

Memo 1994-4 Pledging and Proposed Custodian Agreements

TO: All Staff
FROM: William D. Grant, Jr., Staff Attorney
DATE: February 14, 1994

**RE: Pledging to Public Deposits;
Proposed Pledge Custodian Agreements**

This memo is intended to describe, in a brief, general fashion, a few recent developments which affect a bank's public deposit activity and this department's future role in this particular matter.

In April, 1992, a U.S. Court of Appeals decided an Arkansas case involving public deposits by ruling that a municipality's pledging arrangement was inadequately structured, and therefore, the FDIC (as receiver of an insolvent bank) was entitled to the pledged securities, leaving, the municipality to get in line with other unsecured creditors.

This ruling most recently caused the Kansas State Treasurer to examine their deposit practices. The result of this examination was the development of a pledging agreement which the Treasurer has required the banks to sign prior to receiving state deposits.

What has surfaced most recently is a similar type of agreement on the local governmental level. The attached agreement is a prototype developed by an official in the Department of Administration's Municipal Accounting division. Apparently this form has been supplied to municipal auditors who have recently been suggesting municipalities should require banks to execute this agreement in order to enhance the municipalities' security interests in the pledged assets.

The question has since arisen from a few bankers as to whether or not this department has a position regarding the agreements. Following a thorough review of the document, the cases, and the public fund deposit laws found at K.S.A. 9-1401 et seq., it has been decided that the execution of a document substantively similar to the one attached would not be criticized by our examiners.

Therefore, so long as the bank remains in compliance with the requirements of the Kansas Statutes regarding pledging, any additional protective measures required by the public entity as a condition to public deposits, should be considered a negotiating point, to be worked out between the bank and the municipality.

PLEDGE CUSTODIAN AGREEMENT

This agreement made and entered into by and between the City of Manhattan, a depositor of public funds, hereinafter referred to as "Depositor"; and _____, a banking institution, hereinafter referred to as "Depositor Bank", and _____ hereinafter referred to as "Custodian" as of the ____ day of _____ 19__.

Whereas, Depository Bank has been selected by Depositor as an appropriate banking institution to act as a legal depository of public funds; and

Whereas, Kansas law, K.S.A. 9-1401 et seq. as amended, requires public funds to be continuously secured by the deposit of securities of the kind and character prescribed to be suitable collateral for public deposits; and

Whereas, all parties to this agreement intend to fully comply with applicable federal and state laws governing pledged securities arrangements; and

Whereas, in order to secure the public funds for the Depositor, the Custodian has been selected as a disinterested banking institution to safekeep and hold the pledged securities under the conditions hereinafter set forth in this agreement;

IN WITNESS WHEREOF, the parties hereto agree as follows:

1. Depository Bank agrees to deliver to Custodian from time to time the necessary securities, as prescribed by K.S.A. 9-1402 as amended, to be pledged which are to be held by Custodian. The market value of the pledged securities must at all times equal or exceed the uninsured deposits at Depository Bank. At the end of each month the Custodian will provide the market value of each pledged security to the Depository Bank. Upon receipt of the market value report provided by the Custodian, the Depository Bank will send a photocopy of the report to Depositor.

2. To perfect the security interest of the Depositor in the collateral pledged by the Depository Bank, the Custodian will hold the collateral in a custody account for the benefit of the Depositor. Depositor Bank hereby agrees to Depositor and grants to Depositor a security interest in those assets owned by the Depositor a security interest in those assets owned by the Depository Bank and held by Custodian for the benefit of Depositor, in accordance with the terms of this Pledge Custodian Agreement to secure the deposits held by Depository Bank for Depositor as required by State and federal law.

3. It is expressly understood and agreed that so long as no notice of default has been given to Custodian said Depository Bank shall have the right to substitute other legally qualified securities for the pledged securities held hereunder at any time provided the Depositor has approved such substitution and that the market value of all pledged securities shall equal at least 100% of the uninsured deposits of Depositor.

4. Until Custodian has been notified in writing that a default has occurred, Depository Bank shall be entitled to receive all interest and other income which may become due on or from the pledged securities, and the Custodian is hereby authorized and directed to pay the same to the Depository Bank.

5. Custodian shall have no responsibility to determine if the original pledged securities, or any additions thereto or substitutions therefore, are permitted collateral under the then applicable laws and regulations in effect.

6. Upon receipt of a notice in writing by the Depositor that there has been a default by Depository Bank, Custodian is hereby authorized and directed to deliver the pledged securities which are demanded by the Depositor, having first given notice of such delivery to Depository Bank, and Custodian shall thereby be discharged of all further responsibility in respect to the securities so surrendered. However, in the event Custodian is notified in writing by either party of a disagreement between Depositor and Depository Bank as to right of possession of any funds or securities demanded by Depositor under default, Custodian shall hold the same, together with any earnings thereon, until the Depositor and Depository Bank notify Custodian in writing that the dispute has been resolved and directing to which party the funds should be released, or until Custodian is directed as to the delivery of the securities and funds by an order or decree of an appropriate court.

7. At such times as Custodian receives securities to be retained by it under the terms hereof, it shall execute in duplicate its receipt setting forth in sufficient detail and identifying such securities so placed with it; and such receipt shall state that the securities are deposited under this agreement. Such receipts, which are neither transferable nor assignable, shall be furnished to the Depositor and Depository Bank, and be accepted by the parties as sufficient evidence of the pledging and depositing of such securities with Custodian Bank. The return of the receipt is required for the release of any or all of the securities. However, fax copies of the receipts, which include the signature of the Depositor or the Depository Bank as appropriate, will suffice to release the securities.

8. The Custodian agrees to act as the pledge holder under the terms hereof in holding and disposing of the securities deposited hereunder, exercising the same care in regard thereto as it does in protecting and disposing of its own securities, but assuming no responsibility other than for the safekeeping and

disposition of the securities and the proceeds thereof as provided herein.

9. Custodian shall not be liable in any respect on account of the identity, authority or rights of the persons executing or delivering, or purporting to execute or deliver, any document, directive, or paper received hereunder, and it may rely upon such document, directive, or paper believed by it to be authentic in making any delivery of money or securities hereunder.

10. Custodian shall be entitled to reasonable compensation for its services, which will be paid entirely by Depository Bank. The parties may terminate this agreement upon thirty (30) days written notice to the other parties. In the event of termination, the Custodian agrees to deliver to the successor custodian all the securities and funds held hereunder.

11. This agreement shall be executed in triplicate with one executed counterpart to be retained by each of the parties hereto, and shall be in full force and effect when executed by all of the parties hereto and upon Depository Bank depositing the securities to be pledged with Custodian. This agreement is neither assignable nor transferable, and there is no requirement that the agreement be returned to Custodian before delivery of any securities held pursuant thereto.

12. A new pledge custodian agreement will be required if at any time there is a lapse of all pledged securities held by the Custodian Bank.

13. In order to fulfill the "contemporaneous" requirement of federal law (section 1823(e) of Title 12 of the U.S. Code), and recognizing that it is impracticable to completely re-execute this agreement each time the moneys on deposit and the collateralizing securities change, the parties hereby agree that the transaction paperwork evidencing these changes in moneys and securities shall constitute limited updating executions of this agreement.

14. The Depository Bank agrees to make this agreement an official and continuous record of the Depository Bank.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be signed as of the date above indicated. The Depository Bank agrees to provide the Depositor with a copy of the minutes showing approval of this agreement by the Board of Directors or loan committee.

Depositor

by _____

Title _____

Depository Bank

by _____

Title _____

Custodian Bank

by _____

Title _____