
January 1989

Lead Lender Failure and the Pitfalls for the Unwitting Participant

Lori Laughlin Dalton Dalton

Recommended Citation

Lori Laughlin Dalton, Comment, *Lead Lender Failure and the Pitfalls for the Unwitting Participant*, 42 SW L.J. 1071 (1989)

<https://scholar.smu.edu/smulr/vol42/iss4/5>

This Comment is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

LEAD LENDER FAILURE AND THE PITFALLS FOR THE UNWITTING PARTICIPANT

by Lori Laughlin Dalton

IN 1975 a mere 14 banks in the United States failed, compared with 120 bank failures ten years later. The number shot up again in 1987, with 184 bank failures, and in 1988, 200 banks failed.¹ More alarming is that 113 of the 200 are Texas banks.² Bank failures on such a grandiose scale clearly cause widespread hardship and uncertainties. To be sure, increased consumer doubts exist. In addition, lenders using loan participation agreements have growing doubts about their contractual relationships with other banks.³

A by-product of the prevalent number of bank failures is the recognition of legal issues that previously went unquestioned.⁴ While the issues surrounding participation agreements have been discussed before, the participant's commercial expectations continue to be disappointed because of an increasing number of statutory and judicial ambiguities⁵ coupled with poor draftsmanship. As participants become aware of previously unforeseen dangers, they will require higher compensation for taking the risks they face in the event the lead bank is declared insolvent. Alternatively, banks will cease to engage in the participation transaction all together. Is one reaction more favorable than the other? Certainly not. Both will be to the detriment of the public in the long run, as the sources of funds will diminish while the cost of funds will increase.

The purpose of this Comment is threefold. First, the Comment assesses the present state of the law surrounding participations. Second, it points out the hidden dangers in participation agreements that usually come to light

1. Telephone interview with Rick Salmon, Federal Deposit Insurance Corporation (Nov. 3, 1988, and June 26, 1989).

2. *Id.*

3. For a full definition and discussion of the participation agreement, see *infra* text accompanying notes 6-30.

4. See, e.g., *In re Continental Resources Corp.*, 43 Bankr. 658 (Bankr. 10th Cir. 1986) (interpreting future advances clause in agreement between lead lender and borrower and application of such to participant); *Hibernia Nat'l Bank v. FDIC*, 733 F.2d 1403 (10th Cir. 1984) (characterizing participant arrangement and borrower's right to offset in relation to participant); *Seattle-First Nat'l Bank v. FDIC*, 619 F. Supp. 1351 (W.D. Okla. 1985) (looking at relationship and requisite standard of care between lead lender and participant).

5. For an example and discussion of such judicial ambiguity, see *infra* text accompanying notes 40-117, discussing classification of the participant arrangement, and notes 144-54, discussing the participant's rights against the FDIC.

after lead lender failure. Third, it proposes changes at both common law and statutory levels. Section I of the Comment outlines the nature of the participation agreement. Section II discusses the various classifications of participation transactions. Section III presents the consequences of lead lender failure as discussed in the context of the respective classifications. And finally, Section IV presents proposed changes in the law as well as a model participation agreement.

I. PARTICIPATION AGREEMENTS: THE PRACTICE AND PURPOSE

A loan participation is an agreement utilized when "two or more banks join a loan with each bank lending a portion of the amount to the borrower."⁶ The banks formally share the loan through the use of a participation agreement.⁷ The agreement is multi-faceted, serving both as an assignment of an interest in the loan and as a statement of the duties of each party.⁸

The participation is different from other types of multibank credit arrangements in that it involves two independent, bilateral relationships.⁹ The parties active in the underlying loan transaction are the lead lender and the borrower.¹⁰ While the participant acquires an interest in the loan, the lead bank retains record title to the loan documents, the right to deal with the borrower, and the right to enforce documents.¹¹ In the event of default, either by the borrower or lead bank, the participant can look solely to the lead bank for satisfaction of its claims.¹² Since the participant is not a creditor of the borrower, the participant cannot enforce loan documents against the borrower.¹³

Banks use the participation arrangement for numerous reasons. First, a bank may use a participation arrangement in order to avoid violation of statutory lending limits.¹⁴ Regulatory statutes limit the loan outstanding from a particular bank to any one borrower.¹⁵ Second, a bank may wish to mini-

6. Ledwidge, *Loan Participations Among Commercial Banks*, 51 TENN. L. REV. 519, 520 (1984) (quoting BLACK'S LAW DICTIONARY 1008 (5th ed. 1979)).

7. *Id.* at 520-21.

8. *Id.*

9. P. Reagan, *Participations*, Meeting of the Banking Law Institute and the Bank Lending Institute 1 (Apr. 25, 1988) (available through Executive Enterprises, Inc.).

10. *Id.*

11. *Id.*

12. See *Hibernia Nat'l Bank v. FDIC*, 733 F.2d 1403, 1407 (10th Cir. 1984); *Seattle-First Nat'l Bank v. FDIC*, 619 F. Supp. 1351, 1357 (W.D. Okla. 1985).

13. *Hibernia*, 733 F.2d at 1407; *In re Yale Express Sys., Inc.*, 245 F. Supp. 790, 792 (S.D.N.Y. 1965).

14. Ledwidge, *supra* note 6, at 521; Norton & Rogers, *Loan Participation Arrangements*, in 2 SOUTHERN METHODIST UNIVERSITY LAW SCHOOL, 4TH ANNUAL INST. ON COMMERCIAL LENDING 1 (1988).

15. 12 U.S.C.A. § 84(a) (West Supp. 1988), establishing lending limits for national banks, provides:

(1) The total loans and extensions of credit by a national banking association to a person outstanding at one time and not fully secured, as determined in a manner consistent with paragraph (2) of this subsection, by collateral having a market value at least equal to the amount of the loan or extension of credit shall

mize credit risk by spreading the loan among two or more lenders.¹⁶ Third, a bank might desire to foster correspondent lending arrangements.¹⁷ Fourth, a bank might utilize the arrangement to improve the lead lender's liquidity and increase capital as a percentage of total assets.¹⁸ Fifth, a borrower may wish to maintain relationships with several banks and thus demand that each of those be allowed to share in its loan.¹⁹ Finally, a participating bank may find the arrangement appealing since it may be able to lend funds at better terms than it might realize through its own marketing efforts and, therefore, realize a greater yield.²⁰ At one point commentators suggested banks preferred participation agreements over other multibank lending arrangements because of the relative ease in negotiating the participation.²¹ This rationale for using participations, however, is now specious given the increasing number of problems and corresponding litigation arising from the use of participation agreements.²²

Participation agreements vary from loan to loan, yet the typical participation can be described as follows. A lead lender, the bank that originated the loan, will sell a participation, or percentage of the loan, to one or more other banks, called participating lenders. This sale normally occurs at the time the loan is closed,²³ however, numerous banks are now entering the arrangement subsequent to closing in efforts to solve undercapitalization problems.²⁴ The lead lender normally retains a percentage interest of the entire loan, selling only a portion of the loan to a participating bank.²⁵ Infrequently, the lead bank arranges for the participating bank to purchase 100% of the loan.²⁶ The lead lender usually keeps the loan documents in its

not exceed 15 per centum of the unimpaired capital and unimpaired surplus of the association.

(2) The total loans and extensions of credit by a national banking association to a person outstanding at one time and fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of the funds outstanding shall not exceed 10 per centum of the unimpaired capital and unimpaired surplus of the association. This limitation shall be separate from and in addition to the limitation contained in paragraph (1) of this subsection.

Id.

16. Norton & Rogers, *supra* note 14, at 1.

17. *Id.*; Ledwidge, *supra* note 6, at 522.

18. Norton & Rogers, *supra* note 14, at 1.

19. *Id.*; Ledwidge, *supra* note 6, at 522.

20. Ledwidge, *supra* note 6, at 522.

21. *Id.*

22. Examples of these problems include: continued dispute over the classification of the arrangement, as discussed *infra* in text accompanying notes 40-117; the borrower's right to offset, as discussed *infra* in text accompanying notes 176-96; the purchasing bank's duty to conduct further credit analysis of both the borrower and the selling bank; and a corresponding increase in risk to the buying bank, which faces not only the borrower's default, but also the selling bank's insolvency.

23. Norton & Rogers, *supra* note 14, at 2.

24. *E.g.*, Savings Bank v. FDIC, 668 F. Supp. 799, 801 (S.D.N.Y. 1987).

25. Norton & Rogers, *supra* note 14, at 2.

26. *Id.*

name, retains the loan documents in its files, and manages the loan.²⁷

The loan participation agreement itself should set forth in detail the arrangement between the lead and the participant. This enumeration includes, but is not limited to, specifying (1) that the transaction is a purchase of a certain percentage of the loan by the participant, (2) the terms of the purchase, (3) the rights and duties of all parties, (4) the method of holding and disbursing funds received from the borrower, (5) the information to be given to the participant, (6) the relationship of the loan and/or collateral in the participated loan to other loans made to the borrower, and (7) other language addressing matters such as setoff, notices, procedures for exercising remedies and in the event of insolvency by any party, and clarification that the lead/participant relationship is that of seller/purchaser as opposed to debtor/creditor.²⁸ Furthermore, in addition to executing the participation agreement, the lead lender often issues participation certificates to the participant, evidencing the amount and percentage of the loan purchased.²⁹ Exclusive use of participation certificates without a companion participation agreement raises many legal concerns and does not demonstrate sound business judgment.³⁰

II. CHARACTERIZATION OF THE LEAD/PARTICIPANT RELATIONSHIP

The relationship between the lead bank and the participating bank is an area that has received extensive treatment,³¹ yet continues to be plagued with uncertainty and controversy. The terms of the agreement govern the relationship;³² however, when the agreement is ambiguous or lacking in detail, the court must look beyond the agreement to all facts, circumstances, and appropriate case law.³³ Accordingly, a court confronting the characterization issue must scrutinize the agreement to determine if it creates a bona fide participation, a true sale, or merely a disguised loan.³⁴ The banks' relationship is of particular importance when the lead bank becomes insolvent,

27. *Id.* at 3. Managing the loan includes servicing the loan and handling all dealings with the borrower. *Id.*

28. *Id.*

29. *Id.* For examples of arrangements utilizing participation certificates, see *Franklin v. Commissioner*, 683 F.2d 125, 126 (5th Cir. 1982); *Northern Trust Co. v. FDIC*, 619 F. Supp. 1340, 1342 (W.D. Okla. 1985); *InterFirst Bank Abilene v. FDIC*, 590 F. Supp. 1196, 1198 (W.D. Tex. 1984), *aff'd*, 777 F.2d 1092, 1093 (5th Cir. 1985); *In re Columbia Pacific Mortgage*, 20 Bankr. 259, 261 (Bankr. W.D. Wash. 1981).

30. See *Norton & Rogers*, *supra* note 14, at 3 (exclusive use of participation certificates is "legally and businesswise foolhardy for any of the parties").

31. See generally *Hutchins, What Exactly Is a Loan Participation?*, 9 RUT.-CAM. L.J. 447, 458-84 (1978) (providing extensive review of lead/participant relationship); *Ledwidge*, *supra* note 6, at 523-28 (discussing relationship between selling bank and purchasing bank); Note, *Classification of Loan Participants Following the Insolvency of a Lead Bank*, 62 TEX. L. REV. 1115, 1126-33 (1984) (revisiting classification dispute).

32. *Franklin*, 683 F.2d at 128; *Colorado State Bank v. FDIC*, 671 F. Supp. 706, 707 (D. Colo. 1987).

33. For a discussion and demonstration of the court's reliance on the banks' intent when classifying the loan participation agreement, see *Savings Bank v. FDIC*, 668 F. Supp. 799, 804-08 (S.D.N.Y. 1987).

34. *Id.*

since the participant's classification determines whether it is entitled to a preferred creditor status or, instead, is relegated to a general unsecured creditor status.³⁵

In characterizing the arrangement, the court will choose one of two broad categories.³⁶ One line of authority considers the purchase of part or all of a lead bank's loan to a third party as a loan from the participant to the lead.³⁷ A second line of authority describes the participant's act of purchasing part or all of the lead bank's loan as a purchase of an undivided property interest in the third-party loan.³⁸ If the transaction is characterized as a purchase, the transaction may fall within numerous subcategories.³⁹ The following sections will look more closely at each of these relationships.

A. Debtor/Creditor Relationship

The line of authority holding that the participant's act of purchasing the lead bank's third-party loan is in reality a loan to the lead bank emphasizes the degree of control, the relative rate of return, and the risk that the lead bank retains.⁴⁰ Looking at the control factor, the court focuses on the degree of control lead banks retain over the third-party loan. In most participations, the lead retains the loan documents, manages the loan, and does not notify the borrower of the change in the relationship.⁴¹ When analyzing the rate of return, the court focuses on whether the lead bank unwarrantedly earns less than the participating bank on the third-party loan. Under the risk factor, the court focuses on the amount of risk the lead bank retains in relation to the amount of risk the participating bank assumes.⁴²

In re Alda involved a participation agreement that purportedly created a joint venture between the lead bank and the participants.⁴³ The court determined that the arrangement lacked one of the requisite elements of joint ventures: joint control.⁴⁴ The court reached this conclusion after considering that the participant played no part in deciding to make the loan, the

35. See Note, *supra* note 31, at 1126.

36. *Id.* at 1122.

37. *Id.*; see, e.g., *Hibernia Nat'l Bank v. FDIC*, 733 F.2d 1403, 1408 (10th Cir. 1984) (participation agreement did not transfer ownership); *In re S.O.A.W. Enters., Inc.*, 32 Bankr. 279, 282 (Bankr. W.D. Tex. 1983) (agreement providing participant with lesser degree of risk and higher rate of return than lead created loan); *In re Alda Commercial Corp.*, 327 F. Supp. 1315, 1317 (S.D.N.Y. 1971) (participation agreement created a lender/borrower relationship).

38. See, e.g., *Franklin v. Commissioner*, 683 F.2d 125, 128 (5th Cir. 1982) (participation certificates indicated transaction was sale); *Stratford Fin. Corp. v. Finex Corp.*, 367 F.2d 569, 571 (2d Cir. 1966) (overall fact situation supported finding that parties intended purchase transaction); *Savings Bank v. FDIC*, 668 F. Supp. 799, 808 (S.D.N.Y. 1987) (banks intended participation arrangement to be sale).

39. See *infra* notes 55-117 and accompanying text.

40. *In re Alda*, 327 F. Supp. at 1317.

41. *Id.*; see also Stahl, *Loan Participation: Lead Insolvency and Participants' Rights* (part 1), 94 BANKING L.J. 882, 883-84 (1977) (typical participation arrangement will include lead bank retaining all documentation, managing loan, and not informing borrower of change in ownership).

42. *In re S.O.A.W. Enters., Inc.*, 32 Bankr. 279, 282-83 (Bankr. W.D. Tex. 1983).

43. *In re Alda*, 327 F. Supp. at 1317.

44. *Id.*

participant had no responsibility for managing the account or for handling collections, and the lead bank did not segregate the monies nor did the parties intend for such.⁴⁵ Furthermore, the court concluded that no basis existed for the assertion that a trust or agency had been created.⁴⁶ Instead, the court found the relationship was that of lender and borrower, despite the agreement granting the participants "an undivided fractional" interest.⁴⁷

Courts may transform a participation from a "true participation" to a lender/borrower transaction when the participant receives a greater rate of return than the lead.⁴⁸ One court noted that structuring a participation transaction in a manner that calls for the participant to receive a preferential return is contrary to the notion of participation, and instead resembles a debtor/creditor relationship.⁴⁹

A final factor considered when determining if a participation agreement constitutes either a sale or a loan focuses on the amount of risk the participant assumes. The participant usually assumes the same level of risk that the party selling the participation has under the loan, each party bearing 100% of the risk related to the portion it owns.⁵⁰ A problem arises when the lead lender agrees to repurchase all or part of the loan under given circumstances, or provides for other recourse arrangements. Such practices create an extension of credit by the participant to the lead bank.⁵¹ The Office of the Comptroller of the Currency (OCC) suggests that any repurchase or recourse agreement between the lead and the participant be reflected in the books of both parties,⁵² and that such loans be included in the lead bank's outstanding loan balances when determining its compliance with the lending limits for national banks.⁵³ To be excluded from the lead bank's lending limit, the participation must effect a proportionate distribution of credit risk according to the respective interests of the originating and participating

45. *Id.* at 1317-18.

46. *Id.*

47. *Id.* at 1316-17. One commentator has suggested that even though the relationship may not have risen to the level of a joint venture, the relationship was not one of lender and borrower, "but one of partial assignee and partial assignor." Hutchins, *supra* note 31, at 461. Accordingly, the participant should have been entitled to preferential interest in the accounts receivable securing the loans without filing a financing statement. *Id.*

48. See *Savings Bank v. FDIC*, 668 F. Supp. 799, 804 (S.D.N.Y. 1987) (discussing attributes that transform participation into loan); see also *In re S.O.A.W. Enters., Inc.*, 32 Bankr. 279, 282-83 (Bankr. W.D. Tex. 1983) (participations were in reality loans, given participant received greater rate of return than lead, and participant ran no real risk given lead guaranteed return of participant's investment).

49. *In re S.O.A.W.*, 32 Bankr. at 282.

50. *Id.*

51. See Comptroller of Currency, Banking Circular No. 181 (rev. Aug. 2, 1984), replacing Banking Circular No. 181 (Dec. 8, 1983), 5 FED. BANKING L. REP. (CCH) ¶ 60,799, at 38,859-2.

52. *Id.* Circumstances often giving rise to repurchase of the loan by the originating bank include default by borrower or lead bank. For further discussion see 12 C.F.R. §§ 32.104, 32.107 (1988), both clarifying that loans sold on recourse basis are subject to lending limitations imposed by 12 U.S.C. § 84 to the extent of the total amount the seller may ultimately have to repurchase. The bank does not need to include the amount of the loan sold on a nonrecourse basis in calculating the bank's compliance with lending limits. *Id.*

53. 12 U.S.C.A. § 84 (West Supp. 1988).

lenders.⁵⁴

B. Purchase/Sale Relationship

A true participation agreement has been characterized as (1) an assignment, (2) a tenancy-in-common, (3) a joint venture, (4) an agency, and (5) a trust.⁵⁵ The relationship is governed by the terms of the agreement,⁵⁶ but if the terms are unclear, the court must look beyond the agreement to the intent of the parties as inferred from all circumstances.⁵⁷ This section outlines the analysis of the courts in ascertaining the appropriate characterization of a participation arrangement classified as a bona fide participation.

1. Assignment

Under the assignment analysis, the lead bank assigns an undivided ownership interest in the underlying loan to the participant. The lead bank then becomes the participant's agent, servicing the entire loan. This relationship exists when the language in the agreement provides that the participant is "purchasing" an "undivided interest" or a "fractional interest" in the loan.⁵⁸ The United States Supreme Court confronted the problem of defining the participant's interest in *Small Business Administration v. McClellan*.⁵⁹ In determining if the Small Business Administration (SBA) had preferential rights when it joined in a loan, the Court held that the SBA had "beneficial ownership" of seventy-five percent of the debt.⁶⁰ One commentator interpreted this holding to mean that the lead bank actually conveys a partial assignment of ownership in the loan under a participation agreement.⁶¹

2. Tenancy in Common

Participants may be classified as tenants in common or cotenants with the lead if the participation agreement provides for a purchase of an "undivided interest."⁶² This classification is premised on basic property principles that tenants in common own an undivided interest in the property held concurrently.⁶³ This classification is most important in a mortgage loan transaction after foreclosure.⁶⁴ In the event the participant and lead have a disagreement regarding the management of the foreclosed property, the participant

54. 12 C.F.R. § 32.107 (1988).

55. *Franklin v. Commissioner*, 683 F.2d 125, 128 n.9 (5th Cir. 1982).

56. *Id.* at 128; *Colorado State Bank v. FDIC*, 671 F. Supp. 706, 707 (D. Colo. 1987).

57. *Stratford Fin. Corp. v. Finex Corp.*, 367 F.2d 569, 571 (2d Cir. 1966); *In re Continental Resources Corp.*, 43 Bankr. 658, 661 (Bankr. W.D. Okla. 1984).

58. *Hutchins*, *supra* note 31, at 463.

59. 364 U.S. 446, 448-53 (1960). *McClellan* concerned a loan in which the Small Business Administration participated in 75% of the loan, and the borrower later became bankrupt.

60. *Id.* at 450.

61. *Hutchins*, *supra* note 31, at 464.

62. *Id.* at 468.

63. *Id.*

64. *Id.*

could conceivably sue for partition.⁶⁵

3. Joint Venture

The court may construe the relationship between the lead and the participant as a joint venture.⁶⁶ The consequences of such analysis include (1) implication of a fiduciary relationship and a corresponding higher standard of care; (2) implication of an agreement to share losses as well as profits; and (3) in some jurisdictions, implication of an agency power in the joint venturer, enabling him to obligate his co-venturers.⁶⁷ A joint venture typically has certain characteristics. These characteristics include each party contributing assets to the venture and holding a joint interest in the undertaking.⁶⁸ Additionally, all parties to the venture anticipate a profit and the right to share in such profit. In the event the venture operates at a loss, however, the parties will share the losses.⁶⁹ The remaining indications of a joint venture are a limited undertaking, for example, a single loan, and joint control of the loan.⁷⁰

When defining the relationship, the court scrutinizes the agreement and circumstances very closely before holding a joint venture exists.⁷¹ Thus, a court denied a claim contending that the participation arrangement was a joint venture on the basis that the participant had no share in the profits of the purported joint venturer (the lead), had no role in the initial decision to make the loan, and did not manage the loan or have any input as to security or collections.⁷² The above claim illustrates the most difficult hurdles to overcome before a court will find a joint venture. First, the lead often undertakes the loan independently and does not bring in a participant until a later date.⁷³ Therefore, the contribution to a common undertaking is lacking. Second, since the participant rarely is involved with the day-to-day management of the loan, the requisite mutual management does not exist.⁷⁴

4. Agency

The basis of the agency analysis is that the lead bank retains the loan documentation after an assignment of a property interest, and concomitantly collects and distributes loan payments as an agent.⁷⁵ The court usually relies

65. *Id.* This is an equitable right available to tenants in common, which the courts deny if thought to be unduly prejudicial.

66. *Id.* at 469.

67. *Id.* at 470.

68. *Id.* at 469. Assets commonly contributed include "money, property, effort, knowledge, [or] skill." *Id.*

69. *Id.*

70. *Id.*

71. *See In re Alda Commercial Corp.*, 327 F. Supp. 1315, 1317-18 (S.D.N.Y. 1971).

72. *Id.* at 1317 (participant agreed to be joint venturer with financing corporation and sought declaration that it had interest in property of corporation after its bankruptcy to the extent of money paid to bankrupt pursuant to participation agreement). *See supra* notes 44-47 and accompanying text.

73. Hutchins, *supra* note 31, at 469.

74. *Id.*

75. Note, *supra* note 31, at 1122.

on specific facts in finding an agency relationship,⁷⁶ and the consequences may not always be clear. Some courts have concluded that participation certificates create an assignment coupled with an agency even though the lead does not transfer any ownership rights.⁷⁷ Apparently, this finding turns on the fact that the lead retains virtually all control with minimal accountability to the participant.⁷⁸ Under this scenario, after the lead bank fails and the FDIC takes over as receiver, it is permitted to offset the borrower's deposit accounts at the lead bank against the balance due on the loans, including debts that have participating interests.⁷⁹

5. Trust

A final line of cases construes the arrangement as the creation of a trust for the benefit of the participant.⁸⁰ After the court makes the initial determination that the lead bank sold an interest in the underlying debt to the participant, the court must then determine whether the parties intended to create a trust.⁸¹ Such a finding imposes an obligation on the lead bank to hold the participant's share of the proceeds in trust.⁸² The participant will find that a trust relationship between the lead and the participant is extremely beneficial for two reasons. First, as a fiduciary the lead must meet a higher degree of care in handling the loan.⁸³ Second, in the event the lead is declared insolvent, the participant maintains its status as beneficiary of the trust.⁸⁴ Therefore, the lead bank must hold any collections received in trust for the participant, giving the participant a preferred claim.⁸⁵

Courts have historically employed a three-part test when determining

76. Hutchins, *supra* note 31, at 472.

77. *Hibernia Nat'l Bank v. FDIC*, 733 F.2d 1403, 1407-08 (10th Cir. 1984); *Northern Trust Co. v. FDIC*, 619 F. Supp. 1340, 1341-42 (W.D. Okla. 1985).

78. *Hibernia*, 733 F.2d at 1408; *Northern Trust*, 619 F. Supp. at 1342.

79. The FDIC as receiver is granted the authority to offset in 12 U.S.C. § 1822(d) (1982). The FDIC as receiver:

[M]ay withhold payment of such portion of the insured deposit of any depositor in a closed bank as may be required to provide for . . . any liability of such depositor to the closed bank or its receiver, which is not offset against a claim due from such bank, pending the determination and payment of such liability by such depositor

Northern Trust, 619 F. Supp. at 1342 (quoting 12 U.S.C. § 1822(d)); e.g., *Hibernia*, 733 F.2d at 1407-08 (participation agreement amounts to assignment with agency, and does not convey ownership rights; accordingly, borrower has right to offset, and the setoff extends to participated loans); *Northern Trust*, 619 F. Supp. at 1341-42 (participation certificates create assignment coupled with agency and do not create ownership rights, and thus setoff not precluded).

80. Hutchins, *supra* note 31, at 472.

81. Weiner, *Rights of a Participant Bank Against a Lead Bank in a Participation Loan Agreement*, 104 BANKING L.J. 529, 531 (1987).

82. *Id.*

83. Hutchins, *supra* note 31, at 472.

84. *Id.*

85. *Id.* The court noted in *Seattle-First Nat'l Bank v. FDIC*, 619 F. Supp. 1351 (W.D. Okla. 1985), that preferred claims versus general creditor claims are not common. *Id.* at 1360. The participant has a heavy burden to establish his preferred claim status, which includes identifying a particular fund or payment in the receiver's possession, "cognizable in equity as a claimant's own." *Id.*

whether the arrangement rises to the level of a trust.⁸⁶ First, do the circumstances indicate the parties intended to create a trust?⁸⁷ Second, have the lead bank's funds been augmented by the trust monies?⁸⁸ Third, can the trust be traced into the hands of the receiver?⁸⁹

When ascertaining the parties' intent, the court looks first to the specific agreement to determine if the terms clearly set forth the relationship.⁹⁰ Apparently, thoughts diverge as to when the agreement is unclear, thus necessitating a look beyond the agreement.⁹¹ In *Northern Trust Co. v. FDIC*⁹² the participant claimed that both parties to the transaction intended to create a trust even though the participation certificates lacked language to that effect.⁹³ The court focused on the language indicating the lead retained control and owed the participant nothing more than the same care it exercised in nonparticipated loans.⁹⁴ Based on that language, the court held the certificates clearly indicated the parties intent to create an assignment and agency, and therefore it found no need to look beyond the language.⁹⁵ The court reached this conclusion despite further language that the lead would hold for the participant its pro rata share of loan payments.⁹⁶ The court relied on the rationale that banks normally do not stand in a fiduciary relation to each other.⁹⁷ A participant in an arm's-length commercial transaction should conduct independent credit analysis of loans considered for participation.⁹⁸

In a second line of cases the courts are not so quick to find the agreement dispositive of the matter, and instead look beyond the agreement to all facts and circumstances.⁹⁹ In *Savings Bank v. FDIC*¹⁰⁰ the court confronted the issue of whether the participation arrangement at bar was a loan or sale.¹⁰¹

86. See *John L. Walker Co. v. Alden*, 6 F. Supp. 262, 264-66 (E.D. Ill. 1934).

87. See *id.* at 264.

88. See *id.* at 265.

89. *Id.* at 265-66.

90. *Stratford Fin. Corp. v. Finex Corp.*, 367 F.2d 569, 571 (2d Cir. 1966) (construing 1 SCOTT, TRUSTS § 12.2 (2d ed. 1965)); *Northern Trust Co. v. FDIC*, 619 F. Supp. 1340, 1345 (W.D. Okla. 1985).

91. Compare *Northern Trust Co. v. FDIC*, 619 F. Supp. 1340, 1345 (W.D. Okla. 1985) (terms of agreement clearly created assignment and agency despite language that lead would hold payments for participant) with *Savings Bank v. FDIC*, 668 F. Supp. 799, 806 (S.D.N.Y. 1987) (purchase/sale language conflicted with language stating participant would receive greater return and bear no risk of loss; therefore, must look to parties' intent).

92. 619 F. Supp. 1340 (W.D. Okla. 1985).

93. *Id.* at 1341.

94. *Id.* at 1345.

95. *Id.*

96. *Id.* at 1342.

97. *Id.* at 1344.

98. *Id.*

99. *E.g., In re Penn Central Transp. Co.*, 486 F.2d 519, 524 (3d Cir. 1973) (court found trust despite failure to expressly designate relationship as one of trust on basis of conduct of parties); *Stratford Fin. Corp. v. Finex Corp.*, 367 F.2d 569, 571 (2d Cir. 1966) (court found trust relationship based on intent of parties as indicated in agreement guaranteeing repayment to participant, a term that usually denotes loan instead of purchase); *Savings Bank v. FDIC*, 668 F. Supp. 799, 806 (S.D.N.Y. 1987) (court exercised its equitable powers and found purchase and then trust relationship on basis of parties' intent despite language that participant had no risk and received higher rate of return than lead).

100. 668 F. Supp. 799 (S.D.N.Y. 1987).

101. *Id.* at 804.

The agreement stated the transaction was a purchase/sale, but also stated the participant had no risk of loss and would receive a higher rate of return than the lead. Under these facts the court would normally find the relationship a mere loan disguised as a participation.¹⁰² The court found instead, however, that the parties intended the transaction to be a purchase/sale and, moreover, that the parties intended the lead to hold the proceeds of the loans in trust for the participant.¹⁰³

Turning to the second prong of the test, the assets at the lead bank must be "augmented" in an amount equal to the reduction of the loan balance.¹⁰⁴ Augmentation is not established by bookkeeping transactions or an intrabank transfer.¹⁰⁵ Instead, the lead bank's assets must be increased through the receipt of monies from outside the bank.¹⁰⁶

Under the final requisite factor, the participating bank must be able to trace the funds to the trust.¹⁰⁷ Courts have utilized two tests to determine if the participating bank meets this factor.¹⁰⁸ First, some courts find that the commingling of the trust funds with the lead's general funds destroys the separate character and trust traceability requirement, thus defeating the trust claim.¹⁰⁹ Other courts disregard the fact that the lead commingled the monies with other income for any given period of time.¹¹⁰ The courts follow the rationale that if the bank's remaining assets in the hands of the receiver are sufficient to cover the trust monies, a presumption exists that the lead bank spent its money first, keeping the trust separate, and therefore, meeting the traceability element.¹¹¹ In adopting the latter view, the courts eviscerate

102. *Id.* at 806.

103. *Id.* A couple of external factors in *Savings Bank* are worth noting. First, the FDIC characterizes similar transactions it enters into as purchases/sales. Second, the parties sought and initially received a ruling by the FDIC characterizing the transaction as a purchase/sale. The FDIC changed its position, after the OCC declared the lead insolvent, and characterized the transaction as a loan. *Id.* at 808.

104. Note, *supra* note 31, at 1127-28.

105. *FDIC v. Mademoiselle of Cal.*, 379 F.2d 660, 665 (9th Cir. 1967).

106. *Id.*

107. *See, e.g., Mademoiselle*, 379 F.2d at 665 (participant must be able to identify fund in the hands of receiver); *Chase Manhattan Bank, N.A. v. FDIC*, 554 F. Supp. 251, 254 (W.D. Okla. 1983) (participant must show "traceable res upon which a constructive trust can be imposed"); *John L. Walker Co. v. Alden*, 6 F. Supp. 262, 265 (E.D. Ill. 1934) (claimant must show receiver holds account that includes the claimant's deposit) (quoting *Fiman v. South Dakota*, 29 F.2d 776, 780 (8th Cir. 1928), *cert. denied*, 279 U.S. 841 (1929)).

108. *Compare Stratford Fin. Corp. v. Finex Corp.*, 367 F.2d 569, 571 (2d Cir. 1966) (finding a trust relationship despite commingling of funds) *and Savings Bank v. FDIC*, 668 F. Supp. 799, 807 (S.D.N.Y. 1987) (holding commingling of funds not "fatal" to trust claim) *with Hibernia Nat'l Bank v. FDIC*, 733 F.2d 1403, 1408 (10th Cir. 1984) (requiring the participant to "identify a specific fund") *and Seattle-First Nat'l Bank v. FDIC*, 619 F. Supp. 1351, 1360 (W.D. Okla. 1985) (stating participant must point to an identifiable res).

109. *See, e.g., Stratford Fin. Corp. v. Finex*, 367 F.2d 569, 571 (2d Cir. 1966) (recognized trust only after discussing brevity of commingling and parties' intent to keep funds separate); *Keyes v. Paducah & I.R. Co.*, 61 F.2d 611, 613 (6th Cir. 1932) (trust fund not established since claimant could not point to special deposit fund); *Federal Home Loan Mortgage Corp. v. FDIC*, No. 85-39 (E.D. Ky. 1985) (funds did not create trust since they were not segregated).

110. *Savings Bank*, 668 F. Supp. at 807.

111. *John L. Walker Co. v. Alden*, 6 F. Supp. 262, 265 (E.D. Ill. 1934). *See generally* Note, *supra* note 31, at 1126-29 (discussing the application of the three-part test).

the traceability prong for all practical purposes.¹¹²

One commentator criticizes this three-prong analysis as too simplistic for the increasingly complex loan participations of today.¹¹³ In *John L. Walker Co. v. Alden*¹¹⁴ the court discussed for the first time the three-prong test in relation to the assertion of preferred claims against a failed bank's assets.¹¹⁵ The court noted the hesitancy with which the legislature viewed recoveries against the receiver and therefore applied the strict trust test.¹¹⁶ *Alden* dealt not with a participation arrangement though, but with bond proceeds retained by the bank until the contractor met the conditions of his contract. The *Alden* court did not intend the test for determining the existence of a trust to be carried over to the numerous situations in which it is utilized today.¹¹⁷

III. LEAD BANK FAILURE

A. *The Role of the FDIC*

Whenever the Comptroller of Currency declares a national bank insolvent,¹¹⁸ it must appoint the FDIC as receiver.¹¹⁹ The FDIC as receiver stands in the position of the failed bank and must marshal the assets of the bank for both its creditors and shareholders. The FDIC must wind up the affairs of the closed bank according to the respective law addressing the liquidation of closed national banks.¹²⁰ The FDIC can take one of three possible routes to effectuate the liquidation process. First, the FDIC can carry out the liquidation process by allowing the bank to be closed through a straight liquidation with a deposit insurance payout.¹²¹ Second, the FDIC may choose to set up the Deposit Insurance National Bank, which assumes the insured deposits of the failed bank and performs other functions including accepting new deposits.¹²² Third, the FDIC can arrange a purchase and assumption transaction.¹²³ A purchase and assumption transaction involves the FDIC as receiver, the FDIC in its corporate capacity, and a healthy bank purchasing the assets of the failing bank.¹²⁴

Today the FDIC most commonly uses the purchase and assumption transaction.¹²⁵ The FDIC can effectively use the purchase and assumption

112. Note, *supra* note 31, at 1132.

113. *Id.* at 1131-33.

114. 6 F. Supp. 262 (E.D. Ill. 1934).

115. *Id.* at 264-67.

116. *Id.* at 267.

117. Note, *supra* note 31, at 1131.

118. A bank is insolvent when it can no longer meet the demands of its depositors. 12 U.S.C. § 1821(b) (1982).

119. 12 U.S.C.A. § 1821(c) (West Supp. 1988).

120. 12 U.S.C. § 1821(d) (1982).

121. *Id.* § 1821(f).

122. 12 U.S.C.A. § 1821(h), (i) (West Supp. 1988).

123. *Id.* § 1823(c).

124. Note, *Creditors' Remedies Against the FDIC as Receiver of a Failed National Bank*, 64 TEX. L. REV. 1429, 1432 (1986).

125. The other two alternatives to the FDIC are rarely used due to several disadvantages, including the requirement of a large outlay of cash either for operating expenses or direct

alternative as a tool to deny payment of certain claims.¹²⁶ In a purchase and assumption transaction, the FDIC in its receiver capacity arranges for a healthy bank to purchase the assets and assume certain liabilities, including deposits of the failed bank, without interrupting bank services.¹²⁷ The purchasing bank usually purchases all performing assets, leaving the nonperforming assets with the FDIC as receiver.¹²⁸ The bank normally assumes greater liabilities than assets; therefore, the FDIC will pay the assuming bank cash to balance the equation.¹²⁹ The FDIC as receiver sells the assets that the assuming bank does not purchase, such as nonperforming loans, to the FDIC in its corporate capacity.¹³⁰ The money paid to the FDIC as receiver is equivalent to the cash paid to the assuming bank in order to equalize the assets and liabilities.¹³¹

The corporate FDIC has priority to the claims of the receivership and thus attempts to collect those nonperforming assets it purchased to supplant the monies paid the purchasing bank out of the insurance fund.¹³² In the rare event the corporate FDIC recovers excess proceeds, they are returned to the FDIC receiver for the benefit of the general creditors.¹³³

Through the purchase and assumption transaction, the FDIC as receiver transfers all assets either to the assuming bank or to the corporate FDIC. Claimants of the failed bank can look only to the receiver, which has effectively depleted all assets of the bank. The FDIC frequently answers any claims brought against it with a sovereign immunity defense.¹³⁴ In sum, the FDIC saves money since it pays less for the nonperforming assets than it would pay under a straight liquidation paying off all depositors to the extent they are insured, while at the same time, by virtue of its role of "insuring the nation's banking system," it has special defenses that result in denial of valid claims against the failed bank.¹³⁵

B. Application to Participation Agreements as Loan Transactions

In the event a court concludes the participation agreement is a loan cloaked in participation language, the participant becomes a general creditor

payoffs to depositors. Furthermore, the alternatives require interruption in bank services, lack of depositor access to funds until the depositors prove their claims, and a shaken public confidence. For a general discussion of disadvantages of the various alternatives, see C. Kelly, *FDIC Overview* (unpublished paper, also being prepared for Matthew Bender, Bankruptcy).

126. Note, *supra* note 124, at 1430.

127. *Id.* at 1432.

128. Portis, *FDIC's Powers After a Bank Failure*, 65 U. DET. L. REV. 259, 261 (1988).

129. If the assets were greater than the liabilities, the lead would be able to meet its obligations, and accordingly, this discussion would be inappropriate.

130. Portis, *supra* note 128, at 262.

131. *Id.*

132. *Id.*

133. *Id.*

134. See generally Kronberg, *Failing Banks: Creditors' Rights and the Distribution of Assets*, 7 ANN. REV. BANKING L. 325 (1988) (discussing problems bank creditors face after a purchase and assumption transaction).

135. For an in-depth discussion of the chain of events after a national bank failure, including alternatives to the FDIC and the subsequent litigation, see Portis, *supra* note 128. For additional discussion, see Note, *supra* note 124.

and must engage in the claims process.¹³⁶ All creditors of the failed bank must present their claims. If the FDIC disaffirms the creditor's claim, the creditor may challenge it in court and possibly obtain a court order directing the receiver to pay the claim.¹³⁷

Under a straight liquidation¹³⁸ the FDIC issues receivership certificates to each general creditor holding a valid claim in an amount equal to the creditor's claim, for example the amount of proceeds collected but not distributed with respect to the participated loan.¹³⁹ As the FDIC liquidates the receivership assets, it distributes liquidation dividends in an amount equal to the participant's claim in proportion to the total claims.¹⁴⁰ All general creditors share ratably in distributions from the receivership.¹⁴¹ The participant suffers a great disadvantage in these circumstances. The participant must prove its claim, wait for distributions of proceeds, and hope to recover its full claim, which is extremely doubtful.

If the FDIC chooses the purchase and assumption transaction, it potentially magnifies the participant's problems as a general creditor. The problem arises if the participant's claim is not assumed in the purchase and assumption transaction arranged by the FDIC.¹⁴² Arguably, the purchase and assumption transaction amounts to a preferential distribution of bank assets to those creditors whose claims are assumed.¹⁴³ Whether or not the participant will be able to recoup its full claim from the FDIC is unclear. *First Empire Bank v. FDIC*¹⁴⁴ and *FDIC v. Citizens Bank & Trust Co.*¹⁴⁵ demonstrate diverging thoughts on the issue.¹⁴⁶

In *First Empire* the FDIC liquidated an insolvent bank through a purchase and assumption agreement. The purchasing bank did not assume a number of letter of credit obligations of the insolvent bank. The creditors whose claims had not been assumed contended that the purchase and assumption transaction was a preferential distribution by the receiver to those creditors whose obligations were assumed contrary to the FDIC's duty to make ratable distributions.¹⁴⁷ The court held that the creditors were entitled

136. For a discussion on the claims process, see Note, *supra* note 124, at 1431-40.

137. *Id.* at 1433-34; 12 U.S.C. § 1821(f) (1982) (before paying claim, corporation "may require the final determination of court").

138. See 12 U.S.C. § 1821(f) (1982).

139. See Note, *supra* note 124, at 1431-32.

140. *Id.*

141. 12 U.S.C. § 194 (1982).

142. For discussion of the purchase and assumption transaction, see *supra* notes 125-35.

143. See Kronberg, *supra* note 134, at 332.

144. 572 F.2d 1361 (9th Cir.), *cert. denied*, 439 U.S. 91 (1978).

145. 592 F.2d 364 (7th Cir.), *cert. denied*, 444 U.S. 829 (1979).

146. For an in-depth analysis of these cases and the impact of the disparity, see Kronberg, *supra* note 134.

147. These requirements are set forth in 12 U.S.C. §§ 91, 194 (1982). Section 91 provides "all payments of money . . . made after the commission of an act of insolvency, or in contemplation thereof, made . . . with a view to the preference of one creditor to another . . . shall be utterly null and void." *Id.* § 91. Section 194 adds: "The comptroller shall make a ratable dividend of the money so paid over to him by such receiver on all such claims as may have been proved to his satisfaction or adjudicated in a court of competent jurisdiction . . ." *Id.* § 194.

to receive their ratable share given that the following criteria were met: (1) the insolvent bank's liability was fixed at the date of insolvency, and (2) a claim was filed in a timely manner against the receiver.¹⁴⁸ The court reasoned that equitable payment of all creditors surely is of greater importance than the fiscal integrity of the deposit insurance fund.¹⁴⁹ To hold otherwise would leave unassumed creditors with nothing more than a claim against the undesirable assets of the insolvent bank on which the FDIC as a corporation has a priority status.¹⁵⁰

In *Citizens* the court reviewed a claim arising from a purchase and assumption transaction. The claimant participated in a loan that the purchasing bank did not purchase in the purchase and assumption transaction. The FDIC in its receiver capacity transferred the loan to the FDIC in its corporate capacity. The receivership was left without any assets after the purchase and assumption transaction, precluding recovery by those creditors whose obligations were not assumed. The court concluded that while the FDIC may have breached its duty to distribute the insolvent bank's assets ratably, the FDIC was immune pursuant to sovereign immunity granted under the Federal Torts Claim Act.¹⁵¹

These cases illustrate the uncertainty a participant relegated to a general creditor status faces under different jurisdictions. If the participant is in the Ninth Circuit and meets the requisite criteria, he should receive a pro rata share of the failed bank's assets on equal footing with those creditors whose claims are assumed by the purchasing bank.¹⁵² One commentator suggests that this theory will create certainty regarding which claims the FDIC will recognize, and accordingly, reduce the amount lead banks must compensate participants.¹⁵³ Thus, the overall cost in banking will decrease. If the participant is in the Seventh Circuit, however, his rights as a general creditor are less certain as the court is likely to hold the FDIC immune from creditors' claims.¹⁵⁴

C. Application to Bona Fide Participation Agreements

In the event the participant demonstrates that it purchased a participation and therefore holds a beneficial interest in the loan, its collection rights should be ensured even if the lead is declared insolvent. The participant is a partial owner of the underlying loan rather than just a lender to the lead bank. Even the FDIC does not dispute that the participant has an owner-

148. *First Empire*, 572 F.2d at 1367, 1369.

149. *Id.* at 1371. The courts closing statement provides "it could not have been congressional intent, upon balance, to have the fiscal integrity of the deposit insurance fund . . . outweigh the policy of equitable and ratable payment of creditors in this manner and to permit the FDIC . . . to prefer some creditors over others . . ." *Id.*

150. *Id.*

151. *FDIC v. Citizens Bank & Trust Co.*, 592 F.2d 364, 368-69 (7th Cir.), *cert. denied*, 444 U.S. 829 (1979).

152. *First Empire*, 572 F.2d at 1371.

153. Kronberg, *supra* note 134, at 327.

154. *Citizens Bank*, 592 F.2d at 371-73.

ship interest in the loan if the loan participation is in fact valid.¹⁵⁵ Numerous courts authorize recovery by the participant in preference to the general pro rata distribution of assets if the court finds the participant owns the property.¹⁵⁶ Contrary to the rationale behind this line of cases, however, authority also exists for allowing the FDIC to dilute the participating bank's interest through several vehicles: (1) finding an agreement unenforceable,¹⁵⁷ (2) utilizing a future advances clause,¹⁵⁸ and (3) utilizing setoff.¹⁵⁹ The following subsections discuss these vehicles. The latter two vehicles are of equal concern to all participants regardless if they are classified as lenders or bona fide participants, and thus, the discussion will encompass application to both classifications.

1. *Enforceability of Agreement Against FDIC*

Of concern, even to a bona fide participant, is whether the participation agreement will be effective against the FDIC when it intervenes in the case of a failed lender. If the FDIC arranges a purchase and assumption transaction and transfers the nonassumed assets and liabilities to the FDIC in its corporate capacity, the participant cannot enforce a participation agreement unless the agreement complies with 12 U.S.C. section 1823(e).¹⁶⁰ This section provides that an agreement is valid against the FDIC only if (1) the parties execute the agreement in writing, (2) the parties execute the agreement at the time the lead bank acquires the loan, (3) the board of directors of the bank approve the agreement, and (4) the agreement is an official bank

155. *Savings Bank v. FDIC*, 668 F. Supp. 799, 804 (S.D.N.Y. 1987).

156. *E.g.*, *FDIC v. Mademoiselle of Cal.*, 379 F.2d 660, 664 (9th Cir. 1967) (direct recovery against receiver "is authorized in situations where the facts are such that the court must say in equity that the property is not that of the bank but that of the claimant") (quoting *John L. Walker Co. v. Alden*, 6 F. Supp. 252, 267 (E.D. Ill. 1934)); *Savings Bank v. FDIC*, 668 F. Supp. 799, 808 (S.D.N.Y. 1987) (allowing participating bank to recover its full 80% interest in underlying loan's proceeds in preference to general pro rate distribution of receivership assets after finding parties intended to create trust and a true purchase of undivided interest in underlying loan); *InterFirst Bank Abilene v. FDIC*, 590 F. Supp. 1196, 1200 (W.D. Tex. 1984), *aff'd*, 777 F.2d 1092 (5th Cir. 1986) (when FDIC collected amount due on participated loan, it acted as agent for InterFirst, given participation was purchase/sale, and thus, funds collected were not asset of receivership to be distributed among general creditors, but instead belonged to InterFirst); *In re Columbia Pac. Mortgage*, 20 Bankr. 259, 263 (Bankr. W.D. Wash. 1981) (allowing secondary mortgage participant direct recovery of liquidation proceeds after finding participant was beneficial owner of undivided interest in underlying loans, and accordingly seller was holding trust property subject to beneficiary's interest).

157. 12 U.S.C. § 1823(e) (1982).

158. *In re Continental Resources Corp.*, 43 Bankr. 658, 663-65 (Bankr. W.D. Okla. 1984), *aff'd*, 799 F.2d 622 (Bankr. 10th Cir. 1986).

159. *See, e.g.*, *Hibernia Nat'l Bank v. FDIC*, 733 F.2d 1403, 1408 (10th Cir. 1984) (participation arrangement did not transfer ownership to participant and did not preclude borrower's/depositor's right to offset); *FDIC v. Mademoiselle of Cal.*, 379 F.2d 660, 664 (9th Cir. 1967) (sale of interest in loan did not impact borrower's/depositor's right to offset); *Northern Trust Co. v. FDIC*, 619 F. Supp. 1340, 1343 (W.D. Okla. 1985) (borrower/depositor has right to offset even if another bank is participating in loan as long as lead is still creditor and has responsibility for participated loan); *Seattle-First Nat'l Bank v. FDIC*, 619 F. Supp. 1351, 1356-57 (W.D. Okla. 1985) (finding that participation transaction created property interest in participant does not preclude borrower/depositor from offsetting). For a discussion of the mechanics and ramifications of setoff, see *infra* section III.C.3.

160. 12 U.S.C. § 1823(e) (1982).

record.¹⁶¹ All four statutory requirements must be met before a participant can succeed against the FDIC when the participant attempts to dilute an asset of the failed bank.¹⁶² One of the purposes for the statute is to allow bank examiners to rely on a bank's records when conducting bank examinations to determine the fiscal soundness of the bank.¹⁶³ Not surprisingly, the FDIC refuses to honor oral recourse agreements asserted by the participant against the failed bank.¹⁶⁴

Courts thus far have not concerned themselves with the requirement that the parties execute the agreement contemporaneously with the execution of the underlying loan. This requirement deserves attention as a growing number of banks utilize the participation agreement to "window dress," or to enhance liquidity when the bank is suffering from undercapitalization.¹⁶⁵ Lenders utilizing participations for these purposes frequently enter the agreement subsequent to the initial funding of the loan.

While the courts have not addressed the situation where the lead lender and participant do not execute the participation contemporaneously with the creation of the loan by the lead lender, one commentator suggests the import of such a situation.¹⁶⁶ It is unclear why the FDIC is not quick to jump on this defense as it usually is not timid with its claims. Arguably, the statute is inapplicable to a bona fide participation interest because the lead bank has conveyed the asset to the participant; therefore, the lead does not include that portion of the asset on its books and the FDIC does not include the asset in its evaluation of the bank. Moreover, on the same line of argument, in the event the purchasing bank in a purchase and assumption transaction does not assume the loan, the FDIC would not acquire the participated interest of the loan since it is not an asset of the receivership because the participant now owns the asset. No case law exists to support this proposition,

161. 12 U.S.C. section 1823(e) provides as follows:

No agreement which tends to diminish or defeat the right, title or interest of the Corporation [(FDIC)] in any asset acquired by it under this section, either as security for a loan or by purchase, shall be valid against the Corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the bank and the person or persons claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the bank, (3) shall have been approved by the board of directors of the bank or its loan committee, which approval shall be reflected in the minutes of said board or committee, and (4) shall have been, continuously, from the time of its execution, an official record of the bank.

Id.

162. See *Langley v. FDIC*, 108 S. Ct. 396, 403, 98 L. Ed. 2d 340, 342 (1987).

163. *Id.* at 401, 98 L. Ed. 2d at 342. The Court subsequently notes that such reliance is critical given that the FDIC uses such evaluations in determining if a bank is insolvent and then determining the best way to proceed, e.g., liquidate or arrange a purchase and assumption transaction. *Id.* Since this last evaluation is made "with great speed, usually overnight, in order to preserve the going concern value of the failed bank and avoid an interruption in banking services," banking authorities must be able to review the books and determine the exact nature and terms of all assets. *Id.*

164. See *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447, 457-59 (1942).

165. See, e.g., *Savings Bank v. FDIC*, 668 F. Supp. 799, 801 (S.D.N.Y. 1987) (participation agreement was result of concentrated effort by lead bank's board of directors to sell off part of existing loan portfolio in attempt to "solve its chronic undercapitalization problems").

166. See *Norton & Rogers*, *supra* note 14, at 8.

however, and it is equally feasible that the FDIC will argue the agreement does diminish the FDIC's right in the loan/asset it acquires, given the agreement decreases the interest held by the receivership.

2. *Future Advances Clause*

An obstacle facing both true participants and lending participants arises when the underlying loan agreement contains future advance language.¹⁶⁷ The case of *In re Continental Resources Corp.*¹⁶⁸ provides an illustration of the problem. In *Continental Resources* the debtor (CRC) and Penn Square Bank, N.A. (PSB) entered a secured revolving credit agreement. CRC granted PSB a mortgage on all of CRC's oil and gas wells as security. The mortgage included language indicating the mortgage secured any loans and advances the mortgagee "makes now or hereafter" and any other obligations of the mortgagor to the mortgagee.¹⁶⁹ PSB subsequently entered a participation agreement with Continental Illinois National Bank and Trust Company of Chicago (CINB), in which CINB became a ninety-five percent participant in the loan. Later that year, PSB entered a second lending agreement with CRC.

The Comptroller of Currency later declared PSB insolvent, and appointed the FDIC receiver. The FDIC alleged that the oil and gas mortgages granted with the initial funding also secured the second loan. CINB alleged that PSB had a fiduciary duty to refrain from using the collateral for a second loan between the lead bank and the borrower. In addressing this allegation, the court looked to the language in the participation agreement.¹⁷⁰ Despite conflicting terms regarding whether the lead had to obtain consent before the release of the collateral,¹⁷¹ the court found the language dispositive, holding that the application of the collateral to both loans did not de-

167. A future advances clause provides that the collateral pledged will also cover future advances made by the lender to the borrower and any other debts, obligations, and liabilities the debtor incurs. BLACK'S LAW DICTIONARY 609 (5th ed. 1979). The purpose of using the clause is to preclude having to execute extensive documentation each time the lender makes a future advance to the same borrower. *In re Continental Resources Corp.*, 43 Bankr. 658, 660 (Bankr. W.D. Okla. 1984), *aff'd*, 799 F.2d 622 (Bankr. 10th Cir. 1986).

168. 43 Bankr. 658 (Bankr. W.D. Okla. 1984), *aff'd*, 799 F.2d 622 (Bankr. 10th Cir. 1986).

169. The mortgage included the following clause:

This mortgage is given to secure the following indebtedness . . . [a]ll loans and advances which Mortgagee may hereafter make to Mortgagor, and all other and additional debts, obligations and liabilities of every kind and character of Mortgagor . . . together with any and all renewals and extensions of such loans, advances, debts, obligations and liabilities, or any part thereof, and all interest, attorney's fees and other charges thereof, or incurred in connection therewith.

43 Bankr. at 660.

170. *Id.* at 663.

171. The participation agreement and corresponding certificate both contained clauses dealing with the release of collateral. *Id.* at 664. The participation agreement provided: "[W]e will not without your prior written consent exercise any such rights which would . . . release any collateral for the loans . . ." *Id.* The participation certificate provided: "We reserve the right to release collateral and to permit substitutions of new collateral." *Id.* Arguably, these two clauses are ambiguous, thus requiring the court to look beyond the agreement. It is unclear, however, whether the court would have reached a different result.

stroy the participation agreements.¹⁷² The court found the language in the agreement to be similar to a case where the court disagreed with the participant's argument that the participation transferred ownership.¹⁷³ It is unclear, however, whether ownership language alone would preclude such an outcome. Unless trust language exists creating a fiduciary duty,¹⁷⁴ the court will continue to apply the collateral to any advances covered by the future advance clause, because of the presumption that a commercial financial institution knows the terms of the loan agreement and the value and security of its investment.¹⁷⁵

3. *The Problem of Setoff*

Both bona fide participants and those classified as lenders are faced with an additional and increasingly prevalent pitfall, the problem of setoff. The lead bank makes a loan to a borrower and either contemporaneously or subsequently sells a percentage of the loan to a participating bank. The borrower, either on its own accord or upon the lead bank's suggestion, maintains deposit accounts at the lead bank. Subsequently, the lead bank is declared insolvent, and the FDIC steps in as receiver. The FDIC then allows those debtors who have deposit accounts at the bank to offset those deposits against their indebtedness to the bank, thus reducing their note balance. One might initially think this benefits both the lead and the participant since they have realized a reduction in the total debt. The participant, however, does not fare so well. Instead of receiving its pro rata share of the loan payment effectuated through the setoff, the participant receives Receiver's Certificates in an amount equal to its pro rata share of the setoff proceeds.¹⁷⁶

The problem is more clearly illustrated in *Chase Manhattan Bank, N.A. v. FDIC*,¹⁷⁷ one of numerous cases stemming from the Penn Square Bank (PSB) failure. Chase purchased participations in numerous loans made by PSB. Sometime thereafter, the Comptroller of Currency declared PSB insolvent and appointed the FDIC as receiver. After finding that particular depositors also had outstanding debts to PSB, the FDIC proceeded to offset those funds on deposit against the indebtedness to the bank. This setoff reduced the depositors'/borrowers' debt. Instead of paying Chase its pro rata share of setoffs effectuated against the participated loans, the FDIC indicated that it would give Chase a Receiver's Certificate for its pro rata share of the amount offset.¹⁷⁸

172. *Id.* at 664.

173. *Id.* (discussing *Hibernia Nat'l Bank v. FDIC*, 733 F.2d 1403, 1408 (10th Cir. 1984)).

174. For a discussion of the trust relationship, see *supra* notes 80-117 and accompanying text.

175. *Colorado State Bank v. FDIC*, 671 F. Supp. 706, 707-08 (D. Colo. 1987); *Northern Trust Co. v. FDIC*, 619 F. Supp. 1340, 1344-46 (W.D. Okla. 1985).

176. See generally Comment, *Lead Lender Insolvency and the Problem of Setoff*, 40 *BAYLOR L. REV.* 391 (1988) (discussing the right of setoff and its effect on participants).

177. 554 F. Supp. 251 (W.D. Okla. 1983).

178. The court illustrated the mechanics of the transaction as follows: PSB loans \$1,000,000 to Borrower and Borrower has \$500,000 on deposit with PSB as of the date of

The court upheld the FDIC's method of dealing with participating banks after finding first that the depositor has the equitable right of setoff.¹⁷⁹ Further, the court focused on the lack of augmentation to the receiver's estate after the setoff.¹⁸⁰ Instead, since a mere shifting of credits or paper transaction occurred, the participant could not identify a specific fund held by the receiver that equitably belonged to the participating bank.¹⁸¹ Finally, the court held that since Chase was not an assignee, it had no property rights in the participated loans that might entitle it to a preferred claim.¹⁸²

The differentiation between a payment made on a loan and a setoff against the loan was first made in *FDIC v. Mademoiselle of California*.¹⁸³ The case involved a fact situation similar to that in *Chase*. In *Mademoiselle* the court noted that in order for the participant to establish a preferred claim, it must meet a heavy burden of proof, indicating that the participant fails to meet this burden unless it clearly identifies the fund.¹⁸⁴ The participant did not carry its burden because the indebtedness was reduced by setoff instead of by a specific payment on the note.¹⁸⁵ The court reasoned that a setoff does not establish funds a participant can claim as its own.¹⁸⁶ Since the setoff is merely a shifting of credits, no augmentation of the insolvent bank's assets occurs.¹⁸⁷

These cases illustrate that the depositor/borrower of an insolvent bank has an equitable right to offset its deposits against its indebtedness.¹⁸⁸ The depositor/borrower may exercise this right only if it meets certain conditions. First, the funds on deposit are the debtor's property.¹⁸⁹ Second, the funds on deposit are not a special fund and do not have any restrictions on them.¹⁹⁰ Third, a debt due and owing exists to the bank.¹⁹¹ Last, a mutuality of indebtedness exists between the bank and depositor.¹⁹² The depositor/borrower does not lose its right to offset because of participation so long as the lead bank retains creditor status.¹⁹³ Since the nature of the setoff precludes augmentation of the bank's assets or identification of a specific

PSB's insolvency. Upon insolvency of PSB, the Borrower can offset his \$500,000 deposit against his debt of \$1,000,000, thus now owing PSB \$500,000. PSB would no longer be liable to the Borrower for his \$500,000. If Chase had a 90% participation, the FDIC would give Chase a Receiver's Certificate for \$450,000, which is 90% of the offset. *Id.* at 253.

179. *Id.* at 254.

180. *Id.*

181. *Id.*

182. *Id.* at 256.

183. 379 F.2d 660, 665 (9th Cir. 1967).

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

185. *Id.* at 665.

186. *Id.*

187. *Id.*

188. *Chase Manhattan Bank, N.A. v. FDIC*, 554 F. Supp. 251, 254 (W.D. Okla. 1983) (construing *Scott v. Armstrong*, 146 U.S. 499, 510 (1892)).

189. *Seattle-First Nat'l Bank v. FDIC*, 619 F. Supp. 1351, 1357 (W.D. Okla. 1985).

190. *Id.*

191. *Id.*

192. *Id.* The requirement of mutuality is met if the lead bank and the borrower "each occupy the relation of debtor and creditor on reciprocal demands." *Id.*

193. *Id.*

fund the participant can claim as its own, the courts will relegate the participant to creditor status of the lead bank.¹⁹⁴ One court has recognized the impairment of the participant's property rights, but went on to say that the property rights acquired were merely an expectation, subject to the right to offset.¹⁹⁵ The borrower and receiver can enforce these rights unless the participation agreement provides otherwise.¹⁹⁶

IV. PROPOSED CHANGES

The purpose of this Comment is to discuss the various legal issues related to the participation agreement and to demonstrate the mounting confusion, disparity, and need for reform in the area. The issues are important to all who engage in this method of financing, but become even more important in the context of lead bank failure, an event that has become commonplace in the 1980s. While the courts have been balancing the equities in favor of the borrower and the lead bank on a case-by-case basis, instead of establishing clear principles of law, the courts have created a morass for banks to wade through in considering the use of participations. To eliminate these problems the judiciary and legislature must adopt a uniform, sound method of dealing with these relationships.

The most sensible place to start the reform is with the legal characterization of the participation relationship. At least six categories have been proposed in some form or fashion, yet the courts have failed to build a theory of law surrounding each of these that would enable a party to act with any certainty.¹⁹⁷ Courts today frequently imply, undeservingly, a presumption against the participant.¹⁹⁸ Certainly the participant has an obligation to exercise due diligence in determining the creditworthiness of both the underlying borrower and the lead bank. Once the participant demonstrates such diligence, however, no reason exists for the participant always to have a position behind the borrower and the lead bank, or more precisely the FDIC. Instead, the courts should presume that a purchase transaction occurred unless the substance of the transaction is a loan. The courts should examine the facts and circumstances to determine if the transaction is a loan when the participant assumes a lesser degree of risk either by having recourse against the lead, or by receiving a greater rate of return.

If the transaction is characterized as a purchase, courts should apply the theory that the participant has acquired a property interest in every aspect rather than the current practice of only applying the principle when it serves the government. For example, underlying loan agreements including a future advances clause should not impair the participant's interest. The participant as the owner of property rights has interests that should not be

194. *Chase Manhattan Bank*, 554 F. Supp. at 254-57.

195. *Seattle-First Nat'l Bank*, 619 F. Supp. at 1358 (" 'ownership interest' acquired . . . was merely [the participant's] share of an expectation . . . subject to the borrower's and the bank's rights of offset").

196. *Id.*

197. See *supra* notes 36-117 and accompanying text.

198. See *Seattle-First Nat'l Bank*, 619 F. Supp. at 1358.

diluted by the unfair dealings of the lead lender. Instead, when extending the "purchase" theory through to its logical consequences, the participant should be given credit for X percent of the loan, the lead should retain Y percent, and if the lead chooses to make future advances on the same collateral, it can only do so to the extent of its interest. The lead bank should not be able to dilute the participant's interest contrary to a bona fide participant being characterized as a partial owner of the underlying loan.

Likewise, the growing number of participants' interests diluted by setoff should cease. In upholding setoffs the courts have repetitively focused on what is fair to the borrower and the lead bank, leaving the burden with respect to the market risk of participation ventures on the participant.¹⁹⁹ Courts adopt this theory, viewing it as consistent with the banking policies published by the Comptroller of the Currency in its guidelines for participations.²⁰⁰ Dilution through setoff, however, is inconsistent with the concept of purchasing a property interest.

First, no mutuality exists between the underlying borrower and the lead to the extent of the participant's interest.²⁰¹ The ownership interest now lies with the participant, and the lead bank must exclude that portion of the loan from its outstanding loan balances when determining if the lead is in compliance with statutory lending limits.²⁰² Seemingly, the bank's creditor status in relation to the borrower has been reduced by the portion of the loan participated.

Recognizing the judiciary's reluctance to impair the borrower's right to setoff, especially since the borrower often is unaware of the participation, this proposal does not deny that right. Instead, this Comment proposes that the lead hold the setoff proceeds in trust for the participant, just as the lead does when it receives proceeds by means of a check or other external payment. An incredible disparity requires the lead as "trustee" to turn funds over to the participant if it receives them directly from the borrower, but not if it receives the funds through setoff. The result is the same: a reduction in the borrower's outstanding loan occurs through application of money belonging to it. The interests held by the respective parties have not changed, nor have the relationships changed. The only thing that has changed is the lead bank's status, which is more than likely due to its own mismanagement. Why the judiciary and legislature feel the participant should bear all the hardship is inexplicable.

Accordingly, this Comment suggests that the judiciary overrule the application of the three-prong test, specifically, the requirement of augmenta-

199. *Id.*

200. *Id.* (referring to Comptroller of the Currency Banking Circular No. 181 (rev. Aug. 2, 1984) replacing Banking Circular No. 181 (Dec. 8, 1983), 5 FED. BANKING L. REP. (CCH) ¶ 60,799, at 38,859-2).

201. In *Seattle Banking* the court failed to rule on whether mutuality exists in participated loans after April 14, 1983, when federal regulations took effect excluding certain participation loans from the lead bank's lending limits. *Id.* For a discussion on setoff and the criteria, see *supra* notes 176-96 and accompanying text.

202. 12 U.S.C.A. § 84(a) (West Supp. 1988).

tion.²⁰³ Without this requirement the participant would receive credit for its pro rata share in all cases in keeping with the underlying structure of the transaction: the lead bank acting as trustee and/or agent for the participant, and the participant realizing its interest.

Under this proposal, Congress must institute reforms at the FDIC level, clarifying the scope of federal deposit insurance coverage. Presently, the scope of the coverage includes the net deposit due to the depositor, to the extent it is less than \$100,000.²⁰⁴ The term "deposit" includes money or its equivalent held by the bank.²⁰⁵ This includes funds held for escrow, funds held as security, funds held as advance payments, funds held for letters of credit, and funds held for withheld taxes.²⁰⁶ The term specifically excludes

203. For a full discussion of the requirement of augmentation, see *supra* notes 104-06, 180-87 and accompanying text.

204. 12 U.S.C.A. § 1813(l)(1), (3), (m)(1) (West 1980 & Supp. 1988). The scope of the coverage presently is as follows:

Subject to the provisions of paragraph (2) of this subsection, the term "insured deposit" means the net amount due to any depositor (other than a depositor referred to in the third sentence of this subsection) for deposits in an insured bank (after deducting offsets) less any part thereof which is in excess of \$100,000. Such net amount shall be determined according to such regulations as the Board of Directors may prescribe, and in determining the amount due to any depositor there shall be added together all deposits in the bank maintained in the same capacity and the same right for his benefit either in his own name or in the names of others except trust funds which shall be insured as provided in subsection (i) of section 1817 of this title.

Id. § 1813(m)(1). The term "deposit" means:

(1) [T]he unpaid balance of money or its equivalent received or held by a bank in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to a commercial, checking, savings, time, or thrift account, or which is evidenced by its certificate of deposit, thrift certificate, investment certificate, certificate of indebtedness, or other similar name, or a check or draft drawn against a deposit account and certified by the bank, or a letter of credit or a traveler's check on which the bank is primarily liable: *Provided*, That, without limiting the generality of the term "money or its equivalent", any such account or instrument must be regarded as evidencing the receipt of the equivalent of money when credited or issued in exchange for checks or drafts or for a promissory note upon which the person obtaining any such credit or instrument is primarily or secondarily liable, or for a charge against a deposit account, or in settlement of checks, drafts, or other instruments forwarded to such bank for collection

(3) money received or held by a bank, or the credit given for money or its equivalent received or held by a bank, in the usual course of business for a special or specific purpose, regardless of the legal relationship thereby established, including without being limited to, escrow funds, funds held as security for an obligation due to the bank or others (including funds held as dealers reserves) or for securities loaned by the bank, funds deposited by a debtor to meet maturing obligations, funds deposited as advance payment on subscriptions to United States Government Securities, funds held for distribution or purchase of securities, funds held to meet its acceptances or letters of credit, and withheld taxes: *Provided*, That there shall not be included funds which are received by the bank for immediate application to the reduction of an indebtedness to the receiving bank, or under condition that the receipt thereof immediately reduces or extinguishes such an indebtedness

Id. § 1813(l)(1), (3).

205. 12 U.S.C.A. § 1813(l)(3) (West 1980 & Supp. 1988).

206. *Id.*

money received by the bank to reduce an indebtedness to the bank.²⁰⁷ Funds received by the lead through offset would appear to be within the purview of this last category.

Arguably, when the FDIC as receiver, acting for the lead, offsets the borrower's deposit account against his outstanding debt to both the lead and the participant, the money being held by the lead has just moved to a different creditor: the participant. The monies held are analogous to escrow funds, withheld taxes, and letters of credit.²⁰⁸ The lead is holding money that belongs to someone else. It is unclear, however, whether the existing statutory language includes setoff funds within the definition of deposit. Funds received by the lead bank through setoff reduce or extinguish an indebtedness to the receiving bank and are therefore specifically excluded from the term deposit.²⁰⁹

This writer suggests that the money received reduces not only a debt to the receiving bank, but also reduces the participant's respective debt. To the extent an ambiguity exists under the current statute, however, 12 U.S.C.A. section 1813(l)(3) should be amended by adding the following definition:

The term "indebtedness to the receiving bank" includes only that amount of money that the borrower owes to the bank after subtracting all interests that have been sold, and accordingly, excluded from the bank's outstanding loan balances for the purpose of determining statutory compliance with regulatory lending limits.²¹⁰

The next area this Comment addresses also involves the FDIC, and the need for guidance regarding when agreements will be enforceable against the FDIC acting in its corporate capacity. Ostensibly, the government promotes ambiguity in order to enhance its position against possible litigation. A troubled banking industry, however, cannot continue to operate under such uncertainties.²¹¹ Therefore, this writer proposes the legislative clarification of 12 U.S.C. section 1823(e), stipulating whether the lead must execute a participation agreement contemporaneously with the loan agreement.

Given the growing number of participations executed subsequent to the initial loan, this matter is of special importance. No real need exists for contemporaneous execution of the two agreements; therefore, this Comment proposes an amendment eliminating this requirement for participation agreements. This amendment will not be adverse to the underlying purpose of the section, which is to get an accurate picture of the bank's position.²¹²

A final target for legislative amendment involves the FDIC and its use of the purchase and assumption transaction.²¹³ Before discussing proposed changes, a look at the purpose of the FDIC is warranted. Congress created the FDIC and its function as receiver to protect both depositors and other

207. *Id.*

208. In each of these instances the lead is holding monies on someone else's behalf.

209. 12 U.S.C.A. § 1813(l)(3) (West 1980 & Supp. 1988).

210. *Id.*

211. See *supra* text accompanying notes 1-5.

212. See *supra* note 163 and accompanying text.

213. See *supra* notes 125-35, 142-54 and accompanying text.

creditors.²¹⁴ In the wake of mounting bank failures, however, the FDIC has changed its posture, seeking to preserve the fiscal integrity of the insurance fund versus protecting creditors, and consequently has expanded potential defenses available against creditors claims.²¹⁵

Claims arising from the purchase and assumption transaction demonstrate the use of these expanded defenses.²¹⁶ In the event the purchasing bank does not assume a participant's interest, the participant often alleges that the FDIC has breached its duty to make a ratable distribution.²¹⁷ While the participant may succeed with its claim in some jurisdictions, other jurisdictions quickly recognize an expanded FDIC immunity.²¹⁸ If the FDIC wants to continue to use the purchase and assumption transaction, Congress must remedy the discrepancy demonstrated in *First Empire Bank v. FDIC*²¹⁹ and *FDIC v. Citizens Bank & Trust Co.*²²⁰ This Comment proposes that the statute governing purchase and assumption transactions incorporate the test promulgated in *First Empire*. Incorporation of the test would be in line with the underlying purpose of protecting all creditors ratably.²²¹ Such legislation might provide as follows:

In the event the FDIC arranges a purchase and assumption transaction, it is providing for a distribution of assets and must do so on a ratable basis. Accordingly, all claims that are provable at the time the closed bank, or bank in danger of closing, is placed in the hands of the receiver shall be included in the distribution. A claim is provable

- (1) if it exists and is absolute at the time the bank is placed in receivership;
- (2) if it is made in a timely manner.

In the event certain provable claims are not assumed by the purchasing bank, the FDIC is authorized and obligated to pay dividends on such claims.²²²

Finally, recognizing that legislative change is not always expeditious, a model participation agreement follows in the Appendix with suggested language that attempts to preclude the unforeseen dangers that often arise after lead lender failure. Specifically, a participation agreement should include language reaffirming that the transaction is a sale, with the lead holding

214. Note, *supra* note 124, at 1429.

215. Kronberg, *supra* note 134, at 326-27.

216. See generally Kronberg, *supra* note 134 (discussing problems bank creditors face after FDIC arranges purchase and assumption transaction and disparity in courts' treatment of problems).

217. See *FDIC v. Citizens Bank & Trust Co.*, 592 F.2d 364, 368 (7th Cir.), *cert. denied*, 444 U.S. 829 (1979).

218. Compare *First Empire Bank v. FDIC*, 572 F.2d 1361, 1370-71 (9th Cir.) (FDIC obligated to make ratable distribution of failed bank's assets and use of purchase and assumption did not accomplish), *cert. denied*, 439 U.S. 91 (1978), with *FDIC v. Citizens Bank & Trust Co.*, 592 F.2d 364, 372-73 (7th Cir.) (FDIC immune under FTCA regardless of whether it breached duty to ensure ratable distribution of failed bank's assets), *cert. denied*, 444 U.S. 829 (1979). See also *supra* text accompanying notes 144-54.

219. 572 F.2d 1361, 1370-71 (9th Cir. 1978).

220. 592 F.2d 364, 372-73 (7th Cir. 1978).

221. See Note, *supra* note 124, at 1458.

222. The writer suggests this provision be included in 12 U.S.C. § 1823(c) after (4).

monies from the borrower, received either through direct payment or through setoff, in trust for the participant; language precluding the use of the underlying collateral as security for any other obligations; and language addressing procedures to be followed in the event of insolvency by any party.

V. CONCLUSION

The problems surrounding participation agreements have been mounting over a period of time, beginning with the classification of the arrangement. Moreover, the problems reached a climax in the wake of numerous bank failures. If banks continue to use participation agreements, legislatures and courts must make reforms at every level.

This Comment sets forth the problems facing participants and methods to resolve the related disputes. First, the judiciary should remove the augmentation requirement currently precluding the participant from receiving its pro rata portion of funds received through setoff. Second, the legislature should clarify that it is unnecessary for a lender to execute a participation agreement contemporaneously with the loan agreement. Additionally, the legislature should make a statutory change clarifying the duties of the FDIC when it arranges a purchase and assumption transaction. Specifically, the FDIC should have a duty to make a ratable distribution to all creditors, including those whose claims are not assumed by the purchasing bank. Last, this Comment offers a sample participation agreement emphasizing language intended to resolve questions surrounding ownership, future advances, set-off, and general treatment of the loan in the event of insolvency by the lead lender.

APPENDIX

SAMPLE FORM LOAN PARTICIPATION SALE AND TRUST AGREEMENT²²³

THIS LOAN PARTICIPATION SALE AND TRUST AGREEMENT, herein called "Agreement," is made in the State of Texas between _____, herein called "Seller," and _____, herein called "Purchaser."

Section 1. Purchase and Sale of Participation

1.1 Seller hereby agrees to sell to Purchaser and Purchaser hereby agrees to buy from Seller an undivided participating ownership interest in the principal amount of the loan (the "Loan") made by Seller to _____ (the "Borrower"), as evidenced by that certain note (the "Note") dated _____, 19__, with an original principal balance of \$_____. Purchaser purchases an interest in the principal amount of the Loan to the extent of __% (the "Pro Rata Part"), together with interest thereon at the per annum interest rate (the "Interest Percentage") of __% with respect to the Loan. This Agreement shall govern the sale and transfer by Seller to Purchaser of such participating ownership interest in the Loan, Seller's responsibilities for servicing the Loan, and all other aspects of this transaction.

Section 2. Purchaser's Obligation to Fund; Method of Funding

2.1 Seller shall notify Purchaser to fund hereunder. On the date of each advance by Seller under the Loan (and upon demand by Seller, after acceptance of this Agreement by Purchaser, with respect to funds already advanced by Seller under the Loan), Purchaser shall pay to Seller Purchaser's Pro Rata Part of such advance (or existing balance) in funds available for immediate use by Seller at its Dallas office by 11:00 a.m. Dallas time on such date, and, to the extent available, Seller shall be entitled to debit Purchaser's account or accounts at Seller by an amount equal to such payment obligation of Purchaser on such date.

2.2 In the event Purchaser fails or refuses to make any payment to Seller as required in Subsection 2.1 hereof and sufficient funds are not available therefor in Purchaser's account or accounts at Seller, then Seller shall be entitled to (a) fund Purchaser's Pro Rata Part of the advance (or continue to fund the existing balance) which is the subject of such payment and will be entitled to all interest attributable to Purchaser's Pro Rata Part thereof through the date that Purchaser pays its Pro Rata Part thereof to Seller as required herein, and (b) offset against Purchaser's Pro Rata Part of all sums received by Seller under Subsection 4.4 hereof until reimbursed therefore by Purchaser. Nothing in this paragraph shall be construed as releasing, modifying, or waiving Purchaser's obligation to make payments to Seller as provided in Subsection 2.1 hereof.

223. This agreement is only a representative form. Any actual agreement should be tailored to existing circumstances, following applicable laws. The writer thanks Jim Wallenstein, attorney with Jenkins & Gilchrist, P.C. and Norton & Rogers, *supra* note 14, at 15-20, for providing a source document.

Section 3. Seller's Representations and Disclaimers

3.1 Seller hereby represents and warrants to Purchaser that as of the date Purchaser buys its participating interest in the Loan under this Agreement:

(a) The Loan described in Section 1 hereof is a loan owned solely by Seller, having been made or acquired by it pursuant to and consistent with applicable law and regulations as from time to time amended.

(b) Seller is authorized to sell such participation interest.

(c) Such participation interest is eligible and shall remain eligible under applicable laws and regulations and this Agreement for purchase by the Purchaser.

(d) Seller has in its possession all instruments representing the Loan, including, but not limited to, where applicable, notes, appropriate security instruments, loan applications, appropriate evidence indicating the Borrower's receipt of disclosure materials as required by applicable regulations, appraisals or certificates of valuation, appropriate signed loan closing statements, insurance policies in an amount representing coverage at least equal to the outstanding principal balance of the Loan (together with any accrued and unpaid interest thereon which has been added to the principal balance), containing a Loss Payee clause in favor of Seller (collectively, the "Loan Documents").

(e) The Loan is current as to scheduled periodic payments.

(f) To the extent not already available to Purchaser, Seller shall use its best efforts to provide Purchaser with the information set forth in Subsection 3.1(d) and (e) of this Agreement, promptly after Seller's receipt of Purchaser's written request therefor.

(g) Seller has made no agreement with the Borrower as to its Loan except as stated in the Loan Documents.

(h) To Seller's knowledge there are no delinquent tax or assessment liens or mechanics' liens against the Borrower and/or collateral.

(i) The Loan is not pledged as collateral for any loan or for any other purpose.

3.2 Except as may otherwise be provided in this Agreement, Seller makes no warranty or representation regarding (and shall not be responsible to Purchaser for):

(a) The performance or observance of any of the terms, covenants or conditions of any of the Loan Documents on the part of the Borrower or any party other than Seller.

(b) The due execution, legality, validity, enforceability, genuineness, sufficiency, value or collectability of the Loan Documents or the Loan.

(c) Any representation, warranty, document, certificate, report, or statement herein made or furnished under or in connection with any of such documents.

(d) The adequacy of collateral, if any, for the obligations of the Borrower under the Loan.

(e) The financial condition of the Borrower.

3.3 Seller shall not have any duty to inspect the property (including books and records) of the Borrower. Except as may otherwise be provided in this Agreement, neither Seller nor any of its representatives shall be liable to Purchaser for any error of judgment or for any action taken or omitted to be taken by Seller, in good faith, in the administration and collection of the Loan, except for its own gross negligence and willful misconduct.

3.4 *Notwithstanding any provision contained in this Agreement, it is agreed that the sale by Seller to Purchaser of a participating ownership interest in the Loan pursuant to this Agreement shall be without recourse as provided in the applicable Rules and Regulations for Insurance of Accounts.*²²⁴

3.5 Purchaser represents and warrants:

(a) it has independently reviewed the Loan and all other documents related thereto in the possession of Seller and requested by Purchaser, and that there shall be no recourse on, or any liability incurred by, Seller for any misstatement (whether material or immaterial) or omission (whether negligent or otherwise) of any Person contained in any such documents or otherwise.

(b) Purchaser has conducted, to the extent it deemed necessary, an independent investigation of Borrower, including, without limitation, an investigation relating to the creditworthiness of Borrower, and the risk involved to Purchaser in the advance of its funds pursuant to the Agreement.

(c) Purchaser has not relied upon Seller for any such investigation or assessment of risk.

(d) Purchaser does not consider the acquisition of its participation hereunder to constitute the "purchase" or "sale" of a "security" within the meaning of the Securities Act of 1933, the Securities Exchange Act of 1934 or Rule 10b-5 promulgated thereunder, the Trust Indenture Act of 1939, the Securities Act of the State of Texas, any other applicable securities statute or law, or any rule or regulation under any of the foregoing (collectively, as amended, the "Acts").

(e) Purchaser has no expectation that it will derive profits from the efforts of Seller or any third party in respect of the acquisition of Purchaser's participation hereunder.

(f) This participation constitutes a commercial transaction by Purchaser with Seller regarding Purchaser's Pro Rata Part of the obligations of Borrower under the Loan and does not represent an "investment" (as the term is commonly understood) in Seller or Borrower.

(g) Purchaser is engaged in the business of entering into commercial transactions (including transactions of the nature contemplated herein and in the Loan), can bear the economic risk related to the purchase of the same,

224. This provision enunciates that the participant has no recourse against the lead if, for instance, the borrower defaults. The statement adds to the arrangement being classified as a purchase/sale, and is in accordance with Comptroller of Currency, Banking Circular No. 181 (rev. Aug. 2, 1984) replacing Banking Circular No. 181 (Dec. 8, 1983), 5 FED. BANKING L. REP. (CCH) ¶ 60,799, at 38,859-2. See also *supra* notes 51-54 and accompanying text.

and has had access to all information deemed necessary by it in making its decision whether or not to purchase the same.

Section 4. Legal and Beneficial Ownership

4.1 *No amount paid by Purchaser to purchase any participation in the obligations of Borrower under the Loan shall be considered a loan by Purchaser to Seller. Seller shall have no obligation to repurchase the participation sold under this Agreement upon any default by Borrower under any of its obligations or otherwise.*²²⁵

4.2 *Purchaser's participation ownership interest in the Loan subject to this Agreement shall be effected by the following measures:*

(a) *The Note for the Loan shall be annotated: "An undivided participating ownership in this promissory note has been transferred to _____, as more fully described in the Loan Participation Sale and Trust Agreement dated _____, the terms of which are incorporated herein by reference."*²²⁶

(b) *The Note shall be delivered to _____, ("Agent"), to hold in trust as Purchaser's agent to the extent of Purchaser's interest in the Loan, and as Seller's agent to the extent of Seller's interest in the Loan. Agent's sole function shall be to hold the Note in escrow until (i) the Note has been paid in full (in which event Agent shall forward the Note to its maker), (ii) Seller's exercise of its repurchase option as set forth in Subsection 5.3 of this Agreement (in which event Agent shall annotate the Note to indicate the termination of Purchaser's participation ownership interest and the date of such termination, and forward the Note to Seller), or (iii) the commencement of foreclosure proceedings under the Loan (in which event Agent shall forward the Note to whichever party is the servicing agent under this Agreement at the time).*

(c) *Seller shall send to the Borrower written notice, by postage prepaid U.S. mail certified or registered mail, return receipt requested, advising the Borrower that Purchaser has acquired an undivided interest in the Loan and directing the Borrower to make all payments of principal and interest due under the Loan (the "Payments") to a special escrow account (the "Escrow Account") for such Loan.*²²⁷

(d) *Upon Seller's receipt of any payment under the Loan in which Purchaser participates pursuant to this Agreement, Seller shall promptly deposit such payment into the Escrow Account and shall promptly forward to Purchaser from the Escrow Account the payment due to Purchaser pursuant to the terms of this Agreement.*

4.3 *Seller will continue to hold legal title to the Loan (in trust for Purchaser, to the extent of Purchaser's interest), and Purchaser shall be the*

225. Express language reinforces that the arrangement is not a loan by purchaser to seller.

226. Since the participant is unable to perfect its position, due diligence requires some type of annotation on the note itself reflecting the division of ownership.

227. By providing the loan debtor with notice of the participation arrangement, the participant eliminates one source of dispute upon lead lender insolvency. While the loan debtor's knowledge does not necessarily give the participant any legal rights, it enhances the overall fact situation when determining the parties' intent.

holder, subject to the terms of this Agreement, of equitable title to Purchaser's share of the loan.

4.4 *With respect to Payments, Seller and Purchaser hereby agree to share proportionately in the proceeds of any Payments. Except as expressly provided herein to the contrary, Seller shall promptly:*

(a) *credit to Purchaser's account or accounts at Seller, Participant's Pro Rata Part of each payment of principal or interest received by Seller under the Loan. This includes Payments received in kind and Payments received through the mechanics of setoff in the event the circumstances surrounding the right to offset arise.*

(b) *credit the Purchaser's account or accounts at Seller, Purchaser's Pro Rata Part of all commitment fees received by Seller under the Loan. Except for the obligation of Seller to account for payments received by it, the sale and purchase of the participation hereunder shall be without recourse on, or representation or warranty by Seller.*²²⁸

4.5 *Without limiting rights to which Purchaser is or may become entitled, Purchaser shall have no interest, by virtue of this Agreement and Purchaser's rights hereunder, in (a) any present or future loans from, letters of credit issued by, or leasing or other financing transactions by, Seller to, on behalf of, or with Borrower (collectively, the "other financings") other than the credit facilities provided for under the Loan, (b) any present or future guaranties by or for the account of Borrower which are not contemplated in the Loan, (c) any present or future setoff exercised by Seller in respect of such other financings, (d) any present or future property taken as security for any such other financings, or (e) any property now or hereafter in the possession or control of Seller which may be or become security for the obligations of Borrower arising under any Loan Document by reason of the general description of indebtedness secured or of property contained in any other agreements, documents, or instruments related to such financings; provided that, if payments in respect of such guaranties or such property or the proceeds thereof shall be applied to the obligations of Borrower arising under the Loan, then Purchaser shall be entitled to share in such application according to its Pro Rata Part.*²²⁹

4.6 *Except as provided herein to the contrary, all rights pursuant to the Loan or otherwise and all collateral (if any) held by Seller to secure payment of the obligations of Borrower under the Loan shall be so held (and such rights shall be exercised) for the ratable benefit of Seller and Purchaser (collectively "Lenders"), with such collateral being applied in reduction of the Loan before being applied to any other obligations Borrower owes Seller.*²³⁰

228. The division of any proceeds from the loan debtor pertaining to the participated loan shall be handled in the manner stated, removing any doubt in the area. This provision further provides that in the event of lead lender failure and the loan debtor's corresponding setoff, the participant will still receive its pro rate part of the reduction. *See supra* notes 176-96 and accompanying text.

229. This provision reiterates that any reduction to the participated loan shall be shared proportionately between the lead and the participant.

230. The future advances issue is discussed *supra* at notes 168-75 and accompanying text. The language makes clear that all collateral securing the participated loan shall be applied to

4.7 Seller shall be responsible for maintaining, or requiring the maintenance of, a complete set of books and records, reasonably satisfactory to Purchaser, as to the Loan. Seller shall retain the physical possession of the documentation for the Loan (with the exception of the Note), and shall be responsible for seeing that the title evidence and policies of insurance for the account of Seller and Purchaser are properly maintained. *Seller will keep all such documents in segregated files appropriately marked to show that a participating interest therein has been sold to Purchaser, and all envelopes and files pertaining to such documents shall be so marked.*²³¹

4.8 *Upon Purchaser's payment of the purchase price for the participating ownership interest in the Loan, Purchaser shall immediately become vested, to the extent of its participating interest, with beneficial ownership of the Loan and any and all of the documents of every nature in the possession of the Seller relating to the Loan. Seller thereafter shall hold the Loan and documents in trust and as nominee for the benefit of Purchaser to the extent of Purchaser's beneficial interest.*²³²

4.9 Seller shall not represent to any person that Seller owns any portion of the participation interest sold to Purchaser under this Agreement, and Seller shall reflect the transaction hereunder on its balance sheet and other financial statements as a purchase of assets by Purchaser and a sale of assets by Seller.

4.10 Any beneficial owner of Purchaser's beneficial interest in the Loan or such owner's representative, shall have the right at any reasonable time during the normal business hours to request and have access to and examine any and all books, records and such documents relating to the Loan in which it has a participating interest or relating to any of the matters covered by this Agreement.

Section 5. Servicing, Prepayments, Repurchase Option

5.1 Seller shall be responsible for the execution of all appropriate notices and all other acts necessary to perfect title in Purchaser as to the ownership of Purchaser's participation interest in the Loan, for preserving all rights in the Loan and administering it in all respects consistent with applicable legal requirements and regulations, for servicing the Loan in a manner consistent with good lending practice, and for promptly delivering to Purchaser copies of all notices and other correspondence with the Borrower. It is agreed that Seller and Purchaser are not partners or joint venturers, and that Seller is not to act as agent for Purchaser, but is to act in all Loan administration matters for Purchaser as an independent contractor and as Purchaser's nominee to hold the participating ownership of the Loan, Loan Documents and Payments hereunder, and to make the remittances specified in Subsection 4.4

the participated loan first, before application to any other obligations the borrower has to the lead lender.

231. By providing for separate files and appropriate documentation, the participant is eliminating superfluous issues that could arise in the event of lead lender insolvency.

232. This provision reinforces the participant's ownership interest in the loan and sets forth the relationship between the lead and participant as a trust. Accordingly, the benefits of a trust relationship, such as a higher duty of care, arise.

hereof. Nothing in this Agreement shall be construed to impose any duties or obligations other than those expressly provided for in this Agreement.

5.2 Seller may perform any of its duties hereunder by or through officers, directors, employees, attorneys, or agents (collectively "Representatives"), and Seller and its Representatives shall be entitled to rely, and shall be fully protected in relying, upon any communication or document believed by it or them to be genuine and correct and to have been signed or made by the proper Person and, with respect to legal matters, upon the opinion of counsel selected by Seller. As used herein, the term "Person" means any individual, firm, corporation, association, partnership, joint venture, trust, other entity, or Tribunal, and the term "Tribunal" means any state, federal, foreign, or other court or governmental department, commission, board, bureau, agency, or instrumentality.

5.3 Seller, at its option, but without obligation to do so, shall have the right and privilege at any time to pay to Purchaser all principal, interest, and fees then owing to Purchaser hereunder in respect of its Pro Rata Part, thereby terminating this Agreement.

5.4 Unless Seller receives prior written approval from Purchaser (which approval shall not be unreasonably withheld or delayed), Seller shall not enter into or permit any material amendment of, or permit the assignment or transfer by Borrower of its obligations under, or waive compliance with any of the material terms of the Loan.

5.5 It is agreed that except as herein set forth, the exclusive right to decide how the Loan shall be serviced and what to do and how to do it, when to approve assumptions or similar third party undertakings, when to accelerate the entire balance due on the Loan for any permissible reason, when to foreclose, whether or not to obtain a deficiency judgment, and how to administer foreclosed property, is hereby vested in the Seller, in its reasonable direction, as nominee for Purchaser. Except as herein provided, Purchaser shall be permitted to consult with Seller, but shall not be authorized to give directions to Seller in connection with these matters (except as set forth in Subsection 5.6).

5.6 In the event that Seller is unable to collect the Loan after reasonable efforts to do so, Seller shall be responsible for giving prompt notice thereof to Purchaser and shall foreclose on the collateral for the Loan. If Seller has not commenced foreclosure proceedings within six (6) months after an event of default occurs under the Loan Documents, Purchaser may undertake the foreclosure in Seller's place and Seller will cooperate fully with Purchaser in this regard. Any proceeds received from foreclosure sale shall be distributed in accordance with the terms of this Agreement.

Section 6. Expenses

6.1 Purchaser shall pay its Pro Rata Part of all reasonable Attorneys' fees and other expenses incurred by Seller (but not vice versa) in connection with enforcement of the obligations of Borrower under the Loan, and Purchaser shall be entitled to a Pro Rata Part of any payments subsequently received by Seller with respect to such fees and expenses.

6.2 Purchaser shall repay to Seller any sums paid to Seller by Borrower

and distributed by Seller to Purchaser which Seller shall be required to return to Borrower or to any receiver, trustee, or custodian for Borrower.

Section 7. Increased Participation

7.1 It further is agreed that Seller in its discretion, either directly or through a servicing agent, may make additional advances on the Loan for any purpose pursuant to optional future advance clauses in the Loan, as long as the Loan is in good standing and provided that the resulting unpaid balance shall not exceed the limitations of applicable loan-to-value or loans to one borrower regulations or, in any event, 100% of the value of the collateral, and that before making of any such advance, Seller will offer to negotiate with Purchaser regarding the terms of Purchaser's participation in the transaction including the interest to be paid to Purchaser with respect to such additional advance, and if agreement is reached, Seller then will make the additional advance and issue a participation certificate (the "Participation Certificate") reflecting such additional amount advanced and the interest to be received thereon by Purchaser, and Purchaser then promptly will pay the agreed cost of its pro rata participation in such additional advance. If no agreement is reached within ten (10) days of Seller's offer to negotiate regarding the terms of the transaction, including the interest rate to be paid to the Purchaser on any such additional advances, Seller may make such advance for its own account and Purchaser shall not be entitled to participate therein.

7.2 In the case of every advance, a notation shall be made in the books and records required under Subsection 4.7 hereof identifying and describing each advance and Purchaser's participation or non-participation therein, and a copy thereof shall be furnished to Purchaser.

Section 8. Servicing Transfer Event

8.1 *In the event of the insolvency of Seller, or of the filing by or against Seller of a petition under any provision of bankruptcy law, or of an assignment for the benefit of creditors, or the appointment by any public or supervisory authority of any person in charge of the same or its assets, or a breach by Seller of any covenant or agreement herein or in any Participation Certificate, or in the event of the involuntary sale of the Loan or advances, or the issuance by an appropriate public monitoring or supervisory authority of a cease and desist order or its equivalent against Seller or its Directors and officers involving the safety, soundness or financial viability of the Seller, which would have a material adverse effect on the Loan or Seller's ability to service the Loan, then in any such event, it is agreed that Purchaser shall automatically succeed to all rights, titles, status and responsibilities which Seller may have regarding the holding and servicing of the Loan, and have an option to exercise all of the powers herein above granted to Seller, and have the option to designate itself or any person or firm in its discretion to exercise such powers. In such events the Loan and all records thereof shall be delivered to Purchaser, together with necessary or proper assignments, transfers and documents of authority.*²³³

233. A provision setting forth loan management in the event of lead lender insolvency is desirable. This provision specifically provides for the participant to step into the shoes of the

Section 9. Miscellaneous

9.1 This Agreement contains the entire agreement between the parties hereto, supersedes all prior agreements, if any, relating to the subject matter hereof, and cannot be modified in any respect except by an agreement in writing.

9.2 The invalidity of any portion of this Agreement shall in no way affect the balance thereof; *moreover, in this regard, although the parties hereby reconfirm that this transaction is a sale, they agree that to the extent this transaction is determined by any court of law as being a loan instead of a sale, then it is a secured loan, with Seller hereby granting to Purchaser a present security interest in the Loan pursuant to Article 9 of the Uniform Commercial Code*²³⁴ (with perfection of such security interest to be perfected by the filing of UCC-1 Financing Statements in Texas as well as by the possession specified in Subsection 4.2(b) of this Agreement).

9.3 All headings appearing in this Agreement are for convenience only and shall be disregarded in construing this Agreement.

9.4 None of the provisions in this Agreement shall inure to the benefit of Borrower or any Person other than the Lenders; consequently, Borrower and any Person other than Lenders shall not be entitled to rely upon or raise as a defense, in any manner whatsoever, the failure of either Lender to comply with the provisions of this Agreement. Neither Lender shall incur liability to Borrower or any other Person for any act or omission of the other Lender.

9.5 Whenever this Agreement requires or permits any consent, approval, notice request, or demand from one party to another, the consent, approval, notice, request, or demand must be in writing to be effective and shall be deemed to have been given when actually received or if mailed, on the third banking day in Texas after it is enclosed in an envelope addressed to the party to be notified at the address designated, properly stamped, sealed, and deposited in the appropriate official postal service.

9.6 Whenever in this Agreement the singular is used, the same shall include the plural where appropriate, and vice versa; and words of any gender in this Agreement shall include each other gender where appropriate.

9.7 Purchaser's obligations hereunder are performable in Dallas County, Texas, and the laws of the State of Texas and of the United States of America shall govern the rights and duties of the parties hereto and the validity, construction, enforcement, and interpretation hereof.

9.8 If any legal or equitable action or proceeding is brought by Seller or Purchaser to enforce or construe a provision of this Agreement, the unsuc-

lead for any of the given reasons. Most importantly, by providing for the transfer of all rights to the participant upon the lead's insolvency, the parties have in essence eliminated the borrower's setoff right since the requisite mutuality of debt no longer exists. Of course, for a provision such as this to be upheld, proper notice must be given to the borrower regarding the participation agreement and the terms thereof.

234. The parties have again set forth the nature of the transaction, but have provided a safety clause to come into effect in the odd event a court of law does not deem this transaction to be a sale.

cessful party in such action or proceeding, whether such action or proceeding is settled or prosecuted to final judgment, shall pay all of the attorneys' fees and costs incurred by the prevailing party.

9.9 All agreements among the parties hereto, whether now existing or hereafter arising, are hereby limited so that in no contingency, whether by reason of demand for payment or acceleration of maturity of the loan under the Loan and relating to this Agreement or otherwise, shall interest contracted for, charged or received by any bank thereunder or by any participant exceed the maximum amount permissible under applicable law. If, from any circumstance whatsoever, interest would otherwise be payable to any institution in excess of the maximum lawful amount, or such institution shall ever receive anything of value deemed interest by applicable law in excess of the maximum lawful amount, an amount equal to any excessive interest shall be applied to the reduction of the principal of such loan and not to the payment of interest, or if such excessive interest exceeds the unpaid balance of principal such excess shall be refunded to the Borrower. All interest paid or agreed to be paid to any bank or institution shall, to the extent permitted by applicable law, be amortized, prorated, allocated, and spread throughout the full period until payment in full of the principal so that the interest for such full period shall not exceed the maximum amount permitted by applicable law. This Subsection shall control all agreements among the parties hereto.

IN WITNESS WHEREOF, each party has caused this Agreement to be signed in its name on its behalf by its proper officials duly authorized.

This _____ day of _____, 19 ____.

SELLER:

BY: _____

TITLE: _____

PURCHASER:

BY: _____

TITLE: _____