would be eliminated and there would

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85. This Article assumes that a substantial portion of depositors, if given the opportunity to classify their deposits as bailments or loans, would understand that loans could be subject to financial losses. However, it is no counterargument that some depositors might not understand that the fraction of their deposits classified as loans would be subject to possible financial losses. To the extent that counterargument is true, it applies equally to the widespread public sale of debt or equity securities generally. One could imagine the development of a plethora of investment products designed to cater to the various risk and investing styles of the bank's customers – perhaps something akin to modern bonds and/or mortgage-backed securities.

86. If the bank did not have 100% of its "savings deposits" in the form of reserves then something untoward must have occurred, i.e., theft in one or more myriad forms, or destruction such as by fire or natural disaster.

87. As discussed throughout this Article, it is telling that the reserves in deposit insurance fund are frequently insufficient to cover losses during economic recessions.

be no need for deposit insurance.[88] Indeed, if banks treated the deposits entrusted to them by their clients in accordance with their clients' intentions (as bailments), an awkward conversation would ensue if a bank tried to insure its deposits against embezzlement or conversion by bank officials.[89]

### C. ARTIFICIAL CREDIT CREATION AND SUBOPTIMAL INVESTMENT AND LENDING

As explained in Part II, the default legal classification of a bank deposit as a loan results in a transfer of title from the depositor to the bank. With this transfer of title comes the normal legal accoutrements, in particular the right of the bank to use deposited funds at its discretion. Invariably, since banks, like all businesses, are interested in turning a profit, each bank faces a nearly irresistible temptation to exercise such discretion and use its deposited funds to make loans to third parties,[90] purchase investments, or otherwise engage in speculative business activities. This is the fractional reserve banking process, and it contributes to the artificial expansion of the nation's available credit. But increasing the nation's money supply through credit creation fostered by the fractional reserve banking process is not merely a curious consequence of the debtor-creditor banking relationship that is the subject of this Article: increasing the nation's money supply through this artificial credit creation process is *the* purpose and the most important consequence of the fractional reserve system.[91] The problem,

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88. To clarify, this Article takes the position that banks are likely aware that most of their depositors have little understanding of the banking process in general, and that, specifically, such depositors do not understand that their deposits will be loaned or invested by banks. This raises interesting questions about the origin of legislation codifying the opposite of common, public understanding. However, whether depositors know that their deposits may be used by banks for lending and investment is irrelevant.

89. This assessment does not apply to forms of insurance designed to mitigate losses in connection with third party actions or "natural" losses; e.g., a smoothly operating marketplace might involve the sale of fire-protection insurance to banks, the cost of which might be passed on to the bank's depositors.

90. The bank profits by charging a rate of interest on its loans that exceeds the rate of interest its pays, if any, with respect to funds in its deposit account.

91. PATRICIA A. MCCOY, THE MORAL HAZARD IMPLICATIONS OF DEPOSIT INSURANCE: THEORY AND EVIDENCE, 4, 5 (2007), *available at* http://www.imf.org/external/np/seminars/eng/2006/mfl/pam.pdf ("The unstable balance sheet of banks is not a quirk. Rather, it is inherent to a key economic function of banks,

however, is that the only inherent restriction on prudent lending and investment that exists in the bailment context is entirely absent in the fractional reserve context. That restriction (the classification of an ordinary deposit as a bailment) would require each bank to handle deposits according to the intentions of depositors. Having been relieved of such responsibility, there is nothing inherent in the current legal relationship between a bank and its depositors that serves to encourage prudent lending and investment. This void helps to explain the dizzying array of federal and state banking regulations, each of which presumably is intended to induce prudent banking and lending activities—prudence that would exist if ordinary deposits were classified as bailments, not loans.[92]

Accordingly, regulators are forced to contend with and preempt the harmful consequences of a banking process that would not give rise to such consequences if ordinary deposits were classified in accordance with depositors' intentions. Such regulations include, generally, complex and burdensome restrictions on entry, "activity restrictions, prophylactic rules, examinations, and sanctions"[93] and, more specifically, "monitoring by state and federal regulators . . . [and] regulatory devices such as lending limits, minimum capital requirements, restrictions on insider dealings, and restrictions on competition among firms."[94] An example of such regulations include seemingly prudent restrictions on investment contained in applicable bank regulations, typified by the following: "the business of dealing in securities and stock by [banks] shall be limited to purchasing and selling such securities and stock . . . [for] customers, and in no case for its own account."[95] But even this seemingly-salutary attempt to induce prudent

which is providing financial liquidity. As financial intermediaries, banks accept liquid deposits from the public and reinvest those funds in long-term, illiquid loans . . . . Banks have confidence that they can actually honor depositors' demands based on the principle of fractional reserves.").

92. Perhaps this issue will be the topic of another Article; however, I don't hesitate to observe that such myriad regulations seem to cause many more problems than they resolve.

93. MCCOY, *supra* note 91, at 10 (arguing that deposit insurance is not really insurance because it does not guard against a defined, preventable loss).

94. Jonathan R. Macey & Elizabeth H. Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. ON REG. 215, 220 (1998) [hereinafter Macey & Garrett, *Market Discipline by Depositors*].

95. 12 U.S.C. § 24(7) (2012).

lending and investment is obviated by exceptions in the very same paragraph:

> The limitations . . . contained [in this section] . . . shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof, . . . instruments of or issued by the Federal National Mortgage Association, or the Government National Mortgage Association, or mortgages, obligations or other securities which are or ever have been sold by the Federal Home Loan Mortgage Corporation pursuant to Section 305 or Section 306 of the Federal Home Loan Mortgage Corporation Act . . . [or] securities that . . . are offered and sold pursuant to section 4(5) of the Securities Act of 1933[96] . . . or . . . mortgage related securities.[97]

Permitting banks to purchase the debt of government-sponsored enterprises like Fannie Mae and Freddie Mac is an exception that swallows a rule designed ostensibly to reduce risk.

In addition, notwithstanding the restrictions on investment and lending codified in applicable banking regulations,[98] policymakers enacted exemptions for loans collateralized by real estate, including residential mortgage backed securities: "[a]ny national [bank] may make, arrange, purchase or sell loans or extensions of credit secured by . . . real estate."[99] This particular exemption has obvious consequences for government-sponsored enterprises like Fannie Mae and Freddie Mac. These entities, by alleviating much of the risk borne by banks with respect to their loan portfolios, contributed to the drastic increase in suboptimal lending and inevitable residential mortgage foreclosures that defined the recent financial crisis.[100] Moreover, the economic harm caused by such government-sponsored enterprises magnifies the underlying harm caused by the legal misclassification of ordinary bank

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96. Securities Act of 1933, ch. 4(5), 48 Stat. 74 ("transactions involving offers or sales of one or more promissory notes directly secured by a first lien on a single parcel of real estate upon which is located a dwelling or other residential or commercial structure").

97. 12 U.S.C. § 24. "Mortgage related securities" are defined in 15 U.S.C. § 78c(a)(41) (2012).

98. *See, e.g.*, 12 U.S.C. § 24.

99. 12 U.S.C. § 371(a) (2012).

100. *See generally* PETER J. WALLISON, DISSENT FROM THE MAJORITY REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION (2011) [hereinafter DISSENT FROM THE MAJORITY REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION], *available at* www.aei.org/files/2011/01/26/Wallisondissent.pdf (last visited Nov. 5, 2013).

deposits as loans instead of bailments. As discussed above, the misclassification of ordinary bank deposits coupled with system-wide deposit insurance fosters a nearly irresistible incentive to engage in speculative lending and investment activities. That incentive is enhanced by loan guarantees provided by government-sponsored enterprises. As a result, few forces remain to impede the rapid expansion of credit, in part because credit expansion is the primary purpose of fractional reserve banking.

More general political justifications for expanding the money supply through artificial credit creation are included in explicit federal regulations: "national [banks] . . . shall have power . . . to make investments directly or indirectly . . . to promote the public welfare, including the welfare of low- and moderate-income communities or families (such as by providing housing, services, or jobs)."[101] Surely, such mandates played some role in the recent economic turmoil and government fiscal profligacy. However, a bigger problem is embodied in the premise that greater access to artificial credit will "promote the public welfare." Although not within the scope of this Article, the economics of this proposition are dubious at best. Nevertheless, from the proposition that courts should enforce depositors' property rights and contractual rights (by classifying deposits according to depositors' intentions), it does not follow that lending by banks would grind to a halt,[102] or that no fraction of a bank's deposits would be available for lending. Indeed, the primary direct consequence of enforcing depositors' rights would be the elimination of the discrepancy between the banks' understanding and the depositors' understanding of *which* deposits are available for lending or investment. This, of course, would mean that depositors and not bankers would be the ultimate determinants of the *amount* of lending and investment undertaken by the society as a whole.[103]

The allocation of responsibility between depositors, banks, or other third parties with respect to the *type* of lending and investment cannot be logically predicted using this framework. It is reasonable to assume, as is already the case, that ordinary people would voluntarily abdicate at least a portion of such responsibility to trained investment professionals.

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101. 12 U.S.C. § 24.

102. It is likely the case, however, that the real amount of lending could be expected to decline, *ceteris paribus*.

103. Savings and investment are only identical as the percent of reserves maintained by fractional reserve banks approaches zero.

To be sure, the financial industry (and banks themselves) would have an interest in providing investment management services to depositors. In any event, the legal misclassification of ordinary demand deposits as loans instead of bailments likely results in substantially more lending, as well as a different allocation of capital between types of loans and investments, than would otherwise occur.

### D. SURREPTITIOUS SOCIAL POLICY

The temptation to policymakers to play social engineer is nearly irresistible, more so when the economic consequences of such engineering are not obvious. For example, prior to the 2008 financial crisis, the Community Reinvestment Act ("CRA") "continue[d] to encourage [banks] to extend conventional prime lending to historically underserved segments of the market."[104] The CRA "encouraged" this economically-unsound behavior by utilizing the relevant enforcement provisions which, *inter alia*, permit federal regulators to "withhold approvals for such transactions as mergers and acquisitions and branch network expansion if [an] applying bank [does] not have a satisfactory CRA rating."[105] During the twenty-five years prior to the financial crisis, the CRA effectively forced banks to make loans to high-risk borrowers. Setting aside the intentions behind, *and* consequences of,[106] this social policy, it is difficult to avoid the conclusion that such risky lending would be possible at all without the legal misclassification of ordinary bank deposits as loans. In effect, through legislation like the CRA, Congress induces banks to make loans they would not otherwise make using money that does not belong to them. Why not simply require ordinary people to make loans directly to high-risk borrowers? Presumably, the political costs of such a direct approach would be less than salutary. A healthy and well-functioning polity depends in part upon legislating social policy in a transparent manner. In this regard, the misclassification of ordinary demand deposits contributes to the

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104. William C. Apgar & Mark Duda, *The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments & Future Regulatory Challenges*, 9(2) FED. RESERVE BANK OF N.Y.: ECON. POL'Y REV. 169, 175 (2003), *available at* www.newyorkfed.org/research/epr/03v09n2/0306apga.pdf (last visited Nov. 5, 2013).

105. *See* DISSENT FROM THE MAJORITY REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 100, at 85.

106. *See id*. at 85–92.

corruption of the polity by facilitating the passage furtively of legislation that might not otherwise survive the democratic process.

### E. MORAL HAZARD AND FINANCIAL SYSTEM INSTABILITY

Modern banks make loans and investments using deposited funds that are classified improperly as loans instead of bailments. The depositors of these funds do not intend to lend or invest them (directly, or indirectly through bank intermediation) and, by implication, do not intend to expose them to the risk of loss. Further, such depositors historically had an incentive to pay close attention to the financial integrity of the banks into which they deposited their funds. They had an incentive to monitor the activities of such banks and to respond by withdrawing their deposited funds in the event of financial instability. Such monitoring led to bank runs upon the appearance, real or otherwise, of financial instability.[107] However, the creation of federal deposit insurance obviated the need for depositors to monitor the financial integrity of their respective banks by seeming to eliminate the consequences to depositors of poor investment and lending by banks. In this regard, deposit insurance transfers the risk of loss from the depositors to the shareholders of other banks (to the extent that they too contribute to the insurance fund) or to the monetary unit generally (to the extent that its value is diluted through the issuance of new monetary units to "cover" loan and investment losses). The transfer of this risk is the quintessential "moral hazard problem of deposit insurance."[108] In other words, deposit insurance induces the same risky investment and lending that it is designed to insure against—it reduces the motive to prevent loss.[109]

Of course, the problem of moral hazard in the general insurance context is well understood[110]—a random insurable event is more likely

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107. *See* Wally Suphap, *Toward Effective Risk-Adjusted Bank Deposit Insurance: A Transnational Strategy*, 42 COLUM. J. TRANSNAT'L L. 829, 840–41 (1990) [hereinafter Suphap, *Toward Effective Risk-Adjusted Bank Deposit Insurance*].

108. *Deposit Insurance Before the S. Comm. on Banking, Hous., and Urban* Affair, 108th Cong. 2 (2003) (statement of Alan Greenspan, former Chairman, Federal Reserve Board), *available at* http://www.federalreserve.gov/boarddocs/testimony/2003/20030226/.

109. Steven Shavell, *On Moral Hazard and Insurance*, 93 Q. J. ECON. 541, 541 (1979).

110. *See generally* Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996).

to occur after insurance against the underlying event is obtained.[111] The general moral hazard analysis quickly leads to the banal observation that insured banks have an incentive to partake in speculative lending and investment activities because they do not bear all of the associated risks.[112] But the problem of moral hazard in the deposit insurance context is worse than in the ordinary insurance context for at least three reasons. For example, first, in the years leading up to the 2008 financial crisis, bank loans generated substantial profits to subprime lenders *ab initio* (through the prompt package and sale of these loans into pooled investment vehicles called mortgage-backed securities), thereby rewarding banks that were able to process large quantities of transactions without regard to quality.[113] Second, the costs of deposit insurance are not adjusted to reflect the actual risk of the investment and lending activity of a given bank.[114] As such, each bank "has an incentive to make risky loans that it would not make but for insurance.

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111. *See* JOSEPH E. STIGLITZ, RISK, INCENTIVES AND INSURANCE: THE PURE THEORY OF MORAL HAZARD 30 (1983), *available at* https://www.genevaassociation.org/media/220469/GA1983_GP8(26)_Stiglitz.pdf (arguing that "the shift in the primary locus of . . . insurance . . . to the State, has undoubtedly been accompanied by an increase in the distortions and inefficiencies associated from what we have called the moral hazard problem").

112. *See* J. Huston McCulloch, *Bank Regulation and Deposit Insurance*, 59 J. BUS. 79, 82 (1986) (arguing "[l]argely as a consequence of the federal deposit insurance umbrella, banks and thrifts have engaged with impunity in all manner of excessive risks").

113. *See* DISSENT FROM THE MAJORITY REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 100, at 54–55 (explaining that subprime loans were sold through "Wall Street underwriters to Fannie and Freddie, which became the largest buyers of these high-risk PMBS between 2002 and 2005").

114. *See* Asli Demirgüç-Kunt & Enrica Detragiache, *Does Deposit Insurance Increase Banking System Stability?*, 49 J. MONETARY ECON. 1373 (2002); *see also*, Viral V. Acharya, João A. C. Santos, & Tanju Yorulmazer, *Systemic Risk & Deposit Insurance Premiums*, 16 FED. RESERVE BANK OF N.Y.: ECON. POL'Y REV. 89 (2010), *available at* http://www.newyorkfed.org/research/epr/10v16n1/1008yoru.pdf (last visited Nov. 16, 2013); Suphap, *Toward Effective Risk-Adjusted Bank Deposit Insurance*, *supra* note 107, at 838 (pointing out that "the Federal Deposit Insurance Corporation Improvement Act of 1991 explicitly required the [FDIC] to adopt a risk-based assessment system . . . [but] . . . the FDIC's current authority to charge risk-adjusted premiums has been heavily curtailed by the Deposit Insurance Funds Act of 1996 . . . . As a result . . . over 90 percent of depositary institutions operating in the United States have avoided paying risk-adjusted premiums.") (internal quotations omitted).

Therefore, when the price of insurance is fixed, increasing the riskiness of the loan portfolio redounds primarily to the benefit of the residual claimants—bank stockholders."[115] Third, the fact that the deposit insurance scheme is run by government, as opposed to private companies, contributes to financial system instability by virtually eliminating the incentive for bank shareholders or depositors to monitor investment and lending activity.[116]

These three points suggest that deposit insurance is not insurance at all, but, rather a framework for moral hazard and financial instability through an explicit "guarant[ee] against loss,"[117] because insured banks "can borrow at or below the risk-free rate by issuing insured deposits and then invest[] the proceeds in risky assets with higher expected yields" without concern for potential loss.[118] This means that the conclusion that "[d]eposit insurance creates moral hazard problems that can be mitigated only by regulations" completely misses the point:[119] deposit insurance *facilitates* the moral hazard that is caused by the legal misclassification of ordinary demand deposits, which, itself, is a form of regulation. It is a strange thing to conclude that further regulation is an appropriate remedy to a problem that exists only because of the prevailing regulatory structure. In practice, the process of "insuring" deposits is essential to maintain the illusion that deposits are simultaneously bailments and loans, and thus available for withdrawal by depositors and for lending or investment by banks. Without deposit insurance, depositors would ensure that their deposits were legally classified as bailments, not loans, or else would insist upon interest

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115. Macey & Garrett, *Market Discipline by Depositors*, *supra* note 94, at 218–19 (quoting Fischel, Rosenfield, & Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 314 (1987) (internal ellipses removed)).

116. *See* Demirgüç-Kunt & Detragiache, *Does Deposit Insurance Increase Banking System Stability?*, *supra* note 114 ("[T]he adverse impact of deposit insurance on bank stability tends to be stronger the more extensive is the coverage offered to depositors, where the scheme is funded, *and where the scheme is run by the government rather than by the private sector*.") (emphasis added).

117. MCCOY, *supra* note 91, at 10 (arguing that deposit insurance is not really insurance because it does not guard against a defined, preventable loss).

118. Suphap, *Toward Effective Risk-Adjusted Bank Deposit Insurance*, *supra* note 107, at n.62 (quoting Michael C. Keeley, *Deposit Insurance, Risk & Market Power in Banking*, 80 AMER. ECON. REV. 1183, 1183 (1990)).

119. V. V. Chari, *Banking Without Deposit Insurance or Bank Panics: Lessons from a Model of the U.S. National Banking System*, 13(3) FED. RESERVE BANK OF MINNEAPOLIS QUARTERLY REV. 3, 17 (1989), *available at* http://www.minneapolisfed.org/research/qr/qr1331.pdf.

payments to compensate for the risk of loss. Moral hazard would not exist in this context, and systemic financial instability would be somewhat less, if ordinary bank deposits were classified as bailments instead of loans.

### F. DILUTION OF THE VALUE OF MONEY BY DEPOSIT INSURANCE PAYOUTS

Moral hazard is not the end of the problem, however. As stated above, banks are able to distribute the risks of loss to other banks, their shareholders, and depositors. But, they are able also to distribute the risk of loss to the monetary unit generally. During times of severe economic crisis, dilution of the monetary unit serves as the primary means employed by the FDIC to meet its guarantee obligations. When the FDIC's reserve fund is insufficient to meet its payout obligations, the FDIC has few options but to require participating insured institutions to pre-pay certain assessments,[120] or to borrow from the United States Treasury.[121] As a practical matter, the source of the funds delivered to the FDIC may be the same in either case. For example, during the financial crisis, the FDIC elected to require participating insured institutions to prepay about $46 billion in assessments, as discussed above.[122] At the same time, the excess reserves of such participating institutions reached historic levels.[123] Reserves, of course, are generated when the Federal Reserve purchases securities from insured financial

120. 12 C.F.R. § 327.12 (2013).

121. 12 U.S.C. § 1824(a) (2012) ("The [FDIC] is authorized to borrow from the Treasury . . . for insurance purposes [an amount] not exceeding in the aggregate $100,000,000,000."). Tellingly, at the height of the financial crisis, Congress authorized the FDIC to borrow through 2010 up to $500,000,000,000 as determined to be necessary by the FDIC's Board of Directors. 12 U.S.C. § 1824(a)(3)(A).

122. Press release, FDIC, *FDIC Board Approves Final Rule on Prepaid Assessments* (Nov. 12, 2009), *available at* http://www.fdic.gov/news/news/press/2009/pr09203.html (last visited Nov. 5, 2013). Approximately $46 billion ultimately was paid. Memorandum from Arthur J. Murton (Director of Division of Insurance and Research) to FDIC Board of Directors, 2 (June 8, 2010), *available at* www.fdic.gov/deposit/insurance/memo3.pdf (last visited Nov. 5, 2013).

123. Press release, Donald L. Kohn, Vice Chairman, Bd. of Governors of the Fed. Reserve, *Monetary Policy in the Crisis: Past, Present, & Future* (Jan. 3, 2010), *available at* http://www.federalreserve.gov/newsevents/speech/kohn20100103a.htm.

institutions, giving them cash in exchange.[124] In the event that such financial institutions decline to use such reserves to make new loans or purchase other investments, the reserves become "excess reserves." In December, 2009, when the FDIC required insured financial institutions to prepay $45 billion in assessments, these financial institutions had stored nearly $1.06 trillion in excess reserves—all of it created by the Federal Reserve.[125]

Alternatively, the FDIC could have exercised its legal authority to borrow from the Treasury. If the FDIC had elected to do so, the Treasury would have had two options to generate the funds for the requisite loan. First, the Treasury could have raised tax revenues. Second, the Treasury could have issued new debt. If the Treasury were to issue new debt, it would need willing buyers of that debt. Today, the primary willing buyer is the Federal Reserve,[126] which owns now a record $2.2 trillion in Treasury securities[127]—the Federal Reserve created $2.2 trillion dollars in order to purchase Treasury Securities on the secondary market, and diluted the value of all pre-existing dollars in the process. If the FDIC had borrowed from the Treasury (instead of imposing a special assessment), the Treasury would have funded that

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124. *See, e.g.*, Bob McTeer, *Bank Reserves: A Hot Potato*, FORBES ONLINE (May 22, 2013, 5:26 PM), http://www.forbes.com/sites/bobmcteer/2013/05/22/bank-reserves-a-hot-potato/.

125. *Aggregate Reserves of Depository Institutions and the Monetary Base*, FED. RESERVE (Dec. 31, 2009, 4:30 PM), *available at* http://www.federalreserve.gov/releases/h3/20091231/.

126. Technically, the Federal Reserve Act prohibits the Federal Reserve from purchasing Treasury securities directly from the Treasury. 12 U.S.C. § 355(2) (2012) ("Every Federal reserve bank shall have power . . . to buy and sell in the open market, under the direction and regulations of the Federal Open Market Committee, any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States."). Rather, the Federal Reserve must purchase such securities on the secondary market. In practice, this limitation has no effect since primary market purchasers now purchase Treasury securities with an eye towards selling them immediately to the Federal Reserve. *See, e.g.*, Karen Brettell, *Treasuries – Despite Weak 5-Year Note Sale, Prices End Higher*, REUTERS (June 26, 2013, 3:15 PM) (reporting that sales of Treasuries slumped drastically after the Federal Reserve announced plans, later retracted, to reduce its future purchases), *available at* http://www.reuters.com/article/2013/06/26/markets-usa-bonds-idUSL2N0F21IN20130626.

127. Federal Reserve Bank of St. Louis, *U.S. Treasury Securities Held by the Federal Reserve: All Maturities (TREAST)*, *available at* http://research.stlouisfed.org/fred2/series/TREAST?cid=32218 (last visited Nov. 11, 2013).

loan by issuing debt in the form of Treasury Securities; primary market purchasers would have purchased those Treasury Securities aware that that they could quickly sell them to the Federal Reserve; and, the Federal Reserve, in turn, would have purchased them on the secondary market using newly-created money. In either case, the FDIC would have funded insured deposits using money created *ex nihilo*.

To summarize, deposit insurance funds exist in part to compensate depositors against the risk of lending and investment losses that they do not intend to assume. If those losses are realized, the deposit insurance payments theoretically can be made in real or in nominal dollar terms.

If this is a guarantee of a real value, the amount that can be guaranteed is constrained: the government must impose real taxes to honor a deposit guarantee. If the deposit guarantee is nominal, the tax is the (inflation) tax on nominal assets caused by money creation. Such taxation occurs even if no inflation results; in any case, the price level is higher than it would have been otherwise, so some nominally denominated wealth is appropriated.[128]

Put differently, bank loan or investment losses that result in insufficient liquidity to satisfy withdrawal requests necessarily require a guarantee to depositors from the insuring entity that is either nominally or really equal to the amount of the lost deposits. Since the modern fractional reserve banking system is a primary consequence of the legal misclassification of ordinary bank deposits as loans instead of bailments, and since the expansion of the money supply is a primary consequence of the fractional reserve banking system, there is little reason to believe that any deposit insurance payout will be made in real, as opposed to nominal, terms.

### G. DILUTION OF THE VALUE OF MONEY FROM LOANS AND INVESTMENTS MADE POSSIBLE BY DEPOSIT INSURANCE

As described in Part V, deposit insurance is a critical component of any banking system built upon fractional reserves because it transfers the risk of loss from depositors individually to the economic and monetary systems generally, thereby creating the environment requisite for fractional reserve banking. Thereafter, deposit insurance obviated

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128. Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, & Liquidity*, 24(1) FED. RESERVE BANK OF MINNEAPOLIS QUARTERLY REV. 14, 20 (2000), *available at* http://www.minneapolisfed.org/research/qr/qr2412.pdf.

the market's demand for 100% reserve banks by rendering their services superfluous. What remains is the modern banking system, pursuant to which monetary deposits beget loans in the form of additional deposits thereby increasing the money supply. This process—the process of money creation through fractional reserve banking—constitutes one of the three primary means by which the Federal Reserve conducts monetary policy; i.e., the means by which the Federal Reserve increases or decreases the money supply in order to accomplish its dual mandate of restraining inflation and reducing unemployment.[129] Thus, one of the three primary tools used by the Federal Reserve's to implement macroeconomic policy depends upon the existence of deposit insurance.

Let the reader assume for the purposes of this subsection that the nature of credit expansion brought about by fractional reserve banking (which is the result of the legal misclassification of ordinary deposits as loans) is a cause of the business cycle that ultimately results in the liquidation of the very same investments and loans made by banks with such misclassified deposits. Specifically, assume that there is something fundamentally different between loans or investments made with depositors' explicit consent, on the one hand, and loans or investments made without depositors' explicit consent. It is not the purpose of this Article to convince the reader (i) that there is indeed a fundamental difference between voluntary lending/investment and forced lending/investment,[130] or (ii) that artificial credit expansion brought about by the default classification of ordinary deposits as loans results in a process that ultimately forces the liquidation of banks' investments and loans.

However, these propositions, if true, have significant ramifications for the theoretically optimal ability of deposit insurance to perform its intended role. Although a discussion of monetary economics is beyond the scope of this Article, the net result of banks' speculative business activities described above (in particular the making of loans) is an

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129. *See generally* THE FEDERAL RESERVE SYSTEM PURPOSES AND FUNCTIONS, *supra* note 59.

130. Voluntary lending and investment occur when depositors intend a portion of their deposits be used for lending and investment (and receive interest payments as compensation for the associated risks). Forced lending and investment occur, for purposes of this article, solely as a consequence of the default legal rule that classifies all deposits, in the absence of an agreement to the contrary, as loans to banks. Banks lend or invest such amounts against the intentions of depositors who, as a consequence of deposit insurance, remain unaware of such use.

expansion of the money supply, i.e., inflation.[131] This is relevant, of course, because inflation yields a decrease in the purchasing power of the monetary unit. Thus, the legal classification of an ordinary deposit as a loan instead of bailment is the first step in a curious process that reduces the inherent value of the very funds deposited by the unwary depositor in the first place. In effect, banks fulfill their contractual obligations to depositors by meeting withdrawal requests with money that is worth *less* than when it was deposited. And, the decrease in value results from lending and investment activities that banks can undertake only because of the anomalous legal classification of such deposits and the existence of system-wide deposit insurance. In this regard, the law has rendered legitimate an activity that would otherwise be classified as fraudulent—that is, depositors intend that their bank deposits be bailments that, when withdrawn, will not be devalued as a consequence of actions taken by the bailee.

## CONCLUSION

The default legal classification of ordinary deposits as loans, and the concomitant establishment of debtor-creditor relationships between banks and depositors, respectively, conflicts with the ordinary understanding of depositors. From the outset of the banking relationship, the aberrant legal classification undermines the foundations upon which mutual trust between banks and their depositors could otherwise develop. It serves as the primary justification for the existence of the FDIC, which can fulfill its mandate only by making payments in real terms funded through taxation or in nominal terms funded through a devaluation of money. In turn, deposit insurance coupled with the default legal classification of deposits as loans transform legitimate banking activity into legislatively-induced artificial credit creation through suboptimal investment and lending fueled by a nearly inexhaustible supply of demand deposits. All of this consolidates in the hands of a few financial institutions the power to allocate the nation's deposits between savings, on the one hand, and lending or

131. Use of the term "inflation" to mean an increase in the price level as opposed to an increase in the money supply (which is its proper historical meaning) can be misleading because the former ignores the deleterious consequences of inflation unaccompanied by an increase in prices, such as the misallocation of capital.

investment, on the other.[132] But, it leaves depositors, other bank shareholders, and taxpayers bearing the cost of such failed business ventures; and, on a massive, systematic scale, decreases the purchasing power of money deposited in the first instance. In essence, the existing regulatory structure that provides for deposit insurance plus misclassified demand deposits equals moral hazard. This moral hazard contributes to economic and financial instability, yielding the paradoxical public outcry for further regulation. Lastly, this framework serves as a conduit through which dubious social policies may be implemented by politicians not eager publicly to discuss or address such policies, thereby undermining democratic institutions in the process.

In other words, the legal misclassification of ordinary bank deposits has contributed to the modern banking system in which: (i) depositors intend to save a portion of their disposable income without exposure to the risk of loss, as would be the case if they were to invest or lend it; (ii) to accomplish this goal, they deposit a portion of their disposable income into savings or checking accounts, not realizing that by doing so they are lending to banks; (iii) banks use the majority of these deposits (i.e., the fraction not required to be maintained as reserves) to make new investments and loans that depositors would not make directly; (iv) deposit insurance renders depositors indifferent to the misclassification of their deposits by appearing to transfer the risk of loss to some other party; (v) deposit insurance renders banks indifferent to the quality of such loans and investments; and (vi) as a result, banks make suboptimal loans and investments that cause economic instability and social turmoil.[133] Simply, banks make risky loans and investments using checking and savings account deposits made for the very purpose of avoiding risk, and this divergence in intent is a causal factor that contributes to bank insolvency, the devaluation of money, opaque governance, and unwelcome economic and social costs. The legal misclassification of ordinary demand deposits is an essential component of the fractional reserve banking system; this is its essential merit. Offset against this merit, however, should be a full accounting of its costs.

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132. This power results invariably in more investment and/or lending than would otherwise be the case.

133. For an insightful analysis of the social consequences of a change in the value of money, see Paul A. Cantor, *Hyperinflation and Hyperreality: Thomas Mann in Light of Austrian Economics*, 7 REV. OF AUSTRIAN ECON. 3 (1994); *see also* JORG GUIDO HULSMANN, THE ETHICS OF MONEY PRODUCTION (2008).