

August 2015

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Recommended Citation

Lapine, Kenneth M. (1978) "Loan Participations and the Savings and Loan Association: A Sleeping Giant Stirs," *Akron Law Review*: Vol. 11 : Iss. 3 , Article 2.

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LOAN PARTICIPATIONS AND THE SAVINGS AND LOAN ASSOCIATION: A SLEEPING GIANT STIRS

KENNETH M. LAPINE*

SAVINGS AND LOAN ASSOCIATIONS (S&L's) are specialized financial intermediaries which are organized and operated for two basic purposes: (1) to promote savings and (2) to provide residential financing. They are the principal source of residential credit in the United States today. At year end in 1976, S&L's held \$262 billion or 47.3 percent of all one-to-four family home mortgage loans¹ and \$28.1 billion or 27.6 percent of multi-family or apartment mortgage loans.² These two segments amounted to \$290.1 billion or 44.2 percent of all debt secured by residential real estate in the nation, more than the combined total of such debt held by commercial banks, savings banks and life insurance companies.³ In 1976, S&L's made or held 60.7 percent of the increase in one-to-four family home mortgages and increased their holdings of multi-family loans by \$2.7 billion, while other lenders in the private sector decreased theirs by \$1.4 billion.⁴

There are six principal sources of funds used by S&L's to make mortgage loans:

1. Savings deposits.
2. Advances from the Federal Home Loan Banks and commercial banks.⁵
3. Mortgage loan principal amortization and prepayments.
4. Retained earnings.

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¹ U.S. LEAGUE OF SAVINGS ASS'NS, FACT BOOK '77, 30-31 (1977).

² *Id.* at 33.

³ *Id.* at 31.

⁴ *Id.* at 29.

⁵ Only S&L's which are member-stockholders of one of the twelve Federal Home Loan Banks may borrow money through advances from the Federal Home Loan Bank of which it is a member. All federally chartered S&L's are required by the Home Owners' Loan Act of 1933 to belong to the Federal Home Loan Bank System. 12 U.S.C. § 1464 (f) (1970). State chartered S&L's, mutual savings banks and even life insurance companies may belong to the system on a voluntary basis. 12 U.S.C. § 1424 (1970).

5. Sales of loans and loan participations from existing mortgage portfolios.
6. Sales of debentures and mortgage-backed securities, such as GNMA modified pass-through bonds.

While all of these sources are important, this article will discuss the purchase and sale of mortgage loans. These loans may be transferred either in their entirety (whole mortgage loans) or in part (loan participations).

Savings and loan associations engage in the buying and selling of mortgage loans and loan participations in order to even out the supply and demand of available mortgage funds by channeling funds from areas of the country with an abundance of lendable cash to areas with a strong demand for mortgage money.⁶ In spite of the large sums of money involved, much of the trading resembles that conducted among the various stock brokerage firms in that the actual transactions are consummated in a fairly casual and informal fashion, with a strong measure of faith and reliance on the personal integrity and business reputation of those with whom business is transacted. This is possible because the primary actors in this market are fellow financial institutions which operate within a matrix of basic trading rules which are understood and tacitly followed by the parties.

Savings institutions have believed themselves to be secure in their mortgage trading practices, but recent failures of financial institutions and the entry into the mortgage market of non-regulated, non-banking entities have prompted some much needed re-examination of the real risks and the character of the legal relationships which arise from such transactions. This article shall identify those risks, particularly the insolvency of the originating lender, and the resulting consequences which may be visited upon the investing savings institutions.

I. THE BUSINESS OF BUYING AND SELLING LOANS

A. *Economic Considerations*

The sale of whole loans and loan participations has become more significant in recent years. In 1966, federally insured savings and loan associations⁷ sold \$788 million in whole loans and loan participations,

⁶ In the first quarter of 1976,

states in the West, Southwest and parts of the South tended to be net sellers of whole loans and loan participations in the secondary market. This [was] due to a relatively stronger loan demand compared to the supply of loanable funds. Conversely, in the Northeast and the Midwest, S&L's tended to be net purchasers due to weaker housing and loan demand relative to the availability of mortgage funds.

MORTGAGE FINANCE REV., First Quarter 1976, at 4.

⁷ For the purposes of this discussion, all references to savings and loan associations shall be those which hold savings accounts insured by the Federal Savings and Loan Insurance

which accounted for 5.7 percent of the total cash inflow to S&L's from their mortgage loan portfolios.⁸ By 1976, whole loan and loan participation sales had risen to \$8.4 billion, accounting for 18.4 percent of the total inflow.⁹

There has been an even greater increase in purchases by S&L's of whole loans and loan participations. Traditionally, most S&L's originated home acquisition and construction loans for retention in their own loan portfolios. However, since 1968 purchases of whole loans and loan participations have become more significant, both in dollar amount and as a percentage of the total loan portfolio. In 1968, S&L's originated \$21 billion in loans and purchased whole loans and loan participations totaling \$2.3 billion or 9.9 percent of the total loans added that year. In 1976, \$77 billion in loans were originated, but \$12.8 billion in whole loans and loan participations were acquired, making up 14.2 percent of the additions to loan portfolios for the year.¹⁰

There are several advantages to an S&L in purchasing participation interests in mortgage loans: (1) the S&L realizes a fixed rate of interest or yield in a long term mortgage loan without any origination expenses; (2) it is able to retain an investment in a mortgage loan with no servicing expense other than a fixed fee paid to the servicer of the loan (which is usually the primary lender who sold the participation interest in the loan to the S&L), which servicing fee is netted from the gross interest yield on the loan; (3) the income derived from the S&L's share of the loan qualifies for federal income tax purposes as "interest on loans secured by mortgages on real property" under Temporary Income Tax Regulations section 402.1-2 under the Tax Reform Act of 1969; and (4) the ownership of the participation interest is considered "a loan secured by an interest in real property" within the meaning of section 7701(a)(19)(C)(v) of the Internal Revenue Code. The latter two items are important to an S&L in obtaining its favorable federal income tax treatment.¹¹

Corp. (FSLIC) pursuant to 12 U.S.C. §§ 1724-1735g (1970). All federally chartered S&L's and any approved state chartered S&L's may insure savings accounts up to a limit of \$40,000. 12 U.S.C. § 1724 (Supp. V 1975). As of Dec. 31, 1976, there were 4,044 FSLIC-insured institutions with assets of \$383.2 billion. FACT BOOK '77 *supra* note 1, at 50-51.

⁸ FACT BOOK '77, *supra* note 1, at 76.

⁹ *Id.* at 76.

¹⁰ *Id.* at 69.

¹¹ See I.R.C. §§ 581, 582, 585, 593. Savings and loan associations first became subject to federal income tax in 1951. Until then they paid no federal income tax. In general, S&L's are now taxed as any other corporation with one major difference: under the percentage of taxable income method, an S&L may take a bad debt deduction equal to income which is added to loss reserves, up to specified limits. Until 1970 the percentage deduction was

A lender which sells whole loans or loan participations also gains important advantages: (1) the seller realizes additional funds or liquidity for reinvestment in the mortgage market; (2) the seller will normally continue to service the loans, which generates additional fee income;¹² (3) the seller retains any fees and points charged to the borrower when the loan is originated; and (4) the seller may realize an enhanced yield on its retained interest in the loan, because the whole loan or the participation interest is priced to reflect current interest rates available in the mortgage market, which may be less than the interest rate charged to the borrower.¹³ The seller-servicer collects the stated interest rate due on the entire principal amount of the loan but remits to the purchasing S&L only the proceeds based on the agreed interest rate on the purchasing S&L's proportionate interest in the loan. The result may be a higher yield to the seller-servicer on its retained investment in the loan.¹⁴

Besides seeking to improve liquidity, institutional lenders often sell loan

60 percent, but the Tax Reform Act of 1969 reduced this to 49 percent in 1973, 47 percent in 1974, 45 percent in 1975, 43 percent in 1976 and then by one percent per year to 40 percent in 1979. *Id.* § 593. This method of computing bad debt deductions was used by 82 percent of the savings associations, which held 87 percent of the industry's assets, in 1976. Simonson, *Savings & Loan Taxation*, FHLBB J. 25, 28 (Feb. 1978).

¹² Fees for servicing loans in which participations have been sold are determined in one of two ways. The fee may be set at a straight percentage of the unpaid principal balance of the loan per year (usually one-quarter to one-half percent) but paid monthly based on the loan balance at the beginning of each month. The second way is derived from the pricing of the loan participation. In this case, the loan participation is sold at par, and the yield to be paid by the seller-servicer on the participation is contracted to be X percent. The interest rate stated in the mortgage note, however, is greater than X percent, perhaps X½ percent. The difference, ½ percent, is retained by the servicer as the servicing fee.

¹³ The price to be paid for a loan pool will take into account the anticipated interest yield to the purchaser. A purchase price of par will produce the face or stated rates on the loans, whereas a purchase price of less than par, say 95 percent, will produce a yield in excess of the face rates of the loans. A simple example illustrates the pricing mechanism used in loan participation purchases (and whole loan purchases as well) in the secondary market. X S&L holds a mortgage with an interest rate of 9½ percent. However, at the time Y S&L wishes to buy the mortgage, the going market interest rate is 9 percent. X can either sell the mortgage at a premium or can sell the mortgage at par but only remit to Y interest at 9 percent. If the latter method is adopted, X will receive the amount necessary to adjust the 9½ percent mortgage to the current 9 percent interest rate over the life of the mortgage. Since sales of individual mortgages and participations in individual mortgages are totally impractical in the secondary mortgage market, it is customary for mortgage sellers to aggregate whole loans or participations and sell them in groups or "packages". In any group, there will inevitably be mortgages with a range of interest rates, some below, some at, and some above the current market rate. Buyer and seller will thus agree upon an interest rate with respect to the package. As to some of the mortgages, the seller may incur a loss over the life of the mortgage if the interest rate on the mortgage is less than the current rate; on others, the seller will realize a gain.

¹⁴ Consider this example: A 90 percent participation in a \$100,000 mortgage loan having a rate of interest of ten percent is sold to ABC Savings Association. XYZ Mortgage Company retains a ten percent interest in the loan. The 90 percent participation is sold for \$90,000 (plus accrued interest, which we shall ignore for the purposes of this example) which

participations to diversify and share their risk in a large number of mortgages. Sharing or reducing the risk of loss may not be that important in the case of a single mortgage loan on a single family residence, but it is certainly important in large multi-million dollar commercial property loans or in a large package of residential loans or a package of loans secured by properties concentrated in one project or in one geographic area. Another use of the loan participation is to bring the amount of the loan within the legal lending limits of the originating lender.¹⁵

Purchases and sales of mortgage loans by S&L's and other institutional lenders take place in the secondary mortgage market. This market consists of primary lenders, *e.g.*, savings and loan associations, banks and mortgage bankers, which originate loans for resale to other primary lenders and several government agencies such as the Federal National Mortgage Association (FNMA or "Fannie Mae"), the Government National Mortgage Association (GNMA or "Ginnie Mae") and the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac"). These agencies were organized to increase the liquidity and marketability of mortgage loans and to increase the segment of potential investors in mortgage loans.

B. *The Regulatory Limitations on Savings and Loan Association Powers*

All S&L's operate within the context of a federal and state regulatory matrix. Although they have the powers necessary and proper to enable

by agreement between ABC and XYZ is to yield 9½ percent (net of servicing fees) to ABC. The investment of XYZ in the loan is \$10,000.

	<u>ABC</u>	<u>XYZ</u>	<u>TOTAL</u>
Investment:	\$90,000	\$10,000	\$100,000
Total Annual Amount of Interest Attributable to Respective Shares of Principal Amount of Loan:	9,000	1,000	10,000
Total Income Received:	8,550	1,450	10,000
Annual Yield:	9½%	14½%	

Naturally, out of its 14½ percent return XYZ must cover its servicing expenses. On the other hand, XYZ received loan fees and perhaps loan points (a point is one percent of the original principal balance of the loan) when the loan was made.

¹⁵ Under the Home Owners' Loan Act of 1933 federally chartered S&L's may make an unlimited number of loans having an original principal balance of up to \$55,000 (with certain exceptions) on single family dwellings; any such loans in an amount in excess of \$55,000 must be limited in the aggregate to not more than twenty percent of the assets of the S&L. 12 U.S.C.A. § 1464 (c) (Supp. 1977). On October 12, 1977, President Carter signed the 1977 Housing Act, Pub. L. No. 95-128, § 22, 90 Stat. 1078, which now increases the loan limit to \$60,000 and includes in the "twenty percent of assets loans basket" only that portion of the loan in excess of \$60,000. Only the proportionate portion of the balance of a loan owned by the S&L is taken into account for determining in which basket the loan falls. S&L's are also subject to FSLIC regulations limiting the aggregate amount of loans any one borrower may have with an insured S&L. 12 C.F.R. § 563.9-3 (b) (1977). Selling a participation in such loans can alleviate these problems.

them to carry out the purposes of their organization,¹⁶ S&L's are corporations with limited powers.¹⁷ Among those powers which are limited is the power to invest its idle funds and to make loans. Generally an S&L may invest its funds only in securities enumerated by statute or regulation and may make only those loans which comply with statutory and regulatory requirements.¹⁸ Neither Ohio nor federally chartered S&L's have authority to make loans to third parties secured by pools of mortgage loans or other third party obligations. They do have authority to make loans secured by mortgages or deeds of trust on real property and to purchase or sell participation interests in such loans.¹⁹

Making investments and loans which do not comply with the applicable statutes or regulations will subject an S&L to a variety of administrative sanctions. Federally chartered S&L's are subject to administrative action under the Home Owners' Loan Act of 1933.²⁰ If the Federal Home Loan Bank Board charges and, after appropriate notice and hearing, finds that any statute, rule or regulation governing the lending or investment practices of the S&L has been violated or is about to be violated, the Board may issue an order to the S&L, its directors, officers, employees and agents to cease and desist from any such violation or practice, and to take affirmative action to correct the condition, including divestment of the illegal investment or loan.²¹ The Board may enforce its order through the removal or suspension of the individuals involved, and if necessary, the appointment of a conservator or receiver for the S&L. The Board may also apply for enforcement by the United States district court within the jurisdiction in which the home office

¹⁶ 12 U.S.C. § 1464 (a) (1970); OHIO REV. CODE ANN. § 1151.47 (Page 1968).

¹⁷ Federally chartered S&L's are organized and governed by the Home Owners' Loan Act of 1933, 12 U.S.C. §§ 1461-1468 (1970 and Supp. V 1975); Ohio chartered S&L's are organized under chapter 1151 of the Ohio Revised Code but are governed by the general corporation laws of Ohio (chapter 1701 of the Ohio Revised Code), except where there are special provisions of chapter 1151 on the same subject. Federally chartered S&L's are also subject to the requirements of 12 C.F.R. §§ 545.1-545.29 (1977) (rules and regulations for the Federal Savings and Loan System) and 12 C.F.R. §§ 563.1-563.45 (1977) (rules and regulations for the insurance of accounts); state chartered S&L's which are federally insured are subject both to the requirements of 12 C.F.R. §§ 563.1-563.45 (1977) and the law and regulations of the state in which they are domiciled.

¹⁸ 12 U.S.C.A. § 1464 (c) (Supp. 1977); 12 C.F.R. § 571.13 (1977) (documentation procedures in connection with the purchase of participations in large loan pools by S&L's); OHIO REV. CODE ANN. §§ 1151.29-1151.342 (Page 1968 & Supp. 1977).

¹⁹ Ohio chartered S&L's are permitted to purchase participations in any loan which would otherwise be a legal loan by the S&L if made locally. OHIO REV. CODE ANN. § 1151.311 (b) (Page Supp. 1977). Only the principal amount of the S&L's participating interest is included in applying any asset limitation test under chapter 1151 of the Ohio Revised Code. Federally chartered S&L's derive a similar authority under the Home Owners' Loan Act of 1933. 12 U.S.C.A. § 1464 (1969 & Supp. 1977); 12 C.F.R. §§ 545.6-545.8 (1977).

²⁰ 12 U.S.C. § 1464 (d) (1970).

²¹ 12 U.S.C. § 1464 (d) (1970); 12 C.F.R. §§ 550.1-550.4 (1977).

of the S&L is located. Similar authority is exercised over insured S&L's by the Federal Savings and Loan Insurance Corporation (FSLIC).²² In neither case, however, is there a specific statutory or regulatory scheme for dealing with illegal investments and loans.

State chartered S&L's are subject to administrative action by their respective state savings and loan regulatory agencies. With respect to Ohio chartered S&L's (which are referred to in the statute as building and loan associations), section 1151.18 of the Ohio Revised Code provides that every director, officer and member of an appraisal committee is subject to removal from office by the Superintendent of Building and Loan Associations for fraud, willful neglect of duty, or willful violation of any law governing building and loan associations. Section 1151.18 also prescribes the administrative procedures for such removal and the judicial rights of appeal. In addition, the Code contains provisions prohibiting and penalizing certain acts or conduct by directors, officers, employees and agents of the S&L, along with civil and criminal penalties for such acts or conduct.²³

An Ohio statute enacted in 1972 specifically deals with unauthorized loans and investments by state chartered S&L's.²⁴ If the Superintendent of Building and Loan Associations determines that an S&L has made or is holding any loan or investment not authorized by chapter 1151 of the Ohio Revised Code or by any regulations issued pursuant to section 1155.18²⁵ or has engaged in any practice likely to cause substantial dissipation of assets or earnings, he may serve notice on the S&L to the effect that he is considering the issuance of an order regarding such practice, loan or investment.²⁶ The notice must state the alleged facts constituting the basis for the order and fix a time and place for a hearing.²⁷ If, after the hearing, the Superintendent determines that an unauthorized loan or investment has been made or is being held, or that there is a

²² The National Housing Act and its companion regulations govern the termination of insurance of accounts and the possible termination of Federal Home Loan Bank membership, as well as cease and desist, removal and suspension powers of the FSLIC. 12 U.S.C. § 1730 (1970); 12 C.F.R. §§ 566.1-566.8 (1977).

²³ OHIO REV. CODE ANN. §§ 1153.01-1153.99 (Page 1968 & Supp. 1977) (willful misapplication of any moneys, funds or credits); *id.* § 1115.02 (Page Supp. 1977) (unauthorized loans and investments).

²⁴ *Id.* § 1155.02.

²⁵ OHIO REV. CODE ANN. § 1155.18 (Page 1968), the "parity" or "catch-up" statute, allows the Ohio Superintendent to grant powers to state chartered S&L's which federally chartered S&L's enjoy or will enjoy under federal law, rule, regulation or judicial decision, but are not possessed by state chartered S&L's under the existing laws of Ohio. Such catch-up regulations are effective for thirty months and automatically expire if not enacted into law before then.

²⁶ OHIO REV. CODE ANN. § 1115.02 (A) (Page Supp. 1977).

²⁷ *Id.* § 1155.02 (B).

practice likely to cause substantial dissipation of assets or earnings, he may order the S&L to do any one or more of the following: (1) establish a valuation reserve against the unauthorized loan or investment; (2) divest itself of such loan or investment within a reasonable time of not less than 90 days; (3) cease and desist from any unauthorized lending or investing practice, or any practice likely to cause substantial dissipation of assets or earnings.²⁸

The Superintendent also has authority to issue a summary cease and desist order with respect to such loans, investments and practices. After service of such an order, there must be a hearing. Unless the Superintendent issues a final order within ten days after the hearing, the summary order becomes void; otherwise, the summary order remains effective and enforceable until replaced by a final order, except to such extent as it is stayed, modified, terminated, or set aside by the Superintendent.²⁹ If, in his opinion, the Superintendent has reasonable cause to believe that a lawful summary order or final order has been violated, he may request the Ohio Attorney General to commence and prosecute any appropriate action or proceeding. Any court of competent jurisdiction may enforce such an order and grant such other relief as the facts warrant.³⁰

S&L's are quite sensitive about engaging in practices, such as the making of unauthorized loans or investments, which could bring down on them the heavy hand of their respective regulatory agencies. Moreover, it is the rare case when the management of an S&L will knowingly engage in such prohibited activities.

C. Regulation of Loan Participation Transactions by S&L's

The entry of S&L's into the secondary mortgage market has been relatively recent because prior to 1957 federal regulations prevented most S&L's³¹ from originating or purchasing whole loans secured by property located more than 50 miles from their home offices (except for FHA-insured and VA-guaranteed loans) without the approval of FSLIC.³² The purchase or

²⁸ *Id.*

²⁹ *Id.* § 1155.02 (C).

³⁰ *Id.* § 1155.02 (D).

³¹ Federally chartered S&L's were permitted to participate with other lenders in the making of loans of any type the S&L could otherwise make, provided the security property was located within the S&L's normal lending area and each of the lenders involved was either an instrumentality of the U.S. Government or an FSLIC-insured savings association or FDIC-insured bank. There were no FSLIC regulations restricting the ability of insured state chartered S&L's to participate in loans within the prescribed FSLIC lending area if such institutions had the power under their respective state laws to participate.

³² Certain uninsured S&L's and those taking advantage of a "grandfather clause" in the National Housing Act were excepted from these prohibitions. 12 U.S.C. § 1726 (b) (Supp.

sale of participating interests in loans secured by properties beyond the 50-mile limit was also forbidden.

Beginning in 1957, the Federal Home Loan Bank gradually permitted S&L's to enter the secondary mortgage market. By resolution dated March 29, 1957, the regulations governing the insurance of accounts and federally chartered S&L's were amended to permit such S&L's to acquire up to a 50 percent participating interest in a loan secured by property located beyond the 50-mile limit, provided the loan was originated and serviced by any other insured S&L. The selling S&L had to retain at least a 50 percent interest in each loan. In 1961 the FSLIC regulations as to whole loan purchases were changed to permit an insured S&L to make or purchase whole loans on homes located anywhere in the United States or its territories, provided the S&L had the basic corporate and statutory (in the case of state chartered S&L's) authority to make or purchase such loans. And in 1971, the participation regulations were revised to permit the purchase of up to a 90 percent participation interest with only ten percent retainage required of the selling institution.³³

Although S&L's are now able to participate in more loans, such activity is still subject to regulation. First, requirements regarding loan underwriting, ownership and servicing must be met. The security property must be located within a state, territory, or protectorate of the United States.³⁴ Then, if the property is located beyond the buying S&L's normal lending territory, the S&L may participate in a loan secured by a lien on such property only if the seller is an approved lender and the loan is serviced by or through a local approved lender.³⁵ The approved lender must

V 1975). In addition, other S&L's could make or purchase any whole loan on the security of real estate located outside its normal lending territory provided that such loans "[were] made pursuant to regulations of [FSLIC]." *Id.* At that time the FSLIC regulations permitted such loans only if they were VA-guaranteed (*see* 12 C.F.R. § 561.21; FEDERAL GUIDE, UNITED STATES LEAGUE OF SAVINGS ASSOCIATIONS 6115-9, § 563.9 (c)), or if they were insured, in whole or in part by the FHA (12 C.F.R. §§ 561.20, 563.9 (d)). No other extra-territorial loans could be made without the approval of FSLIC. *Id.* § 563.9 (f). Compliance with the regulations is a condition to the insurance of accounts. 12 U.S.C. § 1726 (b) (Supp. V 1975).

³³ U.S. League of Savings Ass'ns, Special Management Bulletin S #143, Jan. 25, 1974.

³⁴ 12 C.F.R. § 563.9-1 (b) (1977).

³⁵ The term "approved lender" includes

- (i) Any institution whose accounts or deposits are insured by the Federal Savings and Loan Insurance Corporation or the Federal Deposit Insurance Corporation;
- (ii) Any agency or instrumentality of the United States [*e.g.*, FNMA, GNMA, FHMLC] or of any state [*e.g.*, state housing agencies, the Ohio Housing Development Board] engaged in the making, purchasing, or selling of loans on the security of real estate or in the purchasing or selling of participation interests in such loans;
- (iii) Any approved Federal Housing Administration mortgagee; and
- (iv) Any service corporation in which the majority of the capital stock is owned by one or more insured institutions.

12 C.F.R. § 563.9 (g) (1) (1977).

have either its main office or a branch or agency office located within 100 miles of the real estate securing the loan, or the security real estate must be located within its normal lending territory.³⁶ The seller, if a local approved lender, may continue to service the loan. In any event, at the close of the transaction the seller must retain ownership of at least ten percent of the outstanding principal balance.³⁷ In addition, if the seller is not an insured institution, an appraisal report or certificate of valuation must be obtained by the purchasing S&L.³⁸

If the requirement regarding ownership and service by or through an approved lender fails to be met, the buying insured S&L must dispose of the loan or its participation interest within 90 days from the date that the requirement ceases to be met unless an approval for an extension of this 90-day period is obtained in writing from the FSLIC.³⁹ Another option open to a purchasing S&L, should the local approved lender or servicing requirements cease to be met, would be to qualify the loan or its participation interest therein under the FSLIC nationwide lending regulations.⁴⁰

Secondly, the FSLIC regulations place limitations on the volume of loan participation activities on the basis of certain asset ratios of both the buyer and seller. An insured institution may invest no more than 40 percent of its assets in participations in conventional loans secured by properties located beyond its normal lending territory.⁴¹ In addition, it is

³⁶ *Id.* §§ 563.9-1 (a), 563.9-1 (b) (5).

³⁷ *Id.* § 563.9-1 (b). There is no retainage requirement for FHA-insured or VA-guaranteed loans. *Id.* § 563.9-1 (b) (i).

³⁸ *Id.* § 563.10 (c).

³⁹ *Id.* § 563.9-1 (b) (3).

⁴⁰ *Id.* § 563.9. The basic differences between loans and loan participations held under section 563.9-1 and 563.9 are that (1) the S&L's purchases under section 563.9 may not exceed fifteen percent of the S&L's assets, but under section 563.9-1 the asset limitation is twenty percent and (2) the seller-servicer must retain a ten percent ownership interest in the loans under section 563.9-1, but no ownership interest is required of the servicer under section 563.9.

⁴¹ *Id.* § 563.9-1 (b) (4). Participations in FHA-insured and VA-guaranteed loans are exempt from this 40 percent figure. Participations under the nationwide lending regulations are subject to a separate fifteen percent limitation. *Id.* § 563.9 (e).

State chartered associations have their own limitations imposed by state law and regulations. *E.g.*, OHIO REV. CODE ANN. § 1151.311 (Page 1968), which authorizes state chartered S&L's to make or buy participations in loans, prescribes no asset limitation on the amount of loan participations in which an S&L may invest. It does provide, however, that only the amount of the S&L's participation interest in a loan shall be counted within the asset limitation for the type of loan in which the participation interest is held. In other words, if the loan is one which, if made in its entirety by the participating S&L, would be subject to a ten percent asset limitation category, the principal amount of the participation interest owned by the S&L would be included in its asset limitation category for such loans.

Since compliance with the FSLIC regulations is a condition to governmental insurance of an S&L's accounts, 12 C.F.R. § 563.9-1 (b) (4) (1977), the FSLIC figure would govern as to insured institutions, whether federally or state chartered, if the appropriate state law or regulation contained no asset limitations or were less stringent than the FSLIC limitation.

not permitted to buy a participation from any insured institution which had, at the close of the semiannual period immediately prior to the proposed sale, scheduled items in excess of four percent of its specified assets, unless the selling S&L had prior written approval of the FSLIC to make such a sale.⁴²

D. Loan Participations as a Financing Technique

It is important to distinguish the sale of loan participations from the use of loan participations as a financing technique. While a sale results in the transfer of ownership of an undivided interest in a loan, the use of loan participations as a financing technique results in an arrangement whereby the participant acquires only a security interest in the original loans. In the latter transaction the participant loans funds to the originating lender, who uses the original loans as collateral to secure repayment of the funds advanced by the participant, much like accounts receivable factoring.

Under federal law, insured S&L's are prohibited from engaging in this type of financing, but banks, insurance companies, finance companies, mortgage bankers and other lenders often borrow money from other lenders against the security of pools of loans and other types of third party obligations. For example, in a "loan warehousing" transaction, a mortgage banking firm will originate mortgage loans and conditionally assign them to a bank, which will then lend the mortgage banker funds against the security of the mortgage loans to use in making more mortgage loans. The bank loan will eventually be satisfied out of the proceeds of the sale of the pledged mortgage loans in the secondary market. The mortgage banker will then repeat the process, warehousing the newly made mortgage loans pending their sale in the secondary market. Since the pledged mortgage loans are not sold to the bank and were not originated with a view to such sale, the mortgage banker is not acting in any agency or fiduciary capacity for the commercial bank. There is no question that this type of transaction is intended by all parties to be a secured financing arrangement.

Even though this transaction differs from a sale in regard to both intent and the location of title, the outward indicia of the transaction closely resemble a sale. In both cases all documentation for the original mortgage loan will have been written and recorded in the name of the lead lender, and all documents, together with any collateral, will be retained by the lead. Thus, at the time the lead sells or pledges all or part of its interest in the loan, it will be both the equitable and legal owner of the entire loan. Upon the subsequent sale of a participation in, or hypothecation

⁴² 12 C.F.R. § 563.9-1 (b) (2) (1977).

of, the loan there will be no change in the possession of the loan documents, including the note, or the state of the public record title to the loan and the collateral therefor (such as the mortgage or financing statement) or the state of knowledge of the borrower as to the ownership of the obligation or the existence of the interests therein. The borrower will probably never know that such a transaction involving his obligation ever occurred and will continue to deal exclusively with the lead lender, relying on the lead's apparent sole ownership of the obligation.

Because of the similarities between the two types of transactions, it is often difficult to differentiate one from the other. If all goes smoothly, there is no need to do so. But if there is a mishap along the way, and litigation becomes necessary, the distinction is crucial, for the legal consequences flowing from a sale are quite different from those which flow from a secured transaction. One of the most important of these is that secured transactions are subject to the provisions of Article 9 of the Uniform Commercial Code,⁴³ so that the lender-participant will not have the protection he needs in insolvency proceedings involving the lead lender unless his interest is perfected. An owner-participant, on the other hand, will own an interest in the mortgage, which will give him an interest in the property superior to other creditors and a trustee in bankruptcy of the insolvent lead lender.⁴⁴

E. The Mechanics of Buying and Holding Loan Participations

In spite of the billions of dollars involved and the dramatic impact that secondary mortgage market transactions may have on the earnings of both buying and selling S&L's, scant attention has been given to the legal ramifications of buying, selling and owning loan participations. No guidance is provided the S&L industry by its regulatory agencies other than to prescribe who may buy, who may sell, who may service loan participations and how much an S&L may buy or sell. The rest of the process has been left to practice and experience, which until April, 1976 had been relatively trouble-free.

A loan participation offering is usually made by telephone or letter from a mortgage banking company or a mortgage broker on behalf of the lender who has or plans to originate the pool of loans. The solicitation is directed to the prospective purchasing S&L's chief executive officer or the head of its secondary mortgage market department. The description of the offering is often limited to the following items: (1) the aggregate unpaid principal balance of the loans; (2) the net interest yield to the purchasing

⁴³ U.C.C. § 9-203 (1).

⁴⁴ See text accompanying notes 84-127 *infra*.

S&L on the aggregate participation; (3) the kinds of mortgages making up the package; (4) the location of the security properties; and (5) the anticipated date of delivery of the loan participation for funding. The offer may be accepted on the spot on the basis of this data, followed by a brief and informal letter of acceptance or commitment to purchase from the purchasing S&L. If the purchasing S&L issues a written commitment, it will probably state a date or time period at the conclusion of which it will purchase the participation and during which it will review the loans and/or inspect the security properties. The commitment letter may also outline the S&L's requirements regarding the copies of loan documentation it desires or is compelled by FSLIC regulations to have for its files, such as an appraisal report or certification of value for each security property, a copy of a credit report on each borrower, and a copy of the note and mortgage deed for each loan.⁴⁵ The purchasing S&L might also receive a commitment fee⁴⁶ which is usually based on the principal amount of the loan participation. Finally, either the seller or the purchaser will supply a form of participation agreement, which should spell out the procedures for servicing the loans by the seller-servicer and for handling the allocation and disbursement of the loan proceeds.

In reality, the purchasing S&L is concerned primarily with the quality of the loans, the net yield (gross interest yield less servicing fees and

⁴⁵ Examples of other details discussed in a typical commitment letter are (1) the underwriting standards of the purchasing S&L which must be satisfied as a condition to purchase; (2) possible reimbursement to the purchasing S&L of expenses incurred in inspecting the mortgaged properties; and (3) regulatory requirements which must be met by the seller in the origination and sale of the loans, particularly those relating to flood insurance (Flood Disaster Protection Act of 1973, 42 U.S.C. §§ 4001-4128 (1970 & Supp. V 1975); 12 C.F.R. § 523.29 (1977)); Truth in Lending disclosures (Consumer Credit Protection Act of 1968, 15 U.S.C. §§ 1601-1655 (1970 & Supp. V 1975)); and the disclosures under the Real Estate Settlement Protection Act of 1974, 12 U.S.C. §§ 1601-1665 (Supp. V 1975).

⁴⁶ The commitment fee is generally in the range of one percent of the principal amount of the participation interest to be purchased. This fee compensates the purchaser for standing ready to purchase the participation interests if and when the loans are delivered, which may be up to one year from the date the purchaser commits to purchase. The fee compensates the purchaser for remaining at risk as to fluctuations (usually upwards) in the mortgage market. If the seller does not deliver the loans as promised, the purchaser keeps the commitment fee; the usual commitment does not require the seller to deliver. If interest rates for mortgages have fallen since the time the commitment was issued, the seller will not wish to deliver the participations. He is better off keeping the loans in his own portfolio or selling them to someone else at a premium or higher price. On the other hand, if interest rates have risen between the time of the issuance of the commitment and time set for delivery, the seller will deliver the participations at the agreed upon yield, and keep the difference in rates for himself. Armed with a commitment, a seller can be assured of a "take-out" on the loans it will then attempt to originate. In some cases, a seller of loan participations will sell participations in an existing pool of loans and it may be necessary to pay the purchaser a "commitment fee" to adjust the yield on the underlying package of loans to a yield commensurate with the yield available in the market place at the time of delivery of the loan participations.

private mortgage insurance premiums) and compliance with the applicable regulations of its supervisory agencies. It relies a great deal on the honesty and business reputation of the selling and servicing institutions. There is also the attitude that because such transactions are mostly between large or regulated financial institutions, it is impossible for anything to go wrong. As a result, very little attention is directed toward assuring that the acquired loan participation is safe from attack and seizure by creditors of the seller-servicer or from the possible resale by the seller to another purchaser. Too often one hears the rationale, "If we are too particular or fussy in our requirements in the secondary mortgage market, no one would do business with us; there are plenty of other buyers around who could willingly take and get all the good deals."

II. THE RISKS OF LOAN PARTICIPATIONS

Notwithstanding the regulatory framework within which S&L's must operate, they cannot hide behind it or rely on it to protect them against the risks and realities of the financial world. Such realities are that the seller-servicer may be dishonest or unscrupulous, subject to financial pressures or insolvent. The fact that these events have seldom occurred is no guarantee that they will not happen more frequently in the future. The billion dollar loan participation market has been a sleeping giant: it is big, you cannot miss noticing it, but it has been somnolent, bothering no one, and so ignored. But recently it has begun to awaken and the first twitches of consciousness have brought chills to the spines of savings and loan and mortgage banking company executives everywhere. It is therefore desirable to consider the preventive measures that may be taken to avoid unnecessary exposure to financial ruin.

The source of the uncertainty about the rights of the buying participant is that in most loan participations the seller-servicer retains possession of the mortgage loan documents. Possession is important for two reasons: it is one of the essential ways to perfect a secured interest in collateral in cases where the transaction is characterized as a financing arrangement,⁴⁷ and it creates rights in the possessor as a holder under Article 3 of the Uniform Commercial Code.

Because the concept of a "holder" overlaps the concept of an "owner", it may be argued that the holder of the notes is also the owner. However, this conclusion is not necessarily true; a party may own an interest in an instrument and not be the holder and vice versa.⁴⁸ Consider mortgage loan

⁴⁷ U.C.C. § 9-304 (1) provides that "[a] security interest in instruments . . . can be perfected only by the secured party's taking possession."

⁴⁸ See U.C.C. § 3-301, which contemplates that a holder need not be the owner.

notes which are negotiable instruments and may be transferred by negotiation or delivery to a holder or a holder in due course.⁴⁹ A transfer of less than the entire instrument operates only as a partial assignment,⁵⁰ and as such the S&L participant is neither a holder nor a holder in due course, but it is nevertheless an owner and as such takes priority over subsequent creditors, including judgment lien creditors of the seller-servicer.⁵¹ On the other hand, the seller-servicer, because of its retained possession of the mortgage documents, is a holder, albeit in its capacity as a fiduciary and agent. Permitting the seller-servicer to retain possession of the mortgage documents poses risks for the participant.

A. *Resale of the Loan*

The seller-servicer may fraudulently or inadvertently resell the loan in which the S&L owns a participation interest to a holder in due course or to a bona fide purchaser for value who has no knowledge of the S&L's interest therein.⁵² This would defeat the rights of the participant,⁵³ even when the loan is secured by a mortgage.⁵⁴

Exposure to this risk can be reduced by placing some indicia, legend or notice on the note in order to prevent its inadvertent negotiation or transfer to a third party without notice of the participant's interest therein. Other possible courses of action would be to have the party having the largest participation interest retain possession of the loan documents (also with proper notice inscribed thereon) or have an independent third party hold the documents in trust for the participants. Transferring possession has the added benefit of perfecting a secured interest in the loan in the event that the transaction is later deemed to be a financing arrangement.

⁴⁹ See U.C.C. § 3-202, which defines "negotiation" as "the transfer of an instrument in such form that the transferee becomes a holder." "Holder" is defined in U.C.C. § 1-201 (20) as "a person who is in possession of . . . an instrument . . . drawn, issued, or indorsed to him or to his order or bearer or in blank." "Holder in due course" is defined in U.C.C. § 3-302 (1) as a holder "who takes the instrument (a) for value, and (b) in good faith and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person."

⁵⁰ U.C.C. § 3-202 (3). "Thus, when a mortgage is subdivided into participation interests, each recipient of a participation certificate is a partial assignee." R. POWELL, *REAL PROPERTY* § 455 (1966).

⁵¹ See *Kilgore v. Buice*, 229 Ga. 445, 192 S.E.2d 256 (1972); *Walton v. Horkan*, 112 Ga. 814, 38 S.E. 105 (1901).

⁵² See *In re Commonwealth Corp.*, No. TBK 74-14 (N.D. Fla., filed June 25, 1974), which involved a large mortgage banking firm which was servicing nearly \$500,000,000 of mortgages at the time it filed for reorganization under Chapter XI. It came to light during the bankruptcy proceedings that Commonwealth had sold the same loans and participations in loans to multiple purchasers. The case was publicized in *Wall St. J.*, July 25, 1974, at 32, col. 1; *Wall St. J.*, Feb. 2, 1976, at 1, col. 6.

⁵³ U.C.C. § 3-301.

⁵⁴ *Annot.*, 127 A.L.R. 190, 198 (1940).

None of these practices would prevent the seller-servicers from continuing to service the loans. The seller-servicer needs access to the original documents only at times of loan payoff and cancellation, which would be effectuated in its fiduciary capacity for all the participants. Execution of satisfactions of mortgage or assignments thereof (in the case of their sale) would be performed by the participants and forwarded to the seller-servicer for processing and recording where appropriate. This method of operation has already been established in the case of whole loans, where the owner of the loan normally has possession of the original documents and the seller-servicer does not. The only reason the seller-servicer of a loan participation normally retains possession is that it has been customary; since the early loan participation regulations required the seller-servicer to retain a minimum 50 percent interest in participations, it was just as convenient to have the seller-servicer retain possession of the loan documents because each participant was an equal joint tenant. Now that the regulations require the seller-servicer to retain as little as ten percent interest in the loan, the seller-servicer is likely to have a minority interest in the loan, and the practice is no longer supportable on that ground. In cases where there are several participants in a loan, and no one has a predominant interest, an independent trustee could retain possession of the loan documents.

B. Failure to Transmit Loan Payments to the Participant

The seller-servicer may collect the loan payments without transmitting to the S&L its share of the payments. Payment to the party in possession of the instrument is normally sufficient to discharge the debtor,⁵⁵ so the S&L would have no recourse against the mortgagor.

This risk cannot be eliminated in an acceptable fashion by transferring possession to the participant. While the purchaser of a whole loan could be assured of receiving any funds coming from the debtor by notifying the debtor of the new ownership and requiring future payments to be made directly to it, this solution prevents the seller from acting as a servicer. It is not even practicable in the case of loan participations. In cases of multiple ownership, the debtor would be making partial payments to the several owners, and no one would be charged with managing the loan as a whole. In any event, this problem is essentially one between the two financial institutions, and as between themselves there is not much question as to the rights of the owner or lender. Preventive measures consist only in ascertaining the personal integrity and business reputation of the seller-servicer.

⁵⁵ *Murphy v. Barnard*, 162 Mass. 72, 38 N.E. 29 (1894); U.C.C. § 3-301; Annot., 103 A.L.R. 653, 654 (1936).

C. *Claims by Creditors of the Seller-Servicer*

The most serious risk—because it is the one most likely to materialize—is that a judgment creditor of the seller-servicer or, if the seller-servicer becomes insolvent, a receiver or trustee in bankruptcy, may attempt to levy upon or claim an interest in the mortgage loan superior to that of the S&L participant. Various arguments might be made to attack the claim of the participant: that the transaction is voidable as a preference under section 70(a) of the Bankruptcy Act; that the interest has no priority over the rights of a hypothetical lien creditor under section 70(c) of the Bankruptcy Act; or that permitting the seller-servicer to retain the documents in its own name gives rise to an estoppel in favor of a creditor relying on the fact that the seller-servicer had in its possession apparently unencumbered mortgage loans.⁵⁶

To protect itself against this risk, the purchaser of loan participations should make sure that the nature of the participation agreement and the typical course of conduct between it and the seller-servicer clearly indicate that the seller-servicer is acting in the role of an agent for the participants (including itself, to the extent that it has retained an interest in the loans) and as a trustee,⁵⁷ retaining bare legal title and physical possession of the notes, mortgages and other loan documents with respect to participations sold. If this is done, a court should have no difficulty in finding a trust relationship between the parties even if it is not expressly created in the participation agreement.⁵⁸

To understand why this arrangement protects the participant from claims asserted by the creditors, trustee in bankruptcy or receiver of the seller-servicer, it is necessary to understand the manner in which Article 9 of the Uniform Commercial Code and the Bankruptcy Act apply to the transaction. The balance of this article will discuss this complex interaction.

⁵⁶ See note 100 *infra*.

⁵⁷ See notes 84-93 *infra*.

⁵⁸ In *Coffey v. Lawman*, 99 F.2d 245 (6th Cir. 1938) (applying Tennessee law), the Sixth Circuit held that where a national bank sold participation shares in a mortgage pool and the bank retained the mortgage notes and mortgages in its name in order to service the same by the collection of principal and interest, the bank's liability to participation certificate holders was to be measured by the law applicable to trusteeship although the participation agreement was silent. "Whether termed 'trustee' or 'agent' the bank occupied a trust relationship to them in the collection of interest on the mortgages and the other duties resting on it and its liability must be measured by the law applicable to trusteeship." *Id.* at 248. *Accord*, *In re Penn Central Transp. Co.*, 486 F.2d 519 (3rd Cir. 1973); *In re Clemens*, 472 F.2d 939 (6th Cir. 1972); *Stratford Financial Corp. v. Finex Corp.*, 367 F.2d 569 (2d Cir. 1966) (trust relationship between seller and purchaser of a \$40,000 participatory interest in a \$50,000 loan evidenced by ten \$5,000 promissory notes of third party); *Mayfield v. First Nat'l Bank*, 137 F.2d 1013 (6th Cir. 1943).

III. THE BANKRUPTCY OF THE SELLER-SERVICER

A. *Type of Proceedings*

There is a limited array of companies with whom an insured S&L may participate under regulations of the Federal Savings and Loan Insurance Corporation. These include FDIC- and FSLIC-insured financial institutions, certain state and federal governmental agencies, service corporations owned by FDIC- and FSLIC-insured institutions, and bank or savings and loan holding companies or their subsidiaries.⁵⁹ The nature of the seller-servicer determines the type of insolvency proceeding that is conducted. Banks and S&L's are not covered by the Bankruptcy Act;⁶⁰ the insolvency of these entities is handled in an equitable receivership proceeding. However, the claims of creditors against other approved lenders are governed by the Bankruptcy Act.⁶¹ The bankruptcy or insolvency of each of the entities may also pose different problems to the S&L participant as to how intense may be the attack against its ownership interest in a loan.

1. Receivership of Banks and S&L's

In the case of the insolvency of an FDIC-insured national bank, the FDIC is automatically appointed receiver of the bank, and the receivership is conducted under the provisions of the Federal Deposit Insurance Act.⁶² Typically the FDIC attempts to merge the failed bank or to sell as much of the realizable assets of the bank to another bank in consideration of the acquiring bank's assuming the liability of the failed bank's deposits. The

⁵⁹ Participation loans purchased under 12 C.F.R. § 563.9-1 (1977) must be purchased from an "approved lender." ("Approved lender" is defined at note 35, *supra*.) In the case of participations in "nationwide loans" purchased under 12 C.F.R. § 563.9 (e) (2) (1977), the participation must be with an "approved lender," and the loan must be serviced by an "eligible servicer." An eligible servicer may be an approved lender; a corporation whose stock is owned wholly by one or more institutions with FDIC-insured deposits; a bank holding company or subsidiary thereof which has an FDIC-insured institution as a subsidiary; or a savings and loan holding company or subsidiary thereof. *Id.* § 563.9 (g) (2). ("Bank holding company subsidiary" is defined in 12 U.S.C. § 1841 (d) (1970); "savings and loan company subsidiary" is defined in 12 C.F.R. § 583.14 (1977)).

The same requirements apply to Ohio chartered S&L's, whether or not they are federally insured, except that subsidiaries of bank holding companies are excluded. OHIO REV. CODE ANN. § 1151.311 (Page Supp. 1977).

⁶⁰ Section 4 of the Bankruptcy Act, 11 U.S.C. § 22 (1970), exempts banking corporations and building and loan associations from coverage. The term "building and loan association" may be construed to include both state and federally chartered associations. An argument could be made, however, that the term "building and loan association" is a term of art which refers to a state chartered association and does not include a federally chartered S&L. This argument can be answered by pointing out that 12 U.S.C. § 1729 (b) (1970) provides for the appointment of a receiver "[i]n the event that a Federal savings and loan association is in default," so that the insolvent federally chartered S&L still would not be covered by the Bankruptcy Act.

⁶¹ 11 U.S.C. § 22 (1970).

⁶² 12 U.S.C. §§ 1821, 1822 (1970 & Supp. V 1975); 12 C.F.R. §§ 306.1-306.3 (1977).

FDIC then attempts to liquidate the remaining assets and enforce and collect debts and claims due the failed bank. Concurrently, the FDIC undertakes to settle, compromise and obtain the release of claims against the failed bank, and if any assets are left over after satisfying claims and paying the expenses of the receivership, a distribution may be made to the stockholders of the failed bank. Similar procedures are followed in the case of a failed FSLIC-insured institution where the FSLIC is appointed receiver.⁶³

In the case of insolvent state chartered insured banks or savings associations, liquidation may proceed under state statutes,⁶⁴ which usually call for the appointment of the state supervisory authority as the receiver. As a practical matter, the receivership of a state chartered S&L is similar to that conducted under the federal statutes, and may be assumed by FSLIC if the institution is federally insured and certain other conditions exist.⁶⁵

In each case the receiver is charged with marshalling the assets, realizing on those assets, paying the costs of administration, discharging claims of creditors and distributing any excess assets to the shareholders. The issue of the S&L's ownership rights in mortgage loans nominally held by a bankrupt seller-servicer can be an important issue in any of these liquidations. Is the participation purchaser an owner of an undivided interest in a loan or is it a creditor of the bankrupt seller-servicer? If a creditor, is the S&L a secured or unsecured creditor?

It might be thought that neither the FDIC- nor the FSLIC-receiver would be likely to challenge the ownership interest of the S&L participant. After all, these regulatory agencies have been instrumental in promoting an active secondary mortgage market in order to assure that funds from capital-rich areas flow easily to capital-short areas of the nation. It would therefore be extraordinary for either agency to do anything to injure insured institutions or do anything which would threaten the health of the secondary mortgage market.

Furthermore, regulations of the FSLIC and the Federal Savings and Loan System specifically provide for the purchase, sale and holding of participation interests in mortgage loans and prescribe certain procedures and practices to be followed. Because S&L's are prohibited under these regulations from lending funds against the security of mortgage loans, either FDIC or FSLIC might assume that the S&L acted legally and purchased participation interests in loans.

⁶³ 12 U.S.C. § 1729 (b) (1970).

⁶⁴ 12 U.S.C. § 1821 (e) (1970) (state chartered insured banks); *id.* § 1729 (c) (1) (state chartered insured S&L's).

⁶⁵ *Id.* § 1729 (c).

Nevertheless, the divisions of these agencies which are charged with liquidation of insured institutions have one principal objective: to realize as much as possible from the disposition of the assets of the defunct institution to cover the insurance proceeds paid to depositors and to cover other liabilities assumed by the insurance corporation. The fact that challenging the ownership character of a loan participation would be injurious to the well-being of the secondary mortgage market is no guarantee that under the right circumstances the FDIC or FSLIC would not attack the loan participant's ownership position.⁶⁶ And in the case of insured state chartered

⁶⁶ The vision of most governmental bureaucrats is quite narrow, and the overall impact of an agency's actions is contemplated and appreciated only at the highest administrative levels. Consider this example of FHLBB "support" during the Hamilton bankruptcy proceedings. Once the payments due on a loan participation become ninety days in default, the participating interest in that loan becomes a "scheduled item", as that term is defined in 12 C.F.R. § 561.15 (1977). In the case of the Hamilton participations, the payments on the underlying mortgages were, for the most part, being made currently by the mortgagors; the trustee in bankruptcy collected and held them in escrow accounts established for each affected S&L. But because these payments were not currently being passed through to each S&L, the FHLBB preliminarily indicated that each S&L would have to treat its participation interest in each loan as a scheduled item. This, of course, further restricted the S&L's ability to deal in the secondary market and to engage in certain other activities. See text accompanying note 42 *supra*. In response to this Mr. Charles E. Allen, counsel for several of the S&L's involved in the Hamilton case, argued, in a letter dated July 7, 1976 and addressed to Daniel J. Goldberg, then acting general counsel of FHLBB, that:

The definition of "scheduled items" in Section 561.15 (a) and (b) refers to "slow loans" which are defined in Section 561.16. Since the mortgage loans involved in the participation agreements are within the 1 year to 7 years old category, Section 561.16 (b) which uses a 90 days contractually delinquent period is the relevant provision. Section 5 in the Outline following Section 561.16 in the FHLBB Annotated Manual describes "contractual delinquency" as "any amount due and owing to an institution by a borrower which is unpaid". Section 4 of the Outline refers to a "contractually required payment" as the total payment which the contract requires of the borrower". In our view, the references to "borrower" in sections 4 and 5 of the Outline when applied to 90% participations means the mortgagors who are obligated to make payments of principal and interest on the mortgage loans purchased by the associations. The term "borrower" could not refer to Hamilton based on the position of the associations that they purchased assets of Hamilton (i.e., 90% participation interests in specified mortgage loans) and did not loan money to Hamilton. The associations do not view Hamilton or the Hamilton Bankruptcy Trustee as a debtor (secured or unsecured) but rather consider the Hamilton Bankruptcy Trustee (and Hamilton prior to bankruptcy) to be collecting payments from borrowers (i.e., mortgagors) in trust for their benefit based on their ownership interest in the 90% mortgage loan participations purchased.

To characterize the participation agreements as debt obligations which would appear necessary in order to conclude that they constitute "slow loans" would be to accept the Hamilton Bankruptcy Trustee's position in the litigation—a position which the Federal Home Loan Bank Board, Federal Savings and Loan Insurance Corporation, and Federal Home Loan Mortgage Corporation are disputing in amicus briefs being prepared to be filed in support of the 90% ownership interest of the associations in the mortgage loans.

The terms of the participation agreements meet the requirements of Section 563.9 and Section 563-9.1. Although the purported transfer prior to the bankruptcy filing of a 9.9% interest (all but .1% of the 10% retainage required by the participation agreements) in the mortgages by Hamilton to Hamilton National Bank if upheld would cause the 90% participations to no longer satisfy Section 563.9-1, the participations would

institutions, there is no guarantee that the FDIC or FSLIC will even be appointed the receiver. State supervisory authorities and other court-appointed receivers are not likely to be concerned with fostering and protecting the national secondary mortgage market; the protection of local depositors and creditors is bound to be their paramount concern.

2. Bankruptcy of Other Approved Lenders

Other "approved lenders" fall into two categories: (1) service corporations, bank holding companies and their non-bank subsidiaries, and S&L holding companies and their non-S&L subsidiaries and (2) state or federal instrumentalities that engage in the secondary mortgage market as sellers. There is no question that the federal Bankruptcy Act would apply to the group of financial organizations in the first category,⁶⁷ and Chapter IX of the federal Bankruptcy Act⁶⁸ appears to apply to the bankruptcy of governmental agencies. Chapter IX provides for the preparation and court confirmation of a plan of composition of the debts of the petitioning governmental agency. While the agency seeks the approval of the plan by the required number of creditors affected by the plan, the agency continues in operation, somewhat as in a Chapter XI arrangement. In formulating its plan, the petitioner sorts out and classifies the various claims, modifies or

still meet the requirements of Section 563.9 which do not require a 10% retainage by the local servicer. Hamilton continues to satisfy the requirements in Section 563.9 for an "eligible servicer" since as we understand it is still an "approved Federal Housing Administration mortgagee". Even if such status was lost Hamilton would still be a subsidiary of a bank holding company of which an institution insured by the FDIC is a subsidiary and therefore an "eligible servicer." Unless the FSLIC is taking the position that these participation agreements are secured borrowings rather than agreements reflecting the purchase of mortgage loans, the transaction with Hamilton does not involve a loan made to Hamilton, and as a result whether or not payments are transmitted on a timely basis by the Hamilton Bankruptcy Trustee to the associations is not relevant in determining whether a "slow loan" is involved. We submit that as far as the definition of "slow loans" is concerned, the FSLIC should look only at payments being made by the mortgagors since they are the borrowers referred to in the Outline to Section 561.16. If the FSLIC were to view Hamilton as the borrower under these participation agreements, it would appear necessary for the FSLIC to take a similar position with respect to participation agreements of the type generally used by other FSLIC insured institutions and the FHLMC. This would mean that participation agreements are loans to the originator/servicer which is not the type of loan transaction a Federally chartered association or many State chartered associations have authority to make since it would be viewed as a loan collateralized by first mortgages rather than as a first mortgage loan.

Mr. Goldberg answered in a letter dated August 6, 1976, that the FHLBB had determined that "in the event that any such association hereafter fails to receive such payment, the provisions of Section 561.15 of our Insurance Regulations (12 C.F.R. Section 561.15) would apply."

⁶⁷ Insofar as is relevant here, section 4 of the Bankruptcy Act, 11 U.S.C. § 22 (1970), excepts only banks and building and loan associations from its provisions. Therefore, holding companies, which are separate entities, are covered by the Act, although their bank and S&L subsidiaries are not. *In re Banker's Trust Co.*, 566 F.2d 1281 (5th Cir. 1978).

⁶⁸ 11 U.S.C. §§ 401-403 (1970).

alters the rights of creditors, secured or unsecured, and generally enjoys all of the avoidance and strong-arm powers of a trustee in bankruptcy under section 60⁶⁹ and section 70⁷⁰ of the Bankruptcy Act.

However, the odds against a state or federal instrumentality such as GNMA⁷¹ or FHLMC⁷² going bankrupt or admitting it are extremely high. If such an unlikely event were to occur, it is hard to imagine that the agency would take a position adverse to participation purchasers since each of these agencies is dependent on the secondary mortgage market for its lifeblood. The ownership issue is theoretically a possibility, but a very remote one.

When the Bankruptcy Act governs the proceedings, several common precepts of law apply: (1) the legal custodian takes charge of the property of the bankrupt and protects the interests of all of the creditors, (2) he examines, allows, compromises, classifies and may object to claims of creditors, and (3) he is vested with the title of the bankrupt as of the applicable date of bankruptcy, which means that he has no better title to the bankrupt's property than belonged to the bankrupt when the legal custodian's title accrued.⁷³ Local law largely determines the nature of these rights. Hence, status of a participant's interest in a loan against that of the seller-servicer's trustee in bankruptcy will most often turn on whether the participation relationship falls within the scope of Article 9 of the Uniform Commercial Code.

B. *The Hamilton Mortgage Corp. Case*

The risk of the possible bankruptcy of a seller-servicer became a reality

⁶⁹ *Id.* § 96.

⁷⁰ *Id.* § 110.

⁷¹ The Government National Mortgage Association (GNMA) is a statutorily created corporate instrumentality of the United States within the Department of Housing and Urban Development. 12 U.S.C.A. §§ 1716-1723e (1969 & Supp. 1977). GNMA provides special assistance for the financing of (1) selected types of home mortgages originated under special housing programs designed to provide housing of acceptable standards at full economic costs for segments of the national population which are unable to obtain adequate housing under established home financing programs, and (2) home mortgages generally as a means of retarding or stopping a decline in mortgage lending and home selling activities. Among other things, GNMA guarantees the timely payment of principal and interest of certain securities issued by the Federal Home Loan Mortgage Corp.

⁷² The Federal Home Loan Mortgage Corporation (FHLMC) is a statutorily created corporate instrumentality of the United States. 12 U.S.C. §§ 1452-1459 (1970 & Supp. V 1975). FHLMC was established primarily for the purpose of increasing the availability of mortgage credit for the financing of urgently needed housing. FHLMC seeks to provide an enhanced degree of liquidity for residential mortgage investments primarily by assisting in the development of secondary markets for conventional mortgages. The principal activity of FHLMC consists of the purchase of residential conventional mortgages or interests in such mortgages and the resale of mortgages or interests so purchased.

⁷³ *Hewitt v. Berlin Mach. Works*, 194 U.S. 296 (1904); 4A W. COLLIER, *BANKRUPTCY* ¶ 70.04 (14th ed. 1976).

on April 14, 1976, when a trustee in possession in a Chapter XI bankruptcy proceeding⁷⁴ claimed that those who had thought that they had purchased participation interests in mortgage loans were not owners at all, but that they were mere lenders. Worse than that, he claimed that their interests were "untransferred, unendorsed, unassigned, and/or undelivered" and therefore vulnerable to claims of priority by lien creditors under section 9-301(1)(b) of the Uniform Commercial Code and consequently to the trustee in bankruptcy under the "strong-arm" provisions of the Bankruptcy Act. In support of his claim, the trustee pointed out that the mortgage loan notes and mortgage deeds on their face indicated that the bankrupt seller-servicer was the sole mortgagee; the trustee was the sole possessor of the mortgage notes, and the real estate records showed that the bankrupt was the sole mortgagee.

The impact of this announcement can be better appreciated when it is realized that the claimants were 27 federally insured S&L's who had purchased 90 percent participation interests in approximately 61 million dollars worth of first mortgage loans secured by residential properties located primarily in Georgia and Tennessee. The bankrupt company was the Hamilton Mortgage Corp. (Hamilton) of Atlanta, Georgia, a wholly-owned mortgage banking subsidiary of Hamilton Bankshares, Inc., whose principal subsidiary was the FDIC-insured Hamilton National Bank of Chattanooga, Tennessee. The trustee also informed the savings and loan associations that he was withholding from them all loan remittances received from the mortgagors "pending determination of certain legal matters." In addition, he temerarily alleged that payments received by the S&L participants during the four months preceding the filing of bankruptcy were payments on account of an antecedent debt, which were therefore in violation of section 60 of the Bankruptcy Act, and so should be set aside and the funds returned to the trustee.

To understand the basis for the trustee's claim, it is helpful to know the procedures and practices followed by the purchasing S&L's and Hamilton, the seller-servicer. Because the procedures were similar to those typically used for loan participations in the industry, they also shed light on the key legal issues surrounding loan participations.

Following the acceptance by Hamilton of an S&L's commitment to purchase a particular dollar amount of loan participations, Hamilton and the S&L would enter into a loan participation agreement. The participation agreement provided that Hamilton would sell to the S&L, and the S&L

⁷⁴*In re* Hamilton Mortgage Corporation, No. BK-1-76-264 (E.D. Tenn., filed Feb. 20, 1976) (originally filed as a voluntary bankruptcy but converted to a Chapter XI rehabilitation proceeding on Mar. 29, 1976).

would purchase from Hamilton, for full value, a 90 percent participation interest in first mortgage residential loans originated by Hamilton which met the underwriting standards of the S&L.

Following the execution of the participation agreement, Hamilton would tender to the S&L "credit packages" relating to mortgage loans originated by Hamilton. Each credit package related to a specific mortgage loan, and each contained the usual information desired by the S&L to determine whether it wanted to purchase a participation interest in that loan, *i.e.*, the principal amount, interest rate and other pertinent terms of the loan, an appraisal and photographs of the property securing the loan, copies of the mortgagor's loan application, credit report and employment verification, real estate purchase contract, Federal Truth-in-Lending Disclosure Statement, hazard insurance policy and policy of title insurance. After reviewing each credit package submitted by Hamilton and, in some cases, after inspecting the mortgaged property, the S&L, through its loan committee, decided whether to accept or reject the mortgage loan and thereafter communicated its decision to Hamilton. If the S&L decided to purchase a 90 percent interest in any of the mortgage loans, a participation certificate identifying those loans was prepared and executed by Hamilton and delivered by Hamilton to the S&L pursuant to the terms of the applicable participation agreement. The participation certificates stated that it evidenced a 90 percent participation interest in each note and mortgage identified therein and that such interest was being sold, transferred and assigned by Hamilton, as "seller," to the S&L, as "purchaser". Thereupon, the S&L would wire to Hamilton funds constituting 90 percent of the aggregate unpaid principal balance of the mortgage loans identified in that participation certificate (plus any adjustment for accrued interest applicable to those mortgage loans).

Under each participation agreement the S&L was entitled to receive out of the amount actually paid by the mortgagor during the preceding month 90 percent of the principal payment plus interest on 90 percent of the outstanding mortgage loan, payable at the rate specified in the participation agreement and participation certificate. The difference between the interest rate specified in the certificate and the average interest rate of the mortgage loans covered by the certificate compensated Hamilton for servicing the mortgage loans and reflected the pricing of the loans at the time of their sale by Hamilton to the S&L. In each case the amount received as interest at the rate specified in the certificate was less than the amount of the interest payment from the mortgagor.

After the purchase was consummated Hamilton flagged each mortgage loan file in which it sold a participation interest by placing an orange card

in the loan folder stating that a 90 percent participation interest in that loan had been sold to a named S&L. Each S&L (known in the trade as an "investor") was also assigned a code number by Hamilton. Hamilton provided to a computer service the investor code number and the loan number of the mortgage loan in which the participation was sold. No document was filed in any public record disclosing the sale of the participation interest and no communication was directed to the mortgagor informing him of the sale. The mortgagors were expected to and did in fact continue to treat Hamilton as the mortgagee and sent their mortgage payments directly to Hamilton.

The payments from the mortgagors would arrive at the offices of Hamilton on a daily basis and would be entered in a log by loan numbers. Those payments would be deposited that same day in a bank clearing account. The mortgagor payment cards would be immediately sent to the computer service which would furnish information to Hamilton the next day as to the amounts paid on each loan purchased in whole or in part by an investor. That same day, a check would be drawn upon the Hamilton clearing account for the full amount of the mortgage loan payment (less any portion attributable to real estate taxes and hazard or credit life insurance premiums) and deposited by a courier in a trust account which Hamilton established for the particular S&L investor. The trust accounts consisted of checking accounts opened in the name of "Hamilton Mortgage Corporation as Trustee for (name of the investor)." Once a month, Hamilton would remit to the investor a check drawn upon that trust account payable to the investor in the amount of the proceeds allocable to the investor's 90 percent participation interest. After making each monthly payment to the investor, Hamilton would draw a check on the investor trust account to the order of Hamilton for the balance. As a matter of operating convenience in performing its servicing responsibilities, Hamilton normally made the monthly payments to the investor based on amounts due from the mortgagors whether or not the payments had actually been received. Hamilton would later adjust subsequent payments to the investor to the extent necessary to recapture any amounts paid out which Hamilton had not eventually received from the mortgagors.⁷⁵

Finally, Hamilton's audited financial statements listed only its ten

⁷⁵ Hamilton Mortgage made payments from its own funds where a loan was delinquent for up to three months. These payments were made for administrative purposes (the stream of income to the participants was uninterrupted by minor delays or temporary delinquencies in remittances from mortgagors) and for good investor relations. When it appeared that a loan was seriously in default and likely to go into foreclosure, the amounts theretofore gratuitously paid by Hamilton were repaid to itself and deducted from the next remittance to the S&L investor (participant).

percent retainage in the pools of loans as an asset and did not show the 90 percent portion as a liability, *i.e.*, a loan from the S&L's.

For the trustee in possession to have prevailed it would have been necessary to show that the parties intended that the transaction be that of lending of funds by the S&L to the mortgage banking firm. In response, the S&L's asserted that the transaction was intended to be a sale—in fact, a loan of funds to a mortgage banker such as Hamilton would have been unlawful for a federally chartered S&L and most state chartered S&L's—and that Hamilton acted for the investors as an *agent* with respect to servicing and as a *trustee* with respect to receipt of the loan payments, functioning as a conduit for the funds flowing from the mortgagor to the investor. Unfortunately, there was sufficient uncertainty as to the outcome of litigation to lead the trustee and the S&L's to settle the controversy out of court.⁷⁶

C. *The Applicability of Article 9 of the Uniform Commercial Code*

1. Operation of the Code

The Uniform Commercial Code splits a loan participation transaction into two distinct parts: (1) the transfer of the interest in the note and (2) the characterization of the transfer as either a sale or a credit transaction. The governing sections are those dealing with instruments, as the note given by the mortgage borrower to the seller-servicer is an "instrument" as defined in Article 9: "any . . . writing which evidences a right to the payment of money and is not itself a security agreement or lease and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment."⁷⁷

If a claimant has a security interest in the note, perfection of that interest could occur only by taking possession of the instrument.⁷⁸ If the interest is not perfected by transfer of possession, it is subordinate to "the rights of . . . a person who [became] a lien creditor before the security interest [was] perfected."⁷⁹ The Code specifically provides that the term "lien creditor" includes a trustee in bankruptcy or a receiver in equity.⁸⁰ In the context of a loan participation the mortgage documents usually remain in the possession of the loan servicer; hence a lender-participant's

⁷⁶ See note 129 *infra*.

⁷⁷ U.C.C. § 9-105 (1) (i). References to the Uniform Commercial Code and Official Comments are to the 1972 edition, which has been adopted in about thirteen states. Differences between this version and the 1962 edition, which is the law in Ohio, will be noted in the footnotes.

⁷⁸ *Id.* § 9-305. If the original loan were characterized as a general intangible instead of an instrument, perfection could be accomplished only by filing a financing statement. *Id.* § 9-302.

⁷⁹ *Id.* § 9-301 (1) (b).

⁸⁰ *Id.* § 9-301 (3).

interest would be unperfected and subject to the claim of the trustee in bankruptcy.

However, where the seller-servicer *sells* the instrument or an undivided interest therein, Article 9, by its terms, does not apply. Article 9 applies only "to any transaction (regardless of its form) *which is intended to create a security interest* in personal property or fixtures, including goods, documents, instruments, general intangibles, chattel paper, or accounts."⁸¹ No sale, other than of accounts or chattel paper,⁸² is covered by Article 9. This result is not changed by the fact that the note which is sold is secured by a mortgage lien.⁸³

Comment 4 to Section 9-102 summarizes the Code's coverage of the transfer of an interest in a mortgage loan:

The owner of Blackacre borrows \$10,000 from his neighbor, and secures his note by a mortgage on Blackacre. This Article is not applicable to the creation of the real estate mortgage. Nor is it applicable to a sale of the note by the mortgagee, even though the mortgage continues to secure the note. However, when the mortgagee pledges the note to secure his own obligation to X, this Article applies to the security interest thus created, which is a security interest in an instrument even though the instrument is secured by a real mortgage. This Article leaves to other law the question of the effect on rights under the mortgage of delivery or non-delivery of the mortgage or of recording or non-recording of an assignment of the mortgagee's interest.

Thus the determination of whether a loan participation is covered by Article 9, and thus subordinate to the claims of a trustee in bankruptcy,

⁸¹ *Id.* § 9-102 (1) (a) (emphasis added). The Ohio statute also includes transactions creating security interests in contract rights. OHIO REV. CODE ANN. § 1309.02 (A) (1) (Page 1962). Legal commentators have agreed that sale of a partial interest in the loan, rather than of the entire loan, does not make the transaction one that creates a security interest. *E.g.*, COOGAN, HOGAN & VAGHTS, SECURED TRANSACTIONS UNDER THE U.C.C. § 23.11 at 2395 (1977); Armstrong, *The Developing Law of Participation Agreements*, 23 BUS. LAW. 689 (1968); Simpson, *Loan Participations: Pitfalls for Participants*, 31 BUS. LAW. 1977 (1976); Stahl, *Loan Participations: Lead Insolvency and Participants' Rights*, 94 BANKING L.J. 882 (1977).

⁸² U.C.C. § 9-102 (1) (b). The Ohio statute also includes the sale of contract rights. OHIO REV. CODE ANN. § 1309.02 (A) (2) (Page 1962).

⁸³ U.C.C. § 9-102, Comment 2, states that

If an obligation is to repay money lent and is not part of chattel paper, it is either an instrument or a general intangible. A sale of an instrument or general intangible is not within this Article, but a transfer intended to have effect as security for an obligation of the transferor is covered by subsection 1 (a). *In either case the nature of the transaction is not affected by the fact that collateral is transferred with the instrument or general intangible.* Such a transfer is treated as a transfer by operation of law, whether or not it is articulated in the agreement.

Accord, id. § 9-105, Comment 2; 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, 271-73 (1965).

hinges on whether the transaction is characterized as a sale of an interest in the loan or as a lending of money secured by an interest in the mortgage loan.

2. Characterization of Participation Interests

Under section 70(a) of the Bankruptcy Act the trustee in bankruptcy is given only those rights or title to the bankrupt's property that belonged to the bankrupt itself at the time the trustee's title accrued.⁸⁴ Thus, "the trustee takes the bankrupt's property subject to all valid liens, claims and equities . . . [and also] succeeds to the bankrupt's interest in the property of others."⁸⁵ If the seller-servicer holds the mortgage documents as a trustee for the loan participant, it cannot claim ownership based on that possession. As the seller-servicer holds the property subject to the outstanding interests of the beneficiaries, so does the trustee in bankruptcy.

The rule is elementary that a trustee in bankruptcy or reorganization succeeds to only the title and rights in property that the particular debtor had formerly possessed; and that, where the debtor had been in possession of trust property, the bankruptcy or reorganization trustee holds such property subject to the outstanding interest of the beneficiaries. Thus, where a cestui que trust is able to point to the specific trust property that is being held by the bankruptcy or reorganization trustee, he is rightly entitled to claim this property as his own and to withdraw it from the bankruptcy or reorganization proceeding free from the conditions that may have been imposed upon the general or secured creditors.⁸⁶

⁸⁴ *Hewitt v. Berlin Mach. Works*, 194 U.S. 296 (1904); 4A COLLIER, *supra* note 73, ¶ 70.04 at 55.

⁸⁵ 4A COLLIER, *supra* note 73, ¶ 70.32 at 445-46.

⁸⁶ *American Service Co. v. Henderson*, 120 F.2d 525, 530 (4th Cir. 1910). In an analogous fact situation (holders of participation certificates in oil syndicates whose assets were oil leases held in the name of the seller of the certificates), the Fifth Circuit impressed a trust and held that the trustee in bankruptcy had no right to proceed against the oil lease properties since the certificate holders were not creditors of the bankrupt but owners of the trust property, which ought to be turned over to its true owners. The court explained:

It is not clear to us why these syndicate trusts have been administered at all in the bankruptcy of Elliot. Though these oil properties stood in the name of Elliot, the bill states he did not own them, but the two groups of unit holders did. He was their agent and so far as he held legal title, was their trustee. It is argued that a bankruptcy trustee takes title to all property to which the bankrupt has title, even though it be held in trust. Though this be true, when it appears that the bankrupt is only a trustee and has no beneficial interest in or claim against the property, the court ought to turn it over to its true owners where possible. Here the State court of equity has appointed receivers to administer these trusts, and so far as the bill discloses the property ought to have been turned over to them. The unit holders are not by virtue of their certificates creditors of Elliot. They are the equitable owners of these trust properties.

Todd v. Pettit, 108 F.2d 139, 140 (5th Cir. 1939). See also *Rumsey Mfg. Corp. v. United States*, 206 F.2d 565 (2d Cir. 1953); *In re Hercules Service Parts Corp.*, 101 F. Supp. 455 (E.D. Mich. 1951), *aff'd sub. nom. Hercules Service Parts Corp. v. United States*, 202 F.2d 938 (6th Cir. 1953). See generally 4A COLLIER, *supra* note 73, ¶ 70.25 at 339-64.

The nature of participation interests in loans was the subject of substantial litigation in the late 1930's and early 1940's, generated as a result of the reorganization of the Prudence Company under section 77B of the Bankruptcy Act. The Prudence Company had originated mortgage loans in the New York City area, which loans were represented by the mortgagor's execution and delivery of bonds and mortgages to the Prudence Company. Thereafter, the Prudence Company sold participation interests in the bonds and mortgages to the public. These interests were represented by participation certificates. Unlike the case with S&L participations, however, the Prudence Company guaranteed payment of the interest on the bonds when due and payment of the principal when due or within eighteen months thereafter. The entire transaction was consummated by the delivery of participation certificates for cash. When the mortgagors and Prudence both defaulted during the Depression, the courts addressed the issue of the status of the certificate holders.

The courts uniformly held that the certificate holders were partial assignees of the loans evidenced by the bonds and secured by the mortgages and were therefore vested with an equitable interest therein, although legal title remained in the holder of the bonds and mortgages as trustee for the certificate holders. The courts which considered the Prudence defalcations in the bankruptcy context treated the certificate holders as owners and tenants in common of the bonds and mortgages to which the certificate pertained. In discussing the nature of the rights and obligations of the parties, the Second Circuit Court of Appeals said that

Here, however, *undivided shares* in a certain mortgage were assigned by means of the [participation] certificates which contained no promise of payment except by reference to the terms of the mortgage itself. The obligation of Prudence Company, Inc. was a guaranty to pay interest on the bonds and mortgages when due, and payment of the principal when due or within eighteen months thereafter with interest after maturity and not otherwise to pay the certificates at all. The certificate holders, *as the owners of the mortgage as tenants in common*, became entitled to have payments made on the mortgage distributed to them in accordance with the terms of their certificates and to have the mortgage paid in accordance with its terms and the guaranty of the Prudence Company, Inc.⁸⁷

That position was reiterated a year later *In re Prudence Co.*:

By the guaranty the Prudence Company was granted an irrevocable agency which nevertheless is held to be revocable upon default on its guaranty. Whether or not there is a default is not clear. But this is

⁸⁷ *In re Westover, Inc.*, 82 F.2d 177, 180 (2d Cir. 1936) (emphasis added).

not material since even if a default exists, the fact remains that the right of revocation inures to the benefit not of the depository but of the certificate holders who, after all, are the *real owners of the mortgage and the parties primarily interested*.⁸⁸

S&L participants should enjoy a more secure position than the participants did in *Prudence*, because sales of loan participations to S&L's are normally without recourse and carry no guarantee from the seller that principal and interest on the mortgage loans will be paid.⁸⁹

The Supreme Court of Errors of Connecticut, rejecting a contention similar to that argued by the Hamilton trustee, held that mortgage loan participants purchased an ownership interest—not a security interest—in the notes and mortgages which the mortgagee holds in trust for them.

To hold that the effect of the transaction was to make the mortgage merely collateral security would be to regard the guaranty of the company to pay the interest and principal of the mortgage as the primary obligation to which the assignment was incidental, whereas, as we read the agreements, the purchase by the certificate holder of an undivided share in the mortgage and the assignment of such a share to him was the primary object of the agreements, to which were attached, as incidents, the obligations and powers of the company. *The certificate holder under these agreements was not buying merely an obligation of the company to pay him certain sums of money secured by collateral, but was purchasing a share in certain definite property owned by the company*, subject, however, to the terms and conditions expressed in the agreements.

While the agreements contain no specific authority to the defendant to foreclose the mortgage in case of default, the power conferred upon it to collect, sue for and receive the principal and interest and to take any action it may deem necessary or desirable in order to protect the interests of the holders of certificates, would give it implied authority, in case the debt was not collectible in money, to bring foreclosure proceedings. The certificate holders as partial assignees became vested with a beneficial interest in the mortgage although the legal title remained in the defendant. Whatever would have been the relationship

⁸⁸ *In re Prudence Co.*, 89 F.2d 689, 692 (2d Cir. 1937) (citation omitted). *Accord*, *Prudence Realization Corp. v. Ferris*, 323 U.S. 650 (1945); *Prudence Realization Corp. v. Geist*, 316 U.S. 89 (1942); *Delatour v. Prudence Realization Corp.*, 167 F.2d 621 (2d Cir. 1948); *In re 1934 Realty Corp.*, 150 F.2d 477 (2d Cir.), *cert. denied*, 326 U.S. 734 (1945); *Prudential Ins. Co. v. Liberdar Holding Corp.*, 72 F.2d 395 (2d Cir. 1934); *In re Espade Realty Corp.*, 66 F. Supp. 683 (E.D.N.Y. 1946); *In re R.A. Security Holdings Inc.*, 46 F. Supp. 254 (E.D.N.Y. 1942), *aff'd sub. nom.* *Brooklyn Trust Co. v. R.A. Security Holdings, Inc.*, 134 F.2d 164 (2d Cir. 1943).

⁸⁹ 12 C.F.R. § 563.23 (1977) and OHIO REV. CODE ANN. § 1151.311 (c) (Page 1976) provide that sales of loan participations by S&L's must be made without recourse.

between the parties before the property came into the possession of the corporation, it would, after foreclosure, have held it charged with a trust for the certificate holders so far as their interests were concerned.⁹⁰

Numerous state court decisions agree with this analysis and either hold, state in dicta or imply that holders of participation certificates are the beneficial owners of an undivided interest in the notes and mortgages held in the name of the mortgagee; and the mortgagee holds the notes and mortgages, together with payments made by the mortgagors, in either an express or constructive trust for the benefit of those participants.⁹¹

The Internal Revenue Service has concurred with this position. In recent years it has considered various arrangements to sell participations in pools of mortgages in the secondary mortgage market. In each case the IRS concluded that for tax purposes the pool of mortgage loans constituted a trust, that each participation certificate holder was an owner of an undivided interest in the trust, that the seller of the participation interest acted as a fiduciary holding the pool of mortgage loans in trust for the benefit of the certificate holders, and that the certificate holders acquired equitable ownership in each of the mortgage loans in the pool.⁹²

Finally, legal scholars who have studied the nature of a participation certificate have concluded that the delivery thereof for value constitutes a *partial assignment of a chose in action*, which effectively transfers to the participant an undivided interest, as tenant in common with the mortgagee-

⁹⁰ *More v. Western Conn. Title & Mortgage Co.*, 128 Conn. 360, 23 A.2d 128, 132 (1941) (citations omitted) (emphasis added).

⁹¹ *E.g.*, *FDIC v. Mademoiselle of California*, 379 F.2d 660 (9th Cir. 1967); *Capital Nat'l Bank v. Chancellor Properties, Inc.*, 291 So. 2d 35 (Fla. App. 1974); *Interstate Trust & Banking Co. v. Breckenridge*, 189 La. 1057, 181 So. 535 (1938); *Croghan v. Savings Trust Co.*, 231 Mo. App. 1161, 85 S.W.2d 239 (1935); *Tannenbaum v. Seacoast Trust Co.*, 16 N.J. Misc. 234, 198 A. 855 (Ct. of Ch., N.J. 1938), *aff'd*, 125 N.J. Eq. 360, 5 A.2d 778 (1939); *Kelly v. Middlesex Title Guar. & Trust Co.*, 116 N.J. Eq. 228, 172 A. 487 (Ct. of Ch., N.J. 1934); *Kelly v. Middlesex Title Guar. & Trust Co.*, 115 N.J. Eq. 592, 171 A. 823, *aff'd*, 116 N.J. Eq. 574, 174 A. 706 (1934); *City Bank Farmers Trust Co. v. Silberberg*, 280 N.Y. 424, 21 N.E.2d 493 (1939); *In re Title & Mortgage Guar. Co.*, 275 N.Y. 347, 9 N.E.2d 957 (1937); *Pink v. Thomas*, 257 App. Div. 354, 13 N.Y.S.2d 226, *rev'd*, 282 N.Y. 10, 24 N.E.2d 724 (1939); *Malinoski v. Mekody*, 48 N.Y.S.2d 940 (S.Ct. 1944), *aff'd sub nom. Kuehnle v. Malinoski*, 269 App. Div. 717, 53 N.Y.S.2d 758 (1945); *In re Brooklyn Trust Co.*, 163 Misc. 117, 295 N.Y.S. 1007 (S.Ct. 1936); *In re Bond & Mortgage Guar. Co.*, 157 Misc. 240, 283 N.Y.S. 623 (S.Ct. 1935); *In re N.Y. Title & Mortgage Co.*, 160 Misc. 67, 289 N.Y.S. 771 (N.Y. Co. 1936); *Kline v. 275 Madison Ave. Corp.*, 149 Misc. 747, 268 N.Y.S. 582 (N.Y. Co. 1933); *State ex rel. Squire v. Central United Nat'l Bank*, 4 Ohio Op. 485 (C.P. 1935); *Pacific Nat'l Bank v. Hall*, 12 Wash. App. 336, 529 P.2d 855 (1974).

⁹² *Rev. Rul. 27*, 1973-1 C.B. 46; *Rev. Rul. 399*, 1971-2 C.B. 433; *Rev. Rul. 545*, 1970-2 C.B. 7; *Rev. Rul. 544*, 1970-2 C.B. 6.

assignor, in the underlying note(s) and mortgage(s) — which survives the bankruptcy of the mortgagee-assignor indefinitely.⁹³

There is, however, one case, recently decided, which runs counter to the line of authority discussed above. The United States District Court for the Southern District of New York in *In re Alda Commercial Corp.*⁹⁴ held that a lender-borrower situation existed between the bankrupt finance company and the participant and, in rejecting the participant's claim to an ownership interest, relegated him to a general creditor status.

Alda was in the factoring business. It made loans to various commercial businesses secured by their accounts receivable and other collateral. Silverman (the petitioner) and Baron entered into participation agreements with Alda, wherein they were to be joint venturers with Alda in two such loans, each being granted an undivided interest to the extent of ten percent of the full amount of the loans and the accounts receivable. The participation agreements also provided that Alda would pay each participant an amount equivalent to interest at the rate of twelve percent per annum on the amount of participation for each month. Alda was to receive as compensation for its services the difference between the amount received from its debtors and the charges paid to the participants. Both the advances from the participants and the money owed by the debtors were paid directly to Alda and deposited in Alda's general account. Alda managed all the transactions and took the security in its own name. Alda's name alone appeared on the financing statements regarding the security furnished by its debtors. None of the debtors had any notice of the participants' interest in the loans, although this interest was reflected on Alda's records and books. Physical delivery of participation certificates, although called for in the agreement, was not effected.

In this fact situation, the court first held that the petitioner did not have a protectable ownership interest. The referee found, as did the court, that had a joint venture truly existed, the petitioner would have been entitled to share in the profits of Alda's business, would have participated with Alda in the determination to lend money to the debtors and would have helped in arranging for collections of the accounts receivable and attaining security for loans.⁹⁵ And because there was no segregation of accounts, the court held that Alda could not have been a trustee or an agent for the petitioner.⁹⁶

⁹³ IV A. CASNER, *AMERICAN LAW OF PROPERTY* § 16.120 (1952); 2 G. GLENN, *MORTGAGES, DEEDS OF TRUST, AND OTHER SECURITY DEVICES AS TO LAND* § 317 (1943); 3 R. POWELL, *REAL PROPERTY* § 456 (1966).

⁹⁴ 327 F. Supp. 1315 (S.D.N.Y. 1971).

⁹⁵ *Id.* at 1317.

⁹⁶ *Id.* at 1318.

At best, the petitioner was a limited partner in Alda's business and, as such, was required to give notice under the New York Partnership Law to protect his interest.⁹⁷

Next, the court found that the petitioner was actually "an investor in a part of the bankrupt's business, from which he expected to derive interest at a higher rate than might otherwise have been available to him."⁹⁸ However, this unrecorded security interest was "unenforceable as against the creditors of the bankrupt since no notice was given to them under the Uniform Commercial Code."⁹⁹

Although the *Alda* decision is subject to criticism in several respects,¹⁰⁰

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ First, the court ignored the intention of the parties, which was to create a joint venture. Surely the petitioner would have taken a security interest in all of the bankrupt's accounts and not just a small portion of them, if a financing arrangement were contemplated.

Second, the court reached the conclusion that if any ownership were created, it could only have been a limited partnership. As such the notice under the statute governing limited partnerships was required to be filed, and failure to do so misled the bankrupt's creditors. But failure to form a limited partnership does not result in a financing arrangement. It is well established that limited partnerships can be formed only by strict compliance with statutory requirements, and where these requirements are not met, a general partnership results. Finding that a general partnership existed would have supported the petitioner's claim because the creditor of a bankrupt partner (here Alda) may reach only the property of the bankrupt and its share of the partnership assets. *In re Petroleum Corp.*, 417 F.2d 929, 935 (8th Cir. 1969).

Third, the court's finding that there was no agency or trust relationship between Alda and Silberman seemed to turn solely on the fact that the bankrupt did not segregate or plan to segregate the pledged accounts receivable. There is no analysis provided to explain why segregation is so critical, other than to suggest that by not segregating the accounts, an estoppel is created in favor of creditors relying on the bankrupt's possession of the property. But lack of segregation should not necessarily mean that the bankrupt could not be acting as an agency or fiduciary capacity. *National Bank v. Insurance Co.*, 104 U.S. 54, 68-69 (1881); *In re Penn Central Transp. Co.*, 486 F.2d 519, 525 (3d Cir. 1973); *MacBryde v. Burnett*, 132 F.2d 898, 900 (4th Cir. 1942); *State v. U.S. Steel Corp.*, 12 N.J. 51, 95 A.2d 740, 744 (1953); *Farmers' & Mechanics' Nat'l Bank v. King*, 57 Pa. 202, 206 (1868). Lack of segregation is relevant only insofar as the creditors of the lead lender relied on the existence of unencumbered assets so that participants should be estopped from claiming an ownership interest in the collateral. *See In re German*, 193 F. Supp. 948 (S.D. Ill. 1961); *In re Cable-Link Corp.*, 135 F. Supp. 277 (E.D. Mich. 1955).

Fourth, even if the attempted joint venture arrangement were a "secret arrangement" between the petitioner and Alda to limit the rights of Alda's creditors, the court nowhere explains how this arrangement deceived or misled any real-life creditor of Alda. An actual, not a hypothetical, creditor—who relied on the fact that the property was held in the bankrupt's name—must exist to create an estoppel, and then the estoppel arises in favor of that creditor only. The estoppel, might, however, benefit the bankrupt estate under section 70 (e) of the Bankruptcy Act, if under applicable state or federal law the arrangement is fraudulent as against or voidable by such creditor.

Finally, even if a security interest were intended, the filing of a financing statement would not have been required to protect the petitioner's interest. U.C.C. § 9-302 (1) (•) excepts "an assignment of accounts which does not alone or in conjunction with other assignments to the same assignee transfer a significant part of the outstanding accounts of the assignor"

and the facts are distinguishable from the typical participation agreement engaged in by S&L's,¹⁰¹ the case serves as a warning to participants who allow both title and possession of the loan documents to remain in the seller-servicer without any indicia thereon evidencing the participants' interest in the loans. In fact, the *Alda* case was the linchpin of the argument made by the bankruptcy trustee in the *Hamilton* case.

D. Avoidance of the Transfers by the Trustee in Bankruptcy

A bankruptcy trustee may try to set aside the interest of a participant in mortgage loans under the "strong-arm" provisions of section 70c of the Bankruptcy Act,¹⁰² which provides that

The trustee shall have as of the date of bankruptcy the rights and powers of: (1) a creditor who obtained a judgment against the bankrupt upon the date of bankruptcy, whether or not such a creditor exists, (2) a creditor who upon the date of bankruptcy obtained an execution returned unsatisfied against the bankrupt, whether or not such a creditor exists, and (3) a creditor who upon the date of bankruptcy obtained a lien by legal or equitable proceedings upon all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt upon a simple contract could have obtained such a lien, whether or not such a creditor exists. If a transfer is valid in part against creditors whose rights and powers are conferred upon the trustee under this subdivision, it shall be valid to a like extent against the trustee.

This provision basically gives the trustee in bankruptcy the rights of a "hypothetical lien creditor" under state law as of the date of bankruptcy.¹⁰³ It does not give the trustee the status of a bona fide purchaser for value

from the general filing requirement, and the facts in the *Alda* case indicate that the accounts receivable in question there represented only a small part of *Alda's* portfolio of factored accounts receivable.

¹⁰¹ Lack of segregation is not likely to occur with respect to loan participations. The standard procedure is to identify in the participation certificate each loan in which a participation is sold, and to indicate by segregation or notation in each loan file the fact that a participation is outstanding for that loan. It is also much easier to identify and segregate mortgage loans than accounts receivable of a third party pledged to the lead lender. Mortgage loans are well-documented, evidenced by promissory notes and mortgage deeds. Accounts receivable are book accounts, with nothing more than entries in ledger books to indicate their existence. There is nothing physical a participant can possess or a lead can physically segregate. The only way a participant in accounts receivable can "perfect" its security interest is by recording a financing statement; there is nothing to take possession of, whereas with mortgage loans physical possession and actual segregation of the notes and mortgage deeds is possible and practical.

¹⁰² 11 U.S.C. § 110 (c) (1970).

¹⁰³ *In re Alikasovich*, 275 F.2d 454 (6th Cir. 1960), *aff'd sub nom. Lewis v. Manufacturers' Nat'l Bank*, 364 U.S. 603 (1961); *In re Robinson-McGill Mfg. Co.*, 70 F.2d 100 (6th Cir. 1934); *In re James, Inc.*, 30 F.2d 555 (2d Cir. 1929); 4A COLLIER, *supra* note 73, ¶¶ 70.04 at 55, 70.25 at 340 n.1, 70.52 at 628.

or an encumbrancer for value or the rights of a hypothetical general or unsecured creditor whose rights may arise under the substantive law of waiver or estoppel.

The trustee in bankruptcy may argue that the participant's interest has no priority over the claim of a lien creditor. However, this argument depends on a finding that the transaction between the participant and the seller-servicer was a loan so that Article 9 of the Uniform Commercial Code will apply and relegate a holder of an unperfected security interest to the status of a general creditor. If the transaction is found to be a sale, Article 9 will not apply; local law governs the transaction and will ultimately determine the rights of the trustee in bankruptcy. The Fifth Circuit has summarized the rule:

We are controlled by federal law in determining what liens are preserved in bankruptcy; what character of title to the debtor's property is vested in the trustee in bankruptcy; and, as to such property, what rights, remedies, and powers are deemed vested in the trustee. We look to state law to ascertain what property the debtor owned immediately preceding the time of bankruptcy; what liens thereon, if any, then existed; the character thereof; and the order of priority among the respective creditors holding such liens. More specifically in this case, we determine under state law whether the purchase money lien creditor would have had priority over a creditor then holding a lien thereon by legal or equitable proceedings [*i.e.*, the trustee in bankruptcy under section 70c].¹⁰⁴

Thus, state law regulates the passage of title from the bankrupt whereas the Bankruptcy Act regulates passage of title to the trustee in bankruptcy. This means that, unless property passes to the trustee by operation of law, the trustee must use one of his avoiding powers to reach it. The trustee would be able to avoid the transaction if state law required the note to be endorsed, possession to be taken or the transfer to be filed or recorded in order to have priority against lien creditors.¹⁰⁵

1. Endorsement of the Notes

The trustee might claim that the transfer was ineffective as against the claim of lien creditors because the notes were unendorsed. As discussed above, state law would determine the effectiveness of the transfer. Ohio law, for instance, does not require delivery or endorsement of the mortgage

¹⁰⁴ *Commercial Credit Co. v. Davidson*, 112 F.2d 54, 55 (5th Cir. 1940).

¹⁰⁵ 8A C.J.S. *Bankruptcy* § 238 (1962). U.C.C. § 9-301 (1) (c) provides that "an unperfected security interest is subordinate to the rights of . . . a person who becomes a lien creditor before the security interest is perfected."

notes for the transaction to be effective against a lien creditor (as opposed to a bona fide purchaser for value).¹⁰⁶

Under Ohio law the delivery of a participation certificate by the seller-servicer to an S&L participant for full consideration should effectively assign to the S&L an ownership interest in each of the mortgage loans identified in the certificates and in the proceeds of those mortgage loans.¹⁰⁷ The participation certificate itself will probably specifically speak in terms of assignment. The assignment of the ownership interests described in the certificate would be superior to all persons except bona fide purchasers for value without notice—a position which a trustee in bankruptcy does not enjoy.

The fact that the notes evidencing the indebtedness of the mortgagors are instruments does not prevent their assignment.¹⁰⁸ Nor is there any legal barrier to a partial assignment of an instrument, although the law merchant and the common law formerly required that a bill or note be transferred in its entirety; notes could not be endorsed or assigned piecemeal.¹⁰⁹ The reasoning behind this rule was that the original contract between the debtor contemplated actions against the potentially delinquent debtor by only the original creditor. A subsequent partial assignment of the debt would create a possible multiplicity of lawsuits against the debtor upon default. Since this possibility was not part of the contract between the debtor and original creditor, courts of law would not allow a partial assignee of the note to sue the debtor.¹¹⁰

To counter inequities worked by this common law rule, a rule has evolved in equity which gives the assignee the right as against the assignor to sue for monies collected from the debtor which properly belong to the assignee.¹¹¹ This rule prevents the unjust enrichment of the assignor, but

¹⁰⁶ State Fidelity Fed. Savings & Loan Ass'n v. Wehrly, 54 Ohio Op. 2d 314, 263 N.E.2d 801 (C.P. 1970); Haley v. Currin, 8 Ohio N.P. 337 (1901); OHIO REV. CODE ANN. § 5301.25 (Page 1967). Note also that in *Westover, Prudence, More* and the cases cited in note 91 *supra*, there was no delivery, endorsement or recording of the mortgage loan documents (the notes and mortgages) or the participation certificates issued in respect thereto when the mortgagee sold participation interests in the mortgage loans to third parties; yet those sales were held to be valid and operated to pass good title to those participants under the applicable state law.

¹⁰⁷ See OHIO REV. CODE ANN. § 1303.23 (Page 1962).

¹⁰⁸ 11 AM. JUR. 2d *Bills & Notes* § 313 (1963).

¹⁰⁹ See *Hubbard v. Bibb Brokerage Co.*, 44 Ga. App. 1, 9-18, 160 S.E. 639, 643-47 (1931); 11 AM. JUR. 2d *Bills & Notes* § 320 (1963).

¹¹⁰ *Hubbard v. Bibb Brokerage Co.*, 44 Ga. App. at 10, 160 S.E. at 644; 4 J. POMEROY, EQUITY JURISPRUDENCE § 1280 (5th Ed. 1941); 11 AM. JUR. 2d *Bills & Notes* § 320 (1963).

¹¹¹ *Bell Finance Co. v. Johnson*, 180 Ga. 567, 569, 179 S.E. 703, 704 (1935); *Hubbard v. Bibb Brokerage Co.*, 44 Ga. App. at 10-18, 160 S.E. at 644-47. The overwhelming majority of jurisdictions follow this rule, 6A C.J.S. *Assignments* § 65 (1975), but some Missouri

still protects the debtor from multiple suits. The right is also enforceable in a court of law in cases where the assignor has collected a fund from the debtor and has no duty to perform with respect to the fund other than pay it over to the assignee.¹¹² Because there has now been a merger of law and equity, this distinction is no longer applicable, and the partial assignee can correctly expect to recover from the assignor to the extent that the debtor has fulfilled his obligations.

The Uniform Commercial Code leaves this body of law intact. Section 3-202(3) prevents partial endorsement of a negotiable instrument from operating as a negotiation,¹¹³ but does not prohibit either partial endorsement or partial assignment as a method of transfer. The Code is silent on the legal effect of such a transfer and leaves that determination to local law.¹¹⁴

In light of this non-exclusivity of transfer methods under the Uniform Commercial Code, an equitable interest in negotiable notes may be assigned in the same way as an equitable interest in any other form of property.¹¹⁵ An equitable assignment conveys equitable title.¹¹⁶

An equitable assignment is such an assignment as gives the assignee a title which, though not cognizable as law, will be recognized and protected in equity. "It is in the nature of a declaration of trust, and is based on principles of natural justice and essential fairness, without regard to form." While a legal assignment must be in writing, an equitable assignment can be made either by oral agreement or in writing In order to infer an equitable assignment, it must appear that an immediate change of ownership with respect to the fund was contemplated by the parties.¹¹⁷

Thus, no particular form or words are necessary to effect an equitable assignment. All that is necessary is that the language show the intention

cases have held that partial assignments that have been made without the consent of the debtor are invalid both in equity and at law. *Subscribers at Casualty Reciprocal Exchange v. Kansas City Pub. Serv. Co.*, 91 S.W.2d 227 (Mo. App. 1936); *Howard Undertaking Co. v. Fidelity Life Ass'n*, 59 S.W.2d 746 (Mo. App. 1933); *Bland v. Robinson*, 148 Mo. App. 164, 127 S.W. 614 (1910).

¹¹² *Bell Finance Co. v. Johnson*, 180 Ga. at 569, 179 S.E. at 704; *Hubbard v. Bibb Brokerage Co.*, 44 Ga. App. at 12-13, 160 S.E. at 645.

¹¹³ *Hodson v. Scoggins*, 102 Ga. App. 44, 48-49, 115 S.E.2d 715, 718-19 (1960); *Edgar v. Haines*, 109 Ohio St. 159, 162-163, 141 N.E. 837, 838 (1923). U.C.C. § 3-202 (3) reads: "An indorsement is effective for negotiation only when it conveys the entire instrument or any unpaid residue. If it purports to be of less it operates only as a partial assignment."

¹¹⁴ U.C.C. § 3-202, Comment 4.

¹¹⁵ *Edgar v. Haines*, 109 Ohio St. at 163, 141 N.E. at 838.

¹¹⁶ See *Hubbard v. Bibb Brokerage Co.*, 44 Ga. App. at 10-13, 160 S.E. at 644-45.

¹¹⁷ *Smith v. Folsom*, 190 Ga. 460, 470-71, 9 S.E.2d 824, 831 (1940) (citations omitted).

of the assignor to transfer the property to the assignee.¹¹⁸ In fact, because negotiation of a partial interest in an instrument is impossible, there is no particular reason for the words to be written on the instrument, and the assignment may be written on a separate paper,¹¹⁹ which is the usual practice in the case of loan participations.

A properly drafted participation agreement and certificate would clearly indicate that a transfer of ownership is intended by the parties. Thus, once an S&L acquires an ownership interest in the mortgage loans listed in the participation certificate, by either a valid written assignment (the participation certificate) or an equitable assignment arising out of the full factual matrix of the transaction, the following principles come into play and should put to rest any claim by a trustee in bankruptcy of a right to retain the proceeds of those mortgage loans:

(1) A partial assignment of an amount owed to the assignor, as distinguished from an assignment of the entire debt, vests in the assignee an equitable interest in the entire fund.

(2) Where the assignor collects the money from his employer (debtor) after his equitable assignment . . . such collection will ipso facto make him a trustee of the entire interest in the amount assigned, for the benefit of the assignee.

(3) In the event of bankruptcy of the assignor before he has accounted to the assignee for the money so collected, the claim of the assignee is such a fiduciary claim as will not be affected by the discharge in bankruptcy of the assignor.¹²⁰

2. Recording of Participation Interests in Mortgage Loans

There is no provision in Ohio law requiring the recordation of documents evidencing the sale of participation interests in mortgage loans. Nor does Ohio law require the recordation of a partial assignment of a mortgage deed. Priorities among conflicting claimants to interests in real estate are determined in most jurisdictions, including Ohio,¹²¹ by a test

¹¹⁸ *Id.*; *General Excavator Co. v. Judkins*, 128 Ohio St. 160, 190 N.E. 389 (1934); 6 AM. JUR. 2d *Assignments* § 83 (1963).

¹¹⁹ 11 AM. JUR. 2d *Bills & Notes* § 314 (1963).

¹²⁰ *Bell Finance Co. v. Johnson*, 180 Ga. at 569, 179 S.E. at 704.

¹²¹ See OHIO REV. CODE ANN. § 5301.25 (Page 1967) which requires that all instruments in writing properly executed for the conveyance or encumbrance of lands, other than mortgages as provided in section 5301.23 of the Revised Code, shall be recorded, and until so recorded or filed for record, they are fraudulent as against a subsequent bona fide purchaser having at the time of purchase no knowledge of the existence of such instrument. A full assignment of a mortgage constitutes a conveyance or encumbrance of lands, OHIO REV. CODE ANN. § 5301.31 (Page Supp. 1977), which comes within the provisions of section 5301.25, and therefore the recording of an assignment of a mortgage is required in order to make the assignment effective as against subsequent mortgagees and subsequent purchasers for value without notice thereof. *Penney v. Merchants' National Bank*, 71 Ohio St. 173,

based on whether the subsequent interest is possessed by a bona fide purchaser or encumbrancer for value. Thus in states which follow the majority rule, the bankruptcy trustee, who is equivalent to a lien creditor, has no priority over the participant's unrecorded ownership interest previously transferred.¹²²

From the point of view of purchasers from, or creditors of, the mortgagor, the recording would serve no purpose as their only concern is that the record notify them of the mortgage and identify the mortgagee of record. Further, recordation of the seller-servicer's assignment of a participation interest in a mortgage loan would not be appropriate since most seller-servicers continue to hold legal and record title in their dual capacity as trustee and servicing agent of the mortgage loan for the benefit of themselves and the participant. In any event, recording would have no legal effect in the absence of a statute so providing.¹²³

72 N.E. 884 (1904); *Strait v. Ady*, 4 Ohio N.P. 86, *aff'd.*, 37 Ohio L. Bull. 281 (1897); *Brooks v. Peoples Savings Bldg. & Loan Co.*, 46 Ohio L. Bull. 214 (1901). A judgment creditor of the mortgagee is not deemed a subsequent purchaser for value and, therefore, recording is not necessary to bind such creditors. *Haley v. Currin*, 8 Ohio N.P. 337 (1901).

¹²² 4A COLLIER, *supra* note 73, ¶ 70.55 at 646-47.

¹²³ *Ramsey v. Riley*, 13 Ohio 157 (1844); *Johnston v. Haines*, 2 Ohio 55 (1825); *Kessler v. Bowers*, 23 Ohio App. 194, 155 N.E. 402 (1926). For an example of a case where recording was required to perfect a security interest in a whole loan see *In re Fidelity Mortgage Co.*, No. J77-00412B (S.D. Miss., Oct. 27, 1977), where the Government National Mortgage Association (GNMA) filed a motion for summary judgment for reclamation of 29 mortgage backed securities pools involving approximately 60 million dollars in mortgages. The trustee in bankruptcy argued that the failure of GNMA as purchaser of the loans to record the assignments of the mortgages under sections 85-5-15 and 17 of the Mississippi Code of 1972 resulted in the trustee acquiring title to the mortgages by virtue of section 70 (c) of the Bankruptcy Act. The procedures for issuing GNMA mortgaged backed securities involve the assignment of the pool of mortgages to GNMA to be held by a third party custodian; the mortgage notes and mortgage deeds are endorsed in blank, accompanied by assignments of the mortgages which are only to be recorded if the issuer of the securities defaults in their payment. The bankruptcy judge concluded that the assignments were required to be recorded in order to be perfected and held that the trustee was a perfect lien creditor under section 70 (c).

GNMA had argued that because it is a sovereign federal governmental agency the trustee could not counterclaim against it and that it is not required to comply with state recording statutes governing transfer of real property interests. The court held:

Pertinent provisions of the United States Code creating GNMA and the Guaranty Agreement entered into between GNMA and Fidelity Mortgage Company, tend to support this proposition of law asserted by Plaintiff (GNMA). Even though Section 1721 (G), Title 12 U.S.C., which empowers GNMA to contract with the issuer, provides:

... in the event of default and pursuant otherwise to the terms of the contract, the mortgages that constitute such trust or pool shall become the absolute property of the association subject only to the unsatisfied rights of the holders of the securities based on and backed by such trust or pool...

the Trustee argues that Section 3.02 of the Guaranty Agreement which provides:

This Agreement is subject to recordation in all appropriate public offices for real property records in all the counties or other comparable jurisdictions in which any

An argument might be made that purchasers from and creditors of the mortgagee-assignor would derive some benefit from the recording of the transfer. After all, if there is no indication to the contrary, the mortgagee would appear to own the entire interest in the note and the underlying mortgage; a creditor could be led to believe that these assets were available for sale or for collateral for a loan or at least that they were unencumbered assets of the holder.

Any concern for the potential purchaser can be readily dismissed because a bona fide purchaser for value is in no need of additional protection. Such a purchaser is already shielded from the claims of any prior buyers. In fact, this situation was discussed above as one that a purchasing S&L should take pains to guard against.¹²⁴

The potential creditor of the mortgagee may be in need of protection, but this protection would not be provided by a recording in most states. In states like Ohio, which do not have a statute which mandates the recording of the partial transfer of a loan, the recording would have no legal effect, except perhaps to eliminate any possible claim based on estoppel or secret arrangement as a fraud on creditors.¹²⁵

Even if there were such a statute, it probably would not aid the creditor or a trustee in bankruptcy who has the rights of a lien creditor. The Ohio recordation statutes, for instance, have been construed as only

and all of the properties covered by the aforesaid mortgages are situated . . . supports his contention that it was intended for the assignments to be recorded in those states requiring recordation of such instruments.

There is a definite conflict of laws in this controversy between the Federal Bankruptcy Act which embraces the lien perfection requirements of each of the individual states and the Act of Congress creating GNMA. There are no decisions on this precise question to guide the Court in resolving this conflict.

While it is well known that the Bankruptcy Court is a Court of equity, as well as a Court of law, solutions in equity should yield to a rational application of existing law. Even though GNMA is a governmental, or quasi-governmental, agency, the Bankruptcy Act is also a Federal law which has been in existence much longer than GNMA. The Bankruptcy Act was intended to deal uniformly with the problems of insolvents, and to that end the Trustee has special statutory powers to recover and retain properties for the benefit of the common creditors of the bankrupt estate. If there was an assignment of the asset in question to GNMA, this Court believes it should meet all of the tests which are applicable to the perfection of any other assignments of real property interests in the State of Mississippi.

The Court concludes that the Bankruptcy Act which embraces the lien perfection requirements of the State of Mississippi, takes precedence over any conflicting provisions in the statute creating GNMA.

Thus, the failure to record the assignments in this case is fatal to the position of the Plaintiff, and the Trustee takes title to the mortgages in question by virtue of Section 70 (c) of the Bankruptcy Act.

¹²⁴ See text accompanying notes 52-54, *supra*.

¹²⁵ See discussion of the *Alda* case at text accompanying notes 95-100, *supra*.

for the benefit of bona fide purchasers for value¹²⁶ and not for the benefit of subsequent creditors of either the mortgagee-assignor or the mortgagor-debtor.¹²⁷

Although this result might seem harsh, there are good policy reasons behind the decision not to require recordation of partial assignments in the context of loan participations. Such a requirement would destroy the "commercial character" of the participation certificates.¹²⁸ In addition, recording partial assignments would seriously hinder the secondary mortgage market. A typical offering by FHLMC, for instance, consists of 100 million dollars worth of mortgage loans in which FHLMC will sell participations in minimum amounts of \$100,000 each. There are a potential 1,000 purchasers of these undivided participation interests, and there would be the need to file 1,000 partial assignments in every county in which the real estate security for each loan comprising the pool of mortgages is located. The secondary mortgage market would crumble under such conditions.

IV. CONCLUSION

The bankruptcy of the Hamilton Mortgage Corporation taught the savings and loan business to be careful about how loan participation transactions are structured and documented. It is critical to demonstrate clearly that the transaction is a sale of an undivided interest in mortgage loans and that the seller-servicer retains possession and legal title to the mortgage loans strictly in the capacity of a trustee for the participants.¹²⁹

Care should be taken in drafting participation agreements to assure that the provisions clearly characterize the transaction as a sale and a purchase; the parties should be referred to as "buyer" and "seller", or as joint tenants in the loans. The agreement and the participation certificate should contain words of transfer and conveyance and should provide that

¹²⁶ *Pinney v. Merchants' Nat'l Bank*, 71 Ohio St. 173, 72 N.E. 884 (1904); *Page v. Thomas*, 43 Ohio St. 38, 1 N.E. 79 (1885); *Tousley v. Tousley*, 5 Ohio St. 78 (1855); *Brooks v. Peoples' Savings Bldg. & Loan Co.*, 46 Ohio L. Bull. 214 (1901); *Strait v. Ady*, 4 Ohio N.P. 86, *aff'd*, 37 Ohio L. Bull. 281 (1897); OHIO REV. CODE ANN. § 5301.25 (A) (Page 1967). Georgia law is the same. *Griffith v. Posey*, 98 Ga. 475 (1896); *Jones v. Howard*, 99 Ga. 451 (1896); *Donovan v. Simmons*, 96 Ga. 340 (1895); *Mack Trucks, Inc. v. Ryder Truck Rental, Inc.*, 110 Ga. App. 68, 137, S.E.2d 718 (1964).

¹²⁷ *Haley v. Currin*, 8 Ohio N.P. 337 (1901).

¹²⁸ GLENN, *supra* note 93, § 317.2.

¹²⁹ Happily, the litigation between the savings and loan associations and the Hamilton trustee was settled in April, 1977 and approved by order of the Bankruptcy Judge in August, 1977. As part of the settlement, the trustee recognized and acknowledged that each S&L was the purchaser of a 90 percent ownership interest in each loan, that the participation agreement and participation certificate created a relationship of purchaser and seller between the S&L and Hamilton, that the participation certificate and participation agreement should

the sale and transfer of the participation interest is without recourse against the seller. The agreement should also emphasize that the participants share the risk on each loan. For example, it should be clear that the participants receive payments on their participation interests only when a payment is made on a loan and that the participants share ratably all foreclosure, maintenance and resale expenses for foreclosed properties.

The interest rate recited in the participation certificate should bear a reasonable relationship to the interest rates on the underlying mortgages, but the rates do not necessarily have to be the same. It is reasonable to expect some differences due to pricing considerations and to permit the seller-servicer to be paid something for servicing the loans. But where the interest rate on the participation certificate is greater than that of the underlying mortgages or where payments on the participation are guaranteed by the seller, regardless of the payment status of the underlying mortgages, it may raise a red flag against the sharing-of-risk concept of a joint tenancy.¹³⁰

Other indices of a sale are the notation and/or endorsement on the notes themselves that an undivided interest therein has been sold to the buyer. The placement of a legend or notice on the face of the mortgage notes may be helpful in preventing a creditor of the seller-servicer from being misled to believe that it is the sole owner of the notes or in preventing their negotiation to a holder in due course; *i.e.*, a bona fide purchaser for value without notice of a claim to it by any other person. It also serves to defuse the argument that the parties intended the transaction to be a secured credit transaction. An example of a legend presently in use by several prominent S&L's is:

be construed as a sale of partial interests in "instruments" which are excluded from Article 9 of the Uniform Commercial Code under section 9-102 (1), that these documents demonstrated an intent to purchase rather than create a security interest in personal property, that no enforceable debt was created between Hamilton and the S&L which either one could have intended to secure and that the participation agreement and the participation certificate created a trust relationship between the parties. The S&L's did pay a price for this settlement: they purchased *at par* the ten percent retainage held by Hamilton, agreed to purchase a modest dollar amount of whole loans from the reorganized Hamilton over a five year period, and agreed to permit the reorganized Hamilton to service all of the aforesaid loans for a competitive servicing fee.

It should be noted that one S&L whose notes contained a form of endorsement or legend on them reached a settlement with the trustee on much more favorable terms, which of course is indicative of the weakened position of the trustee when denied the leverage of the estoppel argument and the argument that the bankrupt could have sold the unendorsed notes to a bona fide purchaser for value.

¹³⁰ See Opinion of General Counsel, Federal Home Loan Bank Board, November 29, 1965.

NOTICE

90% of this instrument has been sold to XYZ Savings Association, 20133 Main Street, Pepper Heights, Ohio 44122, and the holder hereof holds this instrument as Trustee for the benefit of XYZ Savings Association. This instrument may not be further transferred without the prior written consent of XYZ Savings Association.

Another, and perhaps more effective, method of evidencing the participant's ownership interest is to have the seller-servicer endorse the note, thereby effecting a negotiation to itself, as trustee for itself (to the extent of its retained ownership interest) and the other participants in the loan. In this way, there is endorsement and delivery, delivery being to the trustee who holds the instrument for the benefit of the assignees. The trustee's duties and responsibilities with respect to the mortgages should be clearly stated in the participation agreement, which also serves as a trust agreement governing the administration of the trust corpus. The following form of endorsement has come into use directly as a result of the *Hamilton* litigation:

FOR VALUE RECEIVED, the undersigned hereby sells, assigns and transfers without recourse, all its right, title and interest in this instrument and in all other instruments, agreements and collateral in connection therewith to ABC Savings and Loan Association, as Trustee for the benefit of XYZ Savings Association, 20133 Main Street, Pepper Heights, Ohio 44122, and ABC Savings and Loan Association, under the terms of a Participation Agreement and related Participation Certificate dated _____, whereby XYZ Savings Association purchased from ABC Savings and Loan Association 90% of the loan evidenced by this instrument. No portion of this instrument may be further sold, assigned, transferred, pledged or hypothecated in any manner without the prior written consent of XYZ Savings Association.

Separate forms of partial assignment executed in a recordable form may also be used, although there is some question as to whether the recording of such instruments in the real estate records of the county in which the security property is located is effective notice, constructive or otherwise, against either a bona fide purchaser for value or an encumbrancer for value. Very few states have laws which appear to require recordation of such partial assignments, and in those states which do, the only parties who usually would have a superior title would be bona fide purchasers for value and mortgagees, but not judgment creditors or encumbrancers for value.¹³¹ However, recording the assignment of the mortgage may be helpful

¹³¹ See TENN. CODE ANN. § 64-2404 (1976), which provides: "All deeds, bills of sale, agreements and other instruments for the conveyance or mortgage of personal property, shall be registered in the county where the vendor or person executing the same resides and, in the case of his non-residence, where the property is."

where state law requires the recording of full assignments of mortgages. Although it is questionable whether recording accomplishes anything where there is a change only in the capacity in which the mortgages are held, and no change in possession, the public records at least will then reflect the capacity in which the seller-servicer holds the mortgage. The law of the state in which the participation agreement and/or participation certificates are executed and the states in which the security properties are located should be reviewed on this point. As a condition to purchasing a loan participation, a purchasing S&L should require an opinion from seller's counsel addressing these questions.

Accounting records of the seller-servicer should indicate that participating interests in the loans have been sold. This may be done either by carrying the entire amount of the loans as an asset with a netting-out of the participation interest on the asset side of the balance sheet or by showing only the seller's participation interest in the loans on the asset side.

The treatment of the loan payments received from the mortgagors and the holding of such funds pending remittance to the participants is also important. Such funds should be segregated for each participant in separate bank accounts and identified as being held in trust.

Any characteristics of a loan should be avoided. If it is established that the participation transaction is a loan of money secured by a pool of mortgages, the rights of the purchasers will depend on the complex interplay of the Uniform Commercial Code and sections 60, 67 and 70 of the Bankruptcy Act.¹³² To be avoided are arrangements which require the payment on the participation certificate of a rate of interest exceeding that of the underlying mortgages, guaranteed yields, interest rates which increase upon default of the seller-servicer, short term repurchase obligations, or recourse against the seller upon loan defaults. In addition the outstanding aggregate balance of the purchaser's share of the underlying mortgages at the time of sale should not be substantially greater than the price paid by the purchaser for the participation interest; the pool of underlying mortgages would then appear to be collateralizing payments on the participation certificate.

If the seller-servicer of a loan participation becomes bankrupt, there will also be concern over the ability of the bankrupt to continue to service the loans properly. The purchaser would also prefer to sever any relationship with a bankrupt and avoid becoming involved in the bankruptcy proceedings.

There are a variety of termination provisions which may be used to

¹³² See, Simpson, *supra* note 81.

accomplish these objectives. Some participation agreements permit either party to terminate the agreement with or without cause, or provide that the non-terminating party has the option of either buying the terminating party's participation interest or selling its interest to the terminating party at some predetermined price. Agreements may also provide that upon the insolvency of the seller-servicer, the put and call option just described might come into operation, although the purchaser's only practical remedy is to buy out the seller-servicer's interest in the loans, usually at par. Another alternative is to provide for the automatic assumption or transfer of the servicing functions to the purchaser or its designee upon default or insolvency of the seller-servicer.

In most cases the operation of these remedial provisions will not be challenged by a trustee in bankruptcy or other receivers, such as the FDIC or FSLIC. Call provisions, especially, are favored because they provide for an orderly way of liquidating the bankrupt's interest in the property to the most likely purchaser of the property. Such provisions, particularly those providing for automatic termination of servicing upon insolvency, have been held to be enforceable against trustees in bankruptcy.¹³³

Where the bankruptcy proceedings are of a rehabilitative nature, such as Chapters X and XI, the bankruptcy court may refuse to enforce a termination provision if it finds that enforcement would frustrate or endanger the reorganization efforts of the debtor. The purpose of retaining the servicing functions is to have the use of the servicing income to fund the administration of the bankruptcy proceedings until the trustee can realize on some of the less liquid assets of the bankrupt. In the *Hamilton* case the S&L's permitted Hamilton to service the loans for a competitive fee as part of the settlement agreement.¹³⁴

The growing importance of the loan participation as an investment technique makes it imperative that S&L management understand the nature of the transaction so that it is conducted and structured properly. If care is exercised in the purchase and handling of loan participations, S&L's can continue to reap the benefits that accompany these transactions with no fear of the adverse consequences that result from characterizing them as loans. This is necessary not only to protect the self-interest of the S&L's, but also to insure that available mortgage funds continue to flow freely through the national housing financing system.

¹³³ 6 COLLIER, *supra* note 73, ¶ 3.24.

¹³⁴ See note 129 *supra*. In *re* Commonwealth Corp., No. TBK 74-14 (N.D. Fla., filed June 25, 1974). In a Dec. 3, 1975 order the Special Master recommended that such termination clauses be not enforceable within Chapter X proceedings if it is found that enforcement will frustrate or endanger the reorganization efforts of the debtor corporation. The order was made final on Dec. 17, 1975.

LEGISLATIVE DEVELOPMENTS IN THE SAVINGS AND LOAN INDUSTRY

This issue of the Akron Law Review is the first to be devoted entirely to legal questions relating to the savings and loan industry. The following student project consists of three articles which contain in depth examinations of recent legislative developments and their effects on the savings and loan industry. The first article focuses on the structure and constitutionality of state parity statutes and regulations which tie state law to federal law. The second article discusses the possibility of the formation of an Ohio bank for savings associations, owned and operated as a central reserve bank which would exclusively cater to the needs of savings institutions. The final article examines the potential impact of federal securities laws on savings associations which act as trustees for private retirement and pension plans.

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