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ESSAY

THE AFTERMATH OF PENN SQUARE BANK: PROTECTING LOAN PARTICIPANTS FROM SETOFFS

I. INTRODUCTION

In light of the recent failure of Penn Square Bank, N.A.,[1] the subject of loan participations has begun to receive great attention from the legal and business communities alike. Because of Penn Square's extensive loan participation program, the bank's collapse generated nationwide concern. The concept of a loan participation represents the division of a loan among several financial institutions.

> Used by finance companies, mortgage bankers, banks, insurance companies, and many other lenders, loan participations are generally seen as a way of enabling an originating lender to accommodate large customers which it could not otherwise handle, consequently increasing the volume of business, diversifying its risk, and in general improving its liquidity; conversely, those institutions which "participate" in loans see it as a way to invest profitably with a minimum of cost, effort, and risk.[2]

1. Penn Square Bank, N.A., of Oklahoma City, Okla. was declared insolvent on July 5, 1982. Because of the uncertainty surrounding Penn Square's total liabilities and losses, no banks were interested in acquiring the institution. Thus, for only the third time in its history, the FDIC was forced to establish a special bank to aid the refunding of deposits. Bennet, *Bigger Banks Are Hurt By Failure in Oklahoma*, N.Y. Times, July 7, 1982, at D1, col. 4. The bank was dissolved and the FDIC was appointed as receiver under 12 U.S.C. § 191 (1976), which provides in part, "Whenever the [C]omptroller [of the Currency] shall become satisfied of the insolvency of a national banking association, he may, after due examination of its affairs . . . appoint a receiver, who shall proceed to close up such association." For a general discussion of the Penn Square insolvency, see Bayless, *Bank's Problems Called Unique*, Daily Oklahoman, July 7, 1982, at 1, col. 1; Bayless, *Penn Square Bank Declared Insolvent*, Daily Oklahoman, July 6, 1982, at 1, col. 1; Hargrove, *OC bank insolvent; uninsured deposits total $190 million*, Tulsa Tribune, July 6, 1982, at A1, col. 2; *Bank investor losses may top $38 million*, Tulsa Tribune, July 7, 1982, at A1, col. 5; *Government Takes Over, Reopens Failed OC Bank*, Tulsa World, July 7, 1982, at A1, col. 1.

2. Drake & Weems, *Mortgage Loan Participations: The Trustee's Attack*, 52 AM. BANKR. L.J. 23, 23 (1978). Another commentator explains the growth of loan participations as follows:

> Participations have developed rapidly in recent years as a means of developing correspondent bank relations as larger banks share attractive loans with smaller country

Although the use of loan participations is by no means new to the financial world, this type of transaction has yet to be defined as a matter of law.[3] The absence of legal definition has traditionally been tolerated because the banks originating the loans were perceived to be institutions of such stature and stability that the participating banks did not fear for either the solvency of the originating banks or the safety of their participation interests.[4] A more precise legal characterization of loan participations appears imminent since the millions of dollars involved in these transactions demand that the parties involved legally substantiate their positions.[5] Until that characterization is made, however, counsel for the participating bank is confronted with the difficult task of devising an effective loan participation structure that can withstand even the insolvency of the lead bank,[6] thus protecting the partici-

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> banks, join country banks in making large loans to country bank customers, and as a means of servicing the credit needs of factors, financing institutions and banks anxious to satisfy their customers' credit demands but unable to do so fully for reasons of lending limit ceilings, shortage of available cash, risk-spreading and the like. By "participating" their larger loans these institutions can continue to serve valuable customers on a more-or-less exclusive basis. Similarly, as purchasers of participations these same institutions can share in attractive loans which might not come to them in the usual course of their business.

Armstrong, *The Developing Law of Participation Agreements*, 23 BUS. LAW. 689, 689 (1968).

3. Drake & Weems, *supra* note 2, at 23.

4. Stahl, *Loan Participations: Lead Insolvency and Participants' Rights (Part I)*, 94 BANKING L.J. 882, 884 (1977).

5. It is estimated that Penn Square Bank sold over $2 billion in oil and gas loans to major financial institutions throughout the United States. Continental Illinois Nat'l Bank & Trust Co. of Chicago purchased over $1 billion of Penn Square loan participations. Bennett, *Bankers See Tighter Oil-Loan Policy*, N.Y. Times, July 8, 1982, at D1, col. 3. Other major Penn Square loan participants include such institutions as Seattle-First Nat'l Bank ($400 million), The Northern Trust Co. ($125 million), The Chase Manhattan Bank ($250 million), and Michigan Nat'l Bank ($200 million). Bennett, *supra* note 1.

The effect of the Penn Square collapse was immediately apparent as several banking organizations posted major losses for the second quarter of 1982. For example, Seattle-First increased its provision for loan losses by $125 million. *Seafirst Boosts Loss Provision for 2nd Quarter*, Wall St. J., July 14, 1982, at 4, col. 1. Continental Illinois posted a $60.95 million loss; it was estimated that Continental would have shown a $51 million profit in the second quarter had it not been for the failure of Penn Square. Bennett, *Continental Posts $60.95 Million Loss*, N.Y. Times, July 22, 1982, at D1, col. 3. Chase Manhattan charged off $45 million in the second quarter that was directly attributable to the Penn Square failure. *Chase Reports Operating Loss for 2nd Quarter*, Wall St. J., July 21, 1982, at 2, col. 2. Because of its dealings with Penn Square, Michigan Nat'l was forced to triple its write-off from $18 million to $57.4 million. As a result, it is estimated that the participant banks have established almost $450 million in loan loss reserves. Ward & Hargrove, *Penn Square chief to surrender records*, Tulsa Tribune, Nov. 23, 1982, at 1A, col. 1.

6. Although the Penn Square collapse greatly enhanced the public's awareness of the potential for the failure of national banks, the most venerable of all financial institutions, the closing and liquidation of banks by the FDIC is certainly nothing new. In fact, several large banks, including the Franklin Nat'l Bank in New York (ranked in 1973 as the 23rd largest bank in the nation, FORTUNE MAG., July 1973, at 122-23) and numerous smaller banks have failed in recent years. Simpson, *Loan Participations: Pitfalls for Participants*, 31 BUS. LAW. 1977, 1977 n.1 (1976).

One commentator points out that the FDIC has been liquidating banks for several years, but

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pating bank from some of the problems that the Penn Square failure has brought to light.

The Penn Square Bank collapse is unique in that it presents for the first time the failure of a bank that was almost entirely dependent on loan participations for its very existence.[7] Unfortunately, there is very little settled law in this specific area and there is likely to be none until the litigation stemming from the Penn Square insolvency is concluded.[8] This Essay is intended to be used as an aid in the preparation of an effective participation agreement to protect the interests of the participant bank. After a short description of the typical participation structure, the complex and expensive setoff problem now plaguing the participant banks is briefly described.[9] This Essay then offers some practical methods and a form that may be helpful in drafting a skillfully structured participation arrangement that minimizes the risk of

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that the period from 1973 to 1978 saw the eleven largest bank failures in FDIC history. Skillern, *Federal Deposit Insurance Corporation and the Failed Bank: The Past Decade (Part I)*, 99 BANKING L.J. 233, 233-34 (1982) (providing a complete list of the eleven banks, including years of closing and total deposits). In an earlier article, the same author demonstrates that in Texas alone fifteen banks were closed over a seven year period—an average of over two failures per year. Skillern, *Closing and Liquidation of Banks in Texas*, 26 SW. L.J. 830, 830 (1972).

According to FDIC chairman William Isaac, a record high of 35 banks have been closed in 1982 and another 320 banks are on the "problem" list. Hargrove & Ward, *Fraud and abuse cited in bank failures*, Tulsa Tribune, Oct. 26, 1982, at 1C, col. 1. Clearly, then, the liquidation of a bank is nothing new or extraordinary.

7. *See infra* note 34.

8. Approximately 250 lawsuits have been filed as a result of Penn Square's failure. *FDIC finds tangled web in OC bank*, Tulsa Tribune, Oct. 25, 1982, at 1A, col. 1. For a brief discussion of the nature of the suits filed by one major institution involved in the Penn Square loan participation program, see *Michigan National Sues U.S. Receiver of Penn Square Bank*, Wall St. J., Dec. 8, 1982, at 10, col. 3.

9. The problems surfacing in the Penn Square controversy are numerous and diverse. This Essay, however, is concerned exclusively with the borrower's right to set off the losses that it has incurred as a result of the Penn Square insolvency against its outstanding loan obligations owed to Penn Square, in which an undivided interest was conveyed to a participant bank. For a more detailed discussion of loan participations, their concomitant problems, and the subject of setoff in general, see Armstrong, *The Developing Law of Participation Agreements*, 23 BUS. LAW. 689 (1968); Clark, *Bank Exercise of Setoff: Avoiding the Pitfalls*, 98 BANKING L.J. 196 (1981); Coogan, Kripke & Weiss, *The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements*, 79 HARV. L. REV. 229 (1965); Drake & Weems, *Mortgage Loan Participations: The Trustee's Attack*, 52 AM. BANKR. L.J. 23 (1978); Hutchins, *What Exactly Is a Loan Participation?*, 9 RUT.-CAM. L.J. 447 (1978); MacDonald, *Loan Participations as Enforceable Property Rights in Bankruptcy—A Reply to the Trustee's Attack*, 53 AM. BANKR. L.J. 35 (1979); Simpson, *Loan Participations: Pitfalls for Participants*, 31 BUS. LAW. 1977 (1976); Skillern, *Federal Deposit Insurance Corporation and the Failed Bank: The Past Decade (Parts I & II)*, 99 BANKING L.J. 233, 292 (1982); Skillern, *Closing and Liquidation of Banks in Texas*, 26 SW. L.J. 830 (1972); Stahl, *Loan Participations: Lead Insolvency and Participants' Rights (Part I)*, 94 BANKING L.J. 882 (1977); Stahl & Pike, *Loan Participations: Lead Insolvency and Participants' Rights (Part II)*, 95 BANKING L.J. 38 (1978).

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similar setoff problems in the future.[10]

II. The Participation Agreement

A. *Structure*

The contractual provisions contained in participation agreements may vary according to the demands of a given situation.[11] There are, however, certain characteristics common to participation transactions and a brief description of the typical participation structure will prove helpful in understanding the problems presented by Penn Square.

It is generally accepted that the concept of a loan participation represents "the practice of financial institutions of dividing up or sharing a loan."[12] Typically, the loan is made by one party, the originating lender or "lead," who then transfers an undivided portion or percentage of this loan to another financial institution, the "participant." The relationship between the lead and the participant is specifically governed by a participation agreement.[13]

Traditionally, the lead bank originates and consummates the loan. All accompanying loan documentation is written and recorded to reflect the lead as sole owner with the lead retaining the loan documents and recording the mortgage.[14] In the underlying loan documents, only the lead bank is named as the secured party with respect to any related assignments, pledges, or chattel mortgages.[15] Therefore, the note evidencing the borrower's indebtedness is directly payable to the lead, which continues to hold all evidences of indebtedness and collateral.[16] "Thus, at the time immediately prior to the participation transaction, the lead is both the legal and equitable owner of the entire loan."[17] The lead and participant then enter into a participation agreement

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10. A sample participation agreement that may help eliminate future setoff problems is reprinted in its entirety in the Appendix, *infra*.

11. For several examples of participation agreements and certificates, see Armstrong, *supra* note 9, at 696-700; Thuleen, *Survey of Practice and Procedure of Banks in Taking Participations from Correspondent Banks*, J. COM. BANK LENDING, May 1968, at 10, 19-23. These contractual differences have proven critical when determining the ultimate legal consequences of the transfer. *See infra* notes 23-32 and accompanying text.

12. Drake & Weems, *supra* note 2, at 23.

13. *Id.* at 23-24. The terms of a participation transaction are typically embodied in a participation agreement. A participation certificate is used to document the amount that is contributed by each participant. It is quite possible to combine these into one document. Hutchins, *supra* note 9, at 449.

14. Drake & Weems, *supra* note 2, at 24.

15. *See* Armstrong, *supra* note 2, at 689.

16. *Id.* at 690.

17. Drake & Weems, *supra* note 2, at 24 (footnote omitted).

which provides that the lead is "selling"[18] an undivided share of the underlying loan and an undivided share of the collateral that secures the loan to the participant.[19]

Often, the borrower is not notified of the participation transaction.[20] Further, the public is not notified by way of recording assignments of notes or mortgages, nor are any Uniform Commercial Code financing statements filed.[21] Therefore, the lead appears to be the only secured party on the original loan. Moreover, the notes typically remain in the possession of the lead who in turn transfers to the participant only a certificate of participation that lists the various loans involved.[22]

18. Whether a sale actually occurs is a matter of contention. Some commentators argue that the typical participation transaction does not involve a sale of an interest in the loan, but rather that it involves merely a loan to the lead from the participant. *See, e.g.*, Drake & Weems, *supra* note 2, at 25-26. The majority of commentators, however, believe that this type of transaction is a true sale. This better reasoned view is succinctly stated as follows:

> An important feature of the transaction is that the lead and the participant banks do not intend that the participants' acquisition of a partial interest in the loan and the collateral be viewed as a loan to the lead bank from the participant. For practical business reasons, among them the lead bank's obvious objection to appearing as a debtor in its financial statement, the transaction is structured as a sale.

Stahl, *supra* note 4, at 883.

19. The gist of the arrangement is that the lead is transferring an interest in a loan that it has made or is preparing to make in the future. "As purchaser of a participation, the participant institution buys, in effect, an undivided share of the loan made by the lead and an undivided share of the collateral, if any, which secures that loan." Armstrong, *supra* note 2, at 689. Essentially, the lead bank has created a new property interest. Stahl, *supra* note 4, at 883.

20. *E.g.*, Stahl, *supra* note 4, at 883-84.

21. *See* Simpson, *supra* note 6, at 1979.

There is no consensus on whether Article 9 of the U.C.C. covers a participation transaction. One commentator argues that,

> In practice . . . bank counsel have generally concluded that since Article 9 is designed to cover only transactions intended to create a security interest in personal property, and since sales of participatory shares in collateral fall without that intention, [Article 9] is not applicable to the participation situation.
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> . . . .
>
> Where appropriate the lead should file against the debtor, and in some circumstances the lead may choose to file an assignment of record for the benefit of its participants, but as to the much-debated question of how the participants should go about filing against the lead the conclusion of many experienced counsel is that they shouldn't. This is so because the best argument has it that Article 9 does not apply to the sale of participations.

Armstrong, *supra* note 2, at 691 (footnote omitted). *Contra* Coogan, Kripke & Weiss, *supra* note 9, at 266-77. For further discussion of the applicability of Article 9 to participation agreements, see Stahl & Pike, *supra* note 9, at 49-63.

22. For an excellent synopsis of the structure of a loan participation, see Drake & Weems, *supra* note 2, at 24-25.

> As a general rule, the lead originates and closes the underlying loan, with all loan documentation written and recorded to reflect the lead as sole owner; the lead retains the documents (negotiable note) and records the mortgage. Thus, at the time immediately prior to the participation transaction, the lead is both the legal and equitable owner of the entire loan. The lead then contracts with the investor-participant in the form of a

B. *Lead-Participant Relationship*

While the nature of the relationship between the lead and the participant has not been conclusively defined, two competing theories attempt to describe its character.[23] One theory construes the relationship as an extension of credit by the participant to the lead, creating a debtor-creditor relationship.[24] The other theory asserts that the relationship is the sale of a legally cognizable property right in the underly-

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> participation agreement, agreeing to "sell" to the participant an undivided share of the loan (in various percentages) made by the lead and an undivided share of the collateral . . . which secures the loan. In the usual case there is no notification to the public of the participation transaction in the way of recording assignments of notes or of real estate mortgages, nor any filing of financing statements pursuant to the Uniform Commercial Code. As a matter of record, the lead is the only secured party on the original loan. The lead also retains possession of the negotiable notes, transferring to the participant only a participation certificate listing the loan or loans involved. Some agreements provide that the lead holds the documentation in trust for the participant; others neither mention nor attempt to explain the apparent inconsistency of the lead retaining all documentation of ownership.

Id. (footnotes omitted).

23. This lack of definition can be contrasted with the relationship between the participant and the borrower, where it has generally been maintained that the participant does not become a creditor of the borrower by virtue of the participation agreement. *In re* Yale Express Sys., 245 F. Supp. 790, 792 (S.D.N.Y. 1965); Armstrong, *supra* note 2, at 693. Thus, the participant must look only to the lead for satisfaction of claims arising out of the transaction. "This is not to say that participants cannot enter into separate side contracts with the borrower providing for rights to setoff and the like or have themselves named third-party beneficiaries of similar provisions in the borrower-lead loan agreement." *Id.* at 693-94.

24. *E.g.*, *In re* Alda Commercial Corp., 327 F. Supp. 1315, 1317 (S.D.N.Y. 1971); Drake & Weems, *supra* note 2, at 26. In *Alda*, the participants each purchased a 10% undivided interest in certain loans made by Alda Commercial Corp. to identified borrowers, secured by the accounts receivable and other security of the borrowers. The participation agreement provided for a limited investment by the participants in the amount of $10,000. Further, the participation agreement provided for payment to the participants of an amount equal to 12% per annum interest on the amount of their participations for each month. The funds advanced to Alda from the participants were deposited into Alda's general account and only Alda's name was reflected on the financing statements. The borrowers continued to make their payments directly to Alda and were not advised of the participation arrangement. 327 F. Supp. at 1316-17. After Alda was adjudicated as bankrupt, the referee rejected the participants' claims to a specific property interest and held "that the [participant] had no interest in the property of the bankrupt but that he was entitled to file his claim as a general creditor." *Id.* at 1317. In affirming the referee's decision, the court said:

> The arrangement was not brought to the attention of the creditors of the bankrupt, and their rights under the Bankruptcy Act should not be limited by reason of a secret arrangement between [participant] and the bankrupt. If [participant] believed he had a security interest in the bankrupt's assets, he was required to file a financing statement pursuant to Article 9 of the Uniform Commercial Code to protect himself from the claims of creditors. . . .
>
> Finally, there is no basis for holding that the bankrupt was agent for the [participant] in the factoring of these accounts. On the contrary, these accounts were part of the bankrupt's regular financing business and the bankrupt controlled and managed the business, subject only to the right of [participant] to interest and the eventual return of his investment; nor was the bankrupt a trustee for [participant] since there was no segregation of these accounts and none was contemplated.

Id. at 1317-18 (citations omitted).

ing loan and any collateral securing the loan.[25] Under this second theory, the lead bank continues to hold the note and service the loan in a fiduciary capacity for the benefit of the participant.[26]

The distinction between the relationship of debtor-creditor or fiduciary can be critical in the context of the lead's bankruptcy. If the relationship between the lead and participant is construed as debtor-creditor, "the participant may have forfeited any intended lien or security interest unless the participant timely took all steps necessary, under state law, to perfect the lien or security interest thereby rendering it invulnerable to attack"[27] by a trustee in bankrupcty under sections 541(e), 544, or 547 of the Bankruptcy Code.[28] If the participation agreement is construed as a property right, the trustee in bankruptcy will not acquire rights in property that the bankrupt held as a fiduciary for the benefit of a third party.[29] "It thus becomes apparent that in the context of the lead's bankruptcy, the showing of a fiduciary relationship between the lead and the participant and the correlative negation of a debtor-creditor relationship, can be critical."[30]

One commentator has suggested that the confusion surrounding the characterization of loan participations results from the lack of specificity contained in the participation instruments.[31] "[W]hen the participation agreement contains very little detail or is ambiguous, then the agreement must be supplemented by the growing body of case law on the subject of loan participations. . . . [H]owever, the cases fail to provide a uniform interpretation of the participation relationship."[32]

25. MacDonald, *supra* note 9, at 66; Stahl & Pike, *supra* note 9, at 48-49; *see, e.g.*, Stratford Fin. Corp. v. Finex Corp., 367 F.2d 569, 571 (2d Cir. 1966); Todd v. Pettit, 108 F.2d 139, 140 (5th Cir. 1939).

In *Stratford Fin. Corp. v. Finex Corp.*, the participants purchased a 100% interest in certain loans made by Stratford. The president of Stratford continued to make several monthly payments to Finex after filing for bankruptcy. As a result, the debtor in possession along with the creditors committee attempted to reclaim these funds as part of the assets of Stratford. Recognizing that the critical issue was whether the transaction created a trust relationship or a debtor-creditor relationship, the court upheld a finding of a trust relationship even though the notes and funds were not segregated, the payments received from the original borrower were commingled for a brief time in Stratford's general account, and Stratford had promised to pay interest on the advancement. 367 F.2d at 570-71.

26. For a more detailed analysis of the lead-participant relationship as it is characterized as an assignment, tenancy in common, joint venture, agency, or trust, see Hutchins, *supra* note 9, at 463-74.

27. Simpson, *supra* note 6, at 1993.

28. 11 U.S.C. §§ 541(e), 544, 547 (Supp. IV 1980).

29. Simpson, *supra* note 6, at 1992; Stahl & Pike, *supra* note 9, at 48.

30. Simpson, *supra* note 6, at 1993.

31. *See* Hutchins, *supra* note 9, at 458.

32. *Id.*

Therefore, the participant bank should protect its interest by clearly defining in the participation agreement the intended relationship between the parties.

III. The Setoff Problem

One of the most troublesome and expensive problems for the participant banks arising out of the Penn Square controversy involves the right of the depositor of an insolvent bank to set off any of its lost deposits against an indebtedness it owes the bank. Although the concept of setoff did not exist at common law, courts of equity have long recognized that this right inures to the benefit of a depositor.[33] For example, if a bank were to lend a borrower $5,000,000 and the borrower had $400,000 on deposit in this bank, then upon the bank's insolvency the borrower would have the right to set off the $400,000 in lost deposits against the $5,000,000 debt. As a result of this setoff, the bank's liability to the borrower for its $400,000 deposit has been extinguished and the borrower's obligation to the bank has been reduced to the sum of $4,600,000.

The Penn Square insolvency is complicated by the fact that as a lead bank, Penn Square sold participation interests in a great number of loans to various banks.[34] In the example just given, assume that a participant bank purchased a ninety percent interest in the $5,000,000 loan against which the borrower is attempting to set off its $400,000 deposit. Unless the participant can either prevent the setoff by virtue of its ownership right in the $5,000,000 note or, alternatively, establish a preferred claim against the receiver for its ninety percent of the setoff amount, the participant may lose as much as $360,000.[35]

FDIC v. Mademoiselle of California[36] established the right of a depositor to exercise a setoff, even though an undivided interest in the loan has been sold to a participant.[37] The court's decision to allow the

33. FDIC v. Mademoiselle of Cal., 379 F.2d 660, 663 (9th Cir. 1967). The right to set off has been allowed under the National Bank Act; consequently, the balance of the debt after the setoff is considered an asset of the insolvent bank and subject to distribution according to 12 U.S.C. § 194 (1976). 379 F.2d at 663 (citing Scott v. Armstrong, 146 U.S. 499 (1892)).

34. It is estimated that 80% of Penn Square's energy loans were sold to participants. *Aftermath at Penn Square*, N.Y. Times, July 8, 1982, at D7, col. 1.

35. For an indication of the dollar amounts the participating banks have at risk in the Penn Square failure, see note 5 *supra*.

36. 379 F.2d 660 (9th Cir. 1967). It is interesting to note that *Mademoiselle* has not been cited in any subsequent reported decisions and has been of little interest until the Penn Square litigation.

37. *Id.* at 663-64. Union Bank purchased an 80% participation interest in a loan from San

setoff was not grounded on traditional legal principles,[38] but was based primarily on a number of equities found to be in favor of Mademoiselle's claim.

> As assignee of part of the claim, [the participant] takes it subject to any counterclaims and defenses against it. Therefore, the assignment does not operate to defeat the maker's claims against the assignor, *especially* since Mademoiselle was never notified of the assignment and continued to make its payments on the note directly to [the lead], and since [the lead] retained possession of the note. So far as Mademoiselle was concerned, the note was due solely to [the lead], and the unannounced transfer of an interest or sale of a participation certificate in the note should not dilute the uninformed depositor's ordinary right of set-off.[39]

Thus, in reference to the typical participation agreement in which the borrower has no knowledge of the participation arrangement, the equitable right of setoff will not be denied on the basis of the participant's interest.

Once the setoff has occurred, the participant faces the problem of establishing a preferred claim[40] for its proportionate share of the amount set off. Although there are no statutory preferences[41] relating

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Francisco Nat'l Bank (SFNB) to Mademoiselle of California. Later, the Comptroller of the Currency closed SFNB due to insolvency, appointing the FDIC as receiver. As of the bank's closing, Mademoiselle had on deposit in SFNB the amount of $7,473.01 which it sought to set off against the remaining balance of the note. *Id.* at 661-62.

38. In an effort to prevent the setoff, the FDIC argued that the participation sold to Union Bank deprived the debt between SFNB and Mademoiselle of mutuality and therefore was not subject to setoff. In rejecting this argument, the court stated that "[w]hile it is generally true that a separate debt cannot be set off against a joint demand, insolvency may give rise to circumstances that work against the strict application of that rule." *Id.* at 663. For example, a showing that the debt against which setoff is claimed would not be fully paid is an inequity which is raised in light of an insolvency. *Id.* at 664.

39. *Id.* (emphasis added).

40. Three essential prerequisites must be established to impress a trust upon an alleged fund in an insolvent national bank and assert a preferential claim against the receiver:

> First, the establishment of the fact that the transaction, out of which the claim arose, was made under circumstances creating a trust, whereby the banking corporation stood in the relation of trustee to the claimant; second, an affirmative showing that by reason of the transaction the actual, physical assets of the bank coming into the hands of the receiver or assignee were augmented by the fund claimed; and third, the ability of the claimant to trace the fund, either in the original form or in a changed form, into the hands of the receiver.

H. BRAVER, LIQUIDATION OF FINANCIAL INSTITUTIONS § 854, at 985 (1936); *e.g.*, Queenan v. Mays, 90 F.2d 525, 531 (10th Cir.), *cert. denied*, 302 U.S. 724 (1937) (in establishing a preferred claim, it must be shown that transaction did not result in debtor-creditor relationship, but that bank assumed obligation to preserve the funds on behalf of claimant).

41. *See* 12 U.S.C. § 194 (1976).

to the participant's interest, "a direct recovery against the receiver in preference to the general pro rata distribution of assets 'is authorized in situations where the facts are such that the court must say in equity that the property is not that of the bank but that of the claimant.' "[42] As a general rule, a participant may establish a preferred claim in the amount of its participation against the assets of the lead, but the participant "has a heavy burden of proof, and unless he clearly and certainly identifies the fund he must fail."[43] In other words, the participant "must be able to identify a specific fund or payment in the possession of the receiver cognizable in equity as [its] own property."[44]

FDIC v. Mademoiselle of California specifically addresses whether the setoff falls within the criteria of a preferred claim. The court held that the participant was not entitled to a preferred claim because "[t]he set-off has not augmented the assets in the hands of the receiver or created a specific fund to which equity will attach property rights."[45] Therefore, once the setoff has been allowed, it would be extremely difficult for the participant bank to identify a specific fund against which to establish a preferred claim.

Relying on the precedent established in *Mademoiselle*, the FDIC has taken the position with respect to participants of Penn Square loans that, although it will remit the participant's share of any payment actually received on a note sold by Penn Square Bank to a participant, it will send to the participant a receiver's certificate for its pro rata share of the amount of the setoff.[46] For example, if the participant purchased

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42. 379 F.2d at 664 (quoting from John L. Walker Co. v. Alden, 6 F. Supp. 252, 267 (E.D. Ill. 1934)).

43. *Id.* at 664-65 (quoting from Converse Rubber Co. v. Boston-Continental Nat'l Bank, 12 F. Supp. 887, 893 (D. Mass. 1935), *aff'd*, 87 F.2d 8 (1st Cir. 1936)).

44. *Id.* at 665. The court did allow that if Mademoiselle had made a payment on the note, the participant would be entitled to its pro rata share of such payment. *Id.*

By allowing the participant the opportunity to establish a preferred claim in identifiable funds, the *Mademoiselle* decision has been interpreted by one commentator to suggest "that the participant's partial and undivided interest in the borrower's note and underlying collateral represents its security for a loan it really makes to the lead, not for the participation it purchases in the lead's loan to the borrower." Armstrong, *supra* note 2, at 695-96. On the other hand, another commentator has taken the position that this ability to establish a preferred claim "must follow from the characterization of the loan participation as a sale of a partial interest in an instrument and recognition of the participant's ownership." Stahl, *supra* note 4, at 889.

45. 379 F.2d at 665.

46. Reply Brief of Defendant at 5-6, The Chase Manhattan Bank, N.A. v. FDIC, No. Civ-82-1074-R (W.D. Okla. filed Sept. 10, 1982).

After complete liquidation of the insolvent bank and payment of all preferred claims, the remaining funds will be divided among the holders of receiver's certificates. The Penn Square

a ninety percent interest in the $5,000,000 loan against which a depositor made a $400,000 setoff, the FDIC would send to the participant a receiver's certificate in the amount of $360,000.[47]

Thus, as illustrated by Penn Square's collapse, drafters of participation agreements must be sensitive to the risk of loss created by the equitable right of setoff. *Mademoiselle* clearly established that the equities favor allowing the setoff regardless of the participant's interest in the debt when the borrower received no notice of the participation agreement. Consequently, the day of the undisclosed participation should be over. Ideally, the participants are best protected when the borrower executes and delivers separate promissory notes to each participant for its pro rata share of the loan. The banks would then execute an intercreditor agreement specifying details of the administration of the loans. In this instance, the deposits lost due to the lead's insolvency could not be set off against the separate obligations owed to the participants. When separate promissory notes are not practicable, special consideration should be given to provisions in the participation agreement requiring notification to the borrower of the sale of a participating interest in the note.[48] To further assure that adequate notice is given, the participant should give direct notice to the borrower of its ownership interest. Although it is not suggested that these precautions alone will cure the problem of setoff, it should reduce the equities that *Mademoiselle* found in favor of the borrower and thus reduce the risk of loss to the participant.

It is imperative that the participation agreement clearly reflect the intended relationship between the parties. Traditionally, participation agreements have been structured as separate transactions between the lead bank and each participant. Thus, in the future, bank counsel should consider the use of an intercreditor participation agreement

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receivership has issued 1,792 receiver's certificates for a total of $157.8 million. The FDIC has not yet determined the rate of dividends to be paid on the certificates, *Penn Square claims could cost FDIC $50 million*, Tulsa Tribune, Dec. 11, 1982, at 1A, col. 1; however, William Isaac, FDIC Chairman, has estimated that the FDIC may pay only a 20% dividend on Penn Square receiver's certificates. *See* Hargrove & Ward, *supra* note 6. Moreover, the Federal Reserve has announced that receiver's certificates will be accepted as collateral for loans, but *not* at 100% value. Hill, *Penn Square's Failure Bodes Losses For Many*, Wall St. J., July 7, 1982, at 2, col. 2. Thus, the practical effect of the receiver's certificate is that the participant will probably collect only a very small portion of the face value of such certificate.

47. For purposes of the FDIC insurance program, 12 U.S.C. § 1813(m)(1) (Supp. II 1978) provides that an "insured deposit" is calculated after deducting setoffs.

48. For an example of such provisions, see Appendix *infra*, ¶¶ 4(c), 5.

which not only identifies the relationship between the lead and the participants but also establishes the relationship between the participants themselves. Through skillful drafting of the participation agreement, the setoff problems of the present may be avoided in the future.

IV. CONCLUSION

Previously, the practice of transacting loan participations was not a source of trouble since banks were believed to be immune from the misfortunes of insolvency or bankruptcy. The disastrous collapse of Penn Square Bank has proven this notion untrue. It is axiomatic that the financial marketplace functions best in an environment of certainty. In light of the realities of the banking industry, it is likely that the uncertainty that presently clouds the legal consequences following the insolvency of the lead bank could have the deleterious effect of inhibiting the use of loan participations. It therefore follows that the availability of credit could become much more restricted; as a result of this restriction, the inability to secure corporate financing could work a serious hardship on the national economy.

Given the present confusion surrounding loan participations and absent the use of separate promissory notes for each participant, drafting a participation agreement that effectively protects the participant bank from the borrower's right to setoff is a venture laden with uncertainty. It is quite clear at this time that no single rule that would avoid the setoff problem can be established, since each participation agreement varies from the rest as far as it is tailored to meet the specific needs of the situation. Nevertheless, it can be said that when preparing a participation agreement, bank counsel would do well to provide for the following:

1) That the parties intend that this transaction be construed as a sale of a property interest;
2) that the lead bank is simply the servicing agent for the participant bank's interest in the loan; and
3) that the borrower be notified that a percentage of its loan is now owned by a participant bank.

Although the suggested intercreditor participation agreement that appears in the Appendix is no panacea, if properly adapted to meet the specific demands of a given loan transaction, it may prove helpful in precluding the expensive setoff problem that is now plaguing the participant banks involved in the Penn Square Bank failure.

Kevin B. Fisher
Elizabeth R. Muratet

APPENDIX

INTERCREDITOR PARTICIPATION AGREEMENT

THIS AGREEMENT, dated as of __________, 19__, by and between (Bank 1), (Bank 2), and (Bank 3), each of which is individually referred to herein as "Bank" and collectively referred to as the "Banks."

A. __________ (the "Borrower") is obtaining a certain loan (the "Loan") from (Bank 1) as evidenced by a note (the "Note") dated __________ in the principal amount of $__________.

B. The repayment of the Note is secured by the collateral (the "Collateral") described in and covered by the security instruments (the "Security Instruments") attached hereto and made a part hereof as Exhibit ____.

C. (Bank 1) has agreed to sell and (Banks 2 & 3) have agreed to purchase participations in the Loan in the amounts of $__________ and $__________ respectively. Following this sale, the Banks will own the following relative percentages (the "Participation Percentages").

Bank	Amount Participated	Participation Percentage
(Bank 1)		
(Bank 2)		
(Bank 3)		

D. (Bank 1) is in possession of the Note, the Security Instruments, and all other instruments, documents, and correspondence executed, delivered, or prepared in connection with or pertaining to the Loan (which include, without limitation, a guaranty, a loan agreement, and other material in the nature of financial statements, corporate resolutions, or other evidence of authority, all of which together, including the Note and Security Instruments and collateral security interests created thereby, as are herein called the "Loan Documents").

E. The Banks wish to designate (Bank 1) their agent (herein in such capacity referred to as the "Lead Bank") to hold the Note, the Security Instruments, and the other Loan Documents, upon the terms

and subject to the conditions hereinafter set forth, and (Bank 1) is willing to act in such capacity.

NOW THEREFORE, in consideration of the premises and the mutual covenants herein contained, the parties hereto agree as follows:

1. *Sale of Participations*. (Bank 1) agrees to sell and (Banks 2 & 3) agree to purchase participations in the Loan in the amounts and in the Participation Percentages as set forth in section C above.

2. *Ownership Right*. To the extent of their Participation Percentage, (Banks 1, 2 & 3) shall be owners of an undivided fractional interest in the Loan, including but not limited to, the Note and Security Instruments, together with all Collateral securing such indebtedness.

3. *Designation of Lead Bank*. (Bank 1) shall act as the Lead Bank. Lead Bank shall hold all monies received in trust in a segregated account for the benefit of the Banks with amounts to be distributed pro rata. In all other respects, the relationship between the Lead Bank and the Banks is that of agent and principal.

In administering the Loan Documents, the Lead Bank will exercise the same care as it exercises with respect to collateral and loan documents relating to loans made for its account. The Lead Bank shall be obligated to perform its express duties, covenants, and obligations as agent hereunder in good faith and in accordance with the terms set forth herein. Neither the Lead Bank nor any of its respective directors, officers, agents, or employees shall be liable for any action taken or omitted to be taken by it or them hereunder, or in connection herewith or in connection with the Loan Documents, except for its or their own gross negligence, wilful misconduct, or bad faith.

4. *Conditions Precedent*. As conditions precedent to the closing of this Agreement, Lead Bank shall:

a. furnish Banks with a true and correct copy of the Note, Security Instruments, and all other instruments evidencing the loan indebtedness;

b. furnish Banks with evidence of the perfection of Lead Bank's lien;

c. furnish Banks with evidence of Borrower's acknowledgment of

this Agreement and Bank's respective Participation Percentages in the Loan.

5. *Lead's Administration*. Lead Bank shall manage and service the Loan and maintain all necessary books and records with respect thereto. Lead Bank shall receive and collect all payments of principal and interest along with an acknowledgment by Borrower of the Banks' respective Participation Percentages in the Loan that become due and payable on the loans and shall immediately place all such funds in a reserve account as soon as the same are collected, to be held for disbursement as provided below.

The Lead Bank shall not take any of the following actions with respect to the Loan Documents without the written consent of the Bank or Banks (which may include the Lead Bank) whose Participation Percentages with respect to the Note aggregate at least 51% (the "Majority Banks"): (i) amendment, modification, or express waiver of any material provision of any Loan Document; (ii) release of any Collateral for the Note; (iii) exercise of any acceleration right contained in a Loan Document; or (iv) realization on, or disposition of, Collateral by judicial proceedings or otherwise. The Lead Bank shall take any action with respect to the Loan Documents or any Collateral for the Note as is requested in writing by the Majority Banks; provided, however, that in no event shall the Lead Bank be required to take any action wherein, in its opinion, such action will be likely to expose it to expense or liability, unless tendered security and indemnity satisfactory to the Lead Bank against any and all costs, expenses, and liability other than its own Participation Percentage of such costs, expenses, and liabilities; and provided, further, that in no event shall the Lead Bank be required to take any action that, in its opinion, may be contrary to applicable law or regulation.

6. *Marking of Records, Inspection*. Lead Bank represents, warrants, covenants, and agrees to mark the Note, Security Instruments, and other instruments evidencing the Loan and the Collateral securing same, in a conspicuous manner so as to clearly identify Banks' Participation Percentages in the Loan and further agrees to mark all credit files, ledgers, and/or computer printouts and other records pertaining to the Loan.

Insofar as it is empowered to do so by the Loan Documents, the

Lead Bank shall from time to time at the request of any Bank authorize such Bank as its representative to inspect collateral, to examine and copy books and records of the Borrower or of any guarantor of the Note or any part thereof relating thereto, and to discuss the affairs of the Borrower or any such guarantor with the Borrower, guarantor, or the Borrower's owners, officers, and directors.

7. *Payments*. The Lead Bank shall hold as trustee for the Banks, as their respective interest may appear, all monies received, on account of the Loan through realization proceedings or otherwise. The Lead Bank shall first apply monies received with respect to the Note to bring the Banks into parity with respect to their Participation Percentages for the Note, both as to interest and principal payments and shall promptly remit to the Banks their respective Participation Percentages of all collected funds received of the Land Bank with respect to the Note to which the funds are attributable. All transfer of funds under this Agreement shall be made, to the extent possible, by wire in immediately available funds.

8. *Representations*. Lead Bank makes no representation and shall have no responsibility to the Banks with respect to the validity, genuineness, perfection or enforceability of the Note or any other instrument delivered in connection with the above described transaction, or the descriptions of the collateral, collectability of the Note, or the financial condition of the Borrower.

9. *Removal or Resignation of Lead Bank*. By a vote of the Majority Banks, the present Lead Bank may be removed and a new lead bank shall be designated. Such removal shall not affect the Participation Percentage of Lead Bank. In the event of such removal the Lead Bank covenants and agrees to transfer and assign all Loan Documents in its possession to the new lead bank immediately following notice of removal.

In the event of the Lead Bank's resignation, the Lead Bank covenants and agrees to transfer and assign all Loan Documents in its possession to the new lead bank within thirty (30) days of Lead Bank's resignation.

10. *Notices*. The Lead Bank shall promptly send by regular mail

to each of the Banks a copy of any material notice that it receives in its capacity as holder of the Loan Documents. Also, each Bank shall notify every other Bank of all information concerning the Borrower or the Loan Documents that such Bank deems to be material.

All notices, requests, and demands will be given to or made upon the respective Banks at their respective addresses specified on the signature page of this Agreement, or as to any party, at such other addresses as may be designated by it in writing to all such other parties. Written notice may be delivered by hand, sent by certified mail with return receipt requested, or by telex or cable.

11. *Counterparts*. This Agreement may be executed in any number of counterparts, all of which taken together shall constitute one and the same instrument.

12. *Governing Law*. This Agreement shall be construed in accordance with and governed by the laws of ________.

13. *Modification*. This Agreement may be amended only by a writing signed by all the parties hereto.

14. *Binding Effect*. This Agreement shall inure to the benefit of, and shall be binding on, the parties hereto and their respective successors and assigns; provided, however, that Lead Bank may not assign, transfer, or subdivide its interest in the Loan under this Agreement without the prior written consent of the Majority Banks.

15. *Invalidity*. If any one or more of the provisions of this Agreement shall for any reason be held to be invalid, illegal, or unenforceable in any respect, such invalidity, illegality, or unenforceability shall not affect the remaining provisions of this Agreement, and this document shall be construed as if such invalid, illegal, or unenforceable provision had never been contained herein.

16. *Entire Contract*. This Agreement constitutes the entire Agreement among the parties hereto and supersedes any and all prior and contemporaneous negotiations, agreements, and understandings among the parties hereto pertaining to the subject matter hereof.

17. *Headings and Construction*. The headings contained in this Agreement are inserted for convenience only, and shall not constitute a part hereof.

IN WITNESS WHEREOF, the parties hereto have entered into this Agreement as of the day and year first above written.

BANK 1
By ______________________________
Its ______________________________
Address______________________________
____

BANK 2
By ______________________________
Its ______________________________
Address______________________________
____

BANK 3
By ______________________________
Its ______________________________
Address______________________________
____