Loan Participations and Bank Failures: The Penn Square Decisions

Kevin B. Fisher
LOAN PARTICIPATIONS AND BANK FAILURES: THE PENN SQUARE DECISIONS

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Banks that make it to the problem bank list gain sudden recognition by the Comptroller's Washington bureaucracy. Just for the fun of it, one Washington official took a pencil to Penn Square's balance sheet and figured that if the bank kept growing at the current rate, it would be the third largest bank in the country by the end of the century. Awestruck by the phenomenal growth, a senior official of the Comptroller of the Currency in Washington remarked to a colleague, "There's something in Oklahoma City that's growing. It's weird. It's just weird."1

I. PENN SQUARE AND DEPOSITOR SETOFF: AN OVERVIEW

OKLAHOMA City's Penn Square Bank certainly did gain recognition. Its growth in the late 1970s and early 1980s, fueled by the oil and gas boom and the supply of money provided by money center banks eager to share in the riches of energy lending, was nothing short of phenomenal.2 Few people, and even fewer banks, realized at the time that

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I also thank Gary H. Baker for educating a young would-be banking lawyer about the vagaries of loan participations and the intricacies of oil and gas finance. To him I owe a large debt of gratitude.

Most of all, I thank my wife, Robin. To her I owe a debt that can be neither expressed nor repaid. Yet I plan to spend the rest of my days attempting to do just that.

2. In 1976 Penn Square listed total deposits of $30 million. At the time of its closing in 1982, Penn Square's deposits had mushroomed to $470 million and its assets had grown to $517 million. See id.; Isaac, The Role of Deposit Insurance in the Emerging Financial Services Industry, 1 YALE J. ON REG. 195, 205 n.31 (1984).

Among banks, Penn Square was regarded as a maverick energy lender willing to fund the unorthodox and take a risk. It would "bank" a borrower that other banks would not. It was, to say the least, aggressive in lending to the new oil and gas exploration firms, production companies, and promoters created by the halcyon days of Middle East embargoes, gas lines, and skyrocketing petroleum prices.

The bank's explosive growth was due largely to the equally explosive growth in its energy loan portfolio and its loan participation network. When it was closed, Penn Square had loans for its own account of approximately $325 million. But more importantly, Penn Square also had generated $300-400 million in loans that it had participated "downstream" and an aston-
Penn Square's collapse would be even more spectacular.\(^3\)

Although bank failures frequently occur,\(^4\) the Penn Square failure

ishing $2 billion in loans that it had participated "upstream." When this shopping mall bank closed, it was managing a loan portfolio of approximately $2.7 billion — over 85% of which consisted of participations sold to other banks. See P. Zweig, supra note 1; Penn Square Bank — Twelve Months of Agony, Okla. Bus., July 1983, at 40-48; Powell, Thrifts Exposed by the Collapse of Penn Square, Wall St. J., July 23, 1982, at 3, col. 1, at 398; Zweig, Oklahoma Penn Square Bank, Maverick Oil Patch Lender: Some Say It's Bet Too Heavily on Energy, Am. Banker, April 26, 1982, at 1, col. 1; The Stain from Penn Square Keeps Spreading, Bus. Week, Aug. 2, 1982, at 60-62.

By way of contrast to other Oklahoma banks, when Penn Square was closed, Oklahoma's largest bank, First National Bank of Oklahoma City, had a loan portfolio of approximately $1.5 billion — just slightly over half of the amount managed by Penn Square. The state's second largest bank, Liberty National Bank of Oklahoma City, had a loan portfolio of approximately $1 billion and less than two percent of it had been sold to participants.

Amazingly, over 80% of the Penn Square loan portfolio was energy related. Spurred on by projections estimating that petroleum prices would reach $70 to $100 per barrel in the 1980s and the typical oil and gas borrower's willingness to pay almost any price for money, energy lending in the early 1980s at Penn Square, and other banks as well, reached a frenzied pitch. See M. Singer, Funny Money 64 (1985); P. Zweig, supra note 1, at 108; Wilson, Oil Disaster No Immediate Threat, Tulsa World, Aug. 4, 1985, at 1, col. 1 (Department of Energy projected crude prices reaching $100 a barrel in 1990 and $246 a barrel in the year 2000); Gigot, Banks Hurt by Penn Square Collapse Were Victims of Oil Slump, Greed, Wall St. J., July 19, 1982, at 17, col. 4; Hill, Penn Square's Failure Bodes Losses for Many, Wall St. J., July 7, 1982, at 2, col. 3.

3. Penn Square Bank, N.A. of Oklahoma City, Oklahoma was declared insolvent and closed on July 5, 1982. For a general discussion of the Penn Square insolvency, see M. Singer, supra note 2 at 142; P. Zweig, supra note 1 at 398; Bayless, Bank's Problems Called Unique, Daily Oklahoman, July 7, 1982, at 1, col. 1; Bayless, Penn Square Bank Declared Insolvent, Daily Oklahoman, July 6, 1982, at 1, col. 1; Gigot, Banks Hurt by Penn Square Collapse Were Victims of Oil Slump, Greed, Wall St. J., July 19, 1982, at 17, col. 4; Hargrove, OC Bank Insolvent; Uninsured Deposits Total $190 Million, Tulsa Tribune, July 6, 1982, at A1, col. 2; Government Takes Over, Reopens Failed OC Bank, Tulsa World, July 7, 1982, at A1, col. 1. In the year following the bank's failure, over sixty articles discussing Penn Square and its effect on the nation's banks were published in the Wall Street Journal alone. Mullins, supra note 2, at 40.

Penn Square's participants were crippled by the problems that helped cause the Oklahoma bank's demise and those that were caused by the Oklahoma bank. Unlike the Exxons, the Shells, or even the Ewings of the energy world, many of Penn Square's borrowers were small independents, old and new "oilers" alike, unable to withstand the vicissitudes of the industry and crushed between slumping oil and gas prices and mounting indebtedness. See P. Zweig, supra note 1, at 111; M. Singer, supra note 2, at 111. Largely as a result of the downturn in the oil and gas industry and the Penn Square failure, the number of new filings in the United States Bankruptcy Court for the Western District of Oklahoma reached record highs. Bankruptcies Hit Record in State, Daily Oklahoman, Dec. 21, 1985, at 23, col. 5. See also M. Singer, supra note 2, at 106 (discussing gridlock in oil patch); Stott, Bust Economy Means Boom in Foreclosures, Daily Oklahoman, Jan. 5, 1986, at 18, col. 7 (attributing rapid rate of increase in foreclosure actions to falling petroleum prices and Penn Square failure).

The Penn Square Bank failure has also been the subject of Congressional investigations. See Penn Square Bank Failure: Hearings Before the House Comm. on Banking, Finance and Urban Affairs, 97th Cong., 2d Sess. 1 (1982) [hereinafter Penn Square Bank Hearings].

4. Although the highly publicized closings of Penn Square and United American Bank in Knoxville greatly enhanced the public's awareness of the possibility of bank failures, the closing and liquidation of banks is hardly new or unusual. The largest commercial bank failures in the history of the FDIC occurred in the last thirteen years. E. Symons & J. White, Banking Law: Teaching Materials 621 (2d ed. 1984)(listing ten largest failures, year bank closed, amount of deposits held by failed bank, and method by which FDIC closed bank). See also Skiller, Federal Deposit Insurance Corporation and the Failed Bank (Part I), 99 Banking L.J. 233, 233-34 (1982).

In just the past three years there has been an almost exponential increase in the number of

5. A loan participation represents the division of a loan between the originating lender, the lead bank, and one or more other banks, the participants. See infra text accompanying notes 73-165 (discussing loan participations).


In the late 1970s a malaise afflicted most of the nation’s economy. Smoke stack industries were dying out in the Northeast. The Pacific Northwest was caught in a seemingly interminable slump. Interest rates were a stifling twenty percent or more. Businesses were fleeing the Frostbelt.

In the Southwest, however, things were much different. On the road to self sufficiency, domestic oil and gas exploration and production surged. When the federal government deregulated certain areas of the law governing oil and gas production, prices soared. Given the apparent certainty of the inexorable rise in energy prices, it did not seem to matter how much money a borrower wanted or what rate of interest it had to pay to get it. Through the use of financing techniques such as the “evergreen” revolver, both the borrower and the lender could profit. The traditional rules of the energy lending game had been suspended. It was precisely this climate that drew banks from New York, Chicago, Seattle and elsewhere, eager to share in the spoils of the oil and gas boom, to Oklahoma in general and Penn Square in particular. See generally P. Zweig, supra note 1, at 106; M. Singer, supra note 2, at 54.

For an analysis of the changing energy regulatory environment of the late 1970s, see Allison, Natural Gas Pricing: The Eternal Debate, 37 Baylor L. Rev. 1 (1985) (excellent study of changing economic and regulatory environment prompted by energy crisis of 1970s co-sponsored by the ABA and the National Energy Law & Policy Institute and conducted by Professor Gary Allison of The University of Tulsa); Allison, Energy Sectionalism: Economic Origins
largest and most venerated banks anxiously courted Penn Square’s favor and regularly called on the little bank, hoping that Penn Square might have an energy loan or two that it had not already upstreamed to a money center competitor. 8 Continental Illinois National Bank and Trust Company of Chicago, once the nation’s sixth largest bank and touted at one time as the best managed bank in America, 9 actually leased space from Penn Square in order to smooth the process of participating in the Oklahoma bank’s energy loans. 10 Penn Square Bank essentially became a loan production office for several of the nation’s largest banks.

After the Oklahoma bank was closed, the FDIC was appointed as receiver to liquidate the Penn Square estate and pay off the closed bank’s creditors. 11 To lighten this burden, the FDIC began to reduce the amount of the failed bank’s liabilities by setting off the deposits Penn Square borrowers had in the bank against the amounts of their outstanding loan indebtedness owing to Penn Square. 12

As a result of the participation network constructed by Penn Square, however, a participation in a Penn Square borrower’s loan probably had been sold to a money center bank. The participant bank then argued that the

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8. For entertaining discussions of the banking practices involved in brokering Penn Square participations, see P. Zweig, supra note 1 at 260; M. Singer, supra note 2, at 58. An interesting apology of sorts for Penn Square and “what it stood for” was recently written by Oklahoma Congressman Mickey Edwards. Edwards, Banking Attitudes Restrictive, Daily Oklahoman, Jan. 4, 1986, at 8, col. 6. In this editorial Congressman Edwards laments the demise of the wildcat spirit and questions whether Oklahoma can survive the “easternization of the West.” Id.


10. See id., at 73. This arrangement, however, may have helped lead to allegations of fraud and self-dealing being lodged against some of the Chicago bank’s employees. At present the Continental banker in charge of the bank’s Oklahoma City office and its correspondent relations with Penn Square is under indictment by a Chicago grand jury on charges of defrauding Continental’s shareholders. Id.; see also Bennett, Suit Charges Fraud at Continental, N.Y. Times, July 31, 1982, at D2, col. 1.

11. The bank was dissolved and the Federal Deposit Insurance Corporation was appointed as receiver under 12 U.S.C. § 191 (1982), which provides in part that “whenever the Comptroller [of the Currency] shall become satisfied of the insolvency of a national banking association, he may, after due examination of its affairs ... appoint a receiver, who shall proceed to close up such association.”

participated portion of the borrower's outstanding loan indebtedness no longer constituted an obligation owned by Penn Square; rather, it represented an obligation now owned by the participant bank that purchased the loan from Penn Square. Therefore, the argument continued, to set off a Penn Square borrower's account balance against its loan indebtedness meant canceling debt no longer owned by Penn Square, but debt owned instead by the participant. Unpersuaded by this argument, the FDIC concluded that the Penn Square depositor/borrower setoff arrangement was an efficient and expedient method for assisting it to fulfill its obligations as receiver of the insolvent Penn Square.

As a result of the FDIC's actions, several of the participant banks filed suit to enjoin the setoffs. Although many of the participant suits involve different participation contracts, the two central issues in each case remained the same: (1) the propriety of borrower/depositor setoffs against the participated loans; and (2) the right of the participant to an undiminished pro rata share of any such setoff.

Prior to the Penn Square failure, very little law existed to delineate a depositor's right of setoff and the concomitant rights of a loan participant. The courts deciding these Penn Square participation suits thus faced extremely complicated legal issues bearing enormous economic consequences without the benefit of precedent. The rulings resulting from these cases therefore, substantially affect not only the participants but also the financial world in general. This Article, therefore, analyzes these issues in the context of the disastrous collapse of the Penn Square Bank and criticizes the legal conclusions drawn by the courts. Further, this Article advances a different rationale for permitting borrower/depositor setoff, one that protects the interests of both the borrower/depositor and the participant. Most im-

13. See infra notes 87-165 (discussing nature of relationship between lead and participant and whether participation transaction involves sale to participant).

14. See infra text accompanying notes 284-427 (discussing suits filed by participant banks).

15. Id.

16. See infra text accompanying notes 73-165 (discussing classification of loan participations).

17. The full effects of the Penn Square failure are still being felt. Many of the money center participants were staggered by their investment in Penn Square energy loans. Some of the participants, most notably Seafirst and Michigan National, sustained losses from which they could not recover. See P. Zweig, supra note 1 at 113; M. Singer, supra note 2, at 155; BankAmerica Corp.'s Takeover of Seafirst Took Effect Today, Wall St. J., July 1, 1983, at 2, col. 3 (Seafirst's losses hurt bank so badly that regulators negotiated emergency merger with Bank of America.); Zonona, Seafirst to Sue Former Official and Audit Firm, Wall St. J., Aug. 21, 1984, at 4, col. 1; Zonona, Seafirst Still Has Many Obstacles to Hurdle a Year After Near-Insolvency and Merger, Wall St. J., Aug. 16, 1984, at 4, col. 1.

Continental Illinois's highly publicized failure was largely attributable to its relationship with the Oklahoma bank. It took a monumental and unprecedented move into the private sector by the federal government to avert the insolvency of the nation's sixth largest bank. See P. Zweig, supra note 1, at 439-40; Regulators Charged With 'Timid' Action on Continental Illinois in House Hearings, Wall St. J., Sept. 19, 1984, at 12, col. 1; Comptroller Will Face Tough Queries by House Panel on Continental Illinois, Wall St. J., Sept. 17, 1984, at 12, col. 1.

For a discussion of the effect one bank's problems can have on other financial institutions, see P. Zweig, supra note 1, at 409; M. Singer, supra note 2, at 153; Hill, One Bank's Difficulties Can Hurt Many Others Because of Loan Links, Wall St. J., June 1, 1983, at 1, col. 6.
portantly, this rationale seeks to further the commercial expectations and realities of the participation relationship.\textsuperscript{18}

To that end, this Article first examines the role of the FDIC as receiver of the insolvent Penn Square Bank estate, its statutory rights and duties, and the legal and factual background that led the FDIC to offset Penn Square borrowers' deposit accounts against their loan indebtedness.\textsuperscript{19} Next, in the context of the Penn Square participations, this Article analyzes the structure of loan participations and the correlative rights and duties of the lead bank, participant, and borrower.\textsuperscript{20} Finally, this Article analyzes the Penn Square decisions, criticizes the courts' construction of the legal relationships created by the Penn Square loan participations, and discusses the commercial relationships and expectations created by the Penn Square participations.\textsuperscript{21}

II. \textsc{The FDIC And Borrower/Depositor Setoff}

When Penn Square Bank's serious trouble became apparent, many observers assumed the government would assist another bank\textsuperscript{22} in acquiring the ailing Oklahoma City bank.\textsuperscript{23} But the enormous uncertainty surrounding Penn Square's total losses and liabilities,\textsuperscript{24} meant that no other banks were in

\textsuperscript{18} See infra text accompanying notes 428-82. Not incidentally, my proposed view of setoff severely and purposely limits the precedential impact of the Penn Square courts' analyses.

\textsuperscript{19} See infra text accompanying notes 22-72.

\textsuperscript{20} See infra text accompanying notes 73-283.

\textsuperscript{21} See infra text accompanying notes 284-484.

\textsuperscript{22} Several observers believed that Continental Illinois would be involved in the acquisition of Penn Square.

\textsuperscript{23} See P. Zweig, supra note 1, at 342. When acting as receiver of a failed bank, the FDIC has two options: first, merging the insolvent bank with a solvent one; and, second, a deposit payoff. See E. Symons & J. White, Banking Law: Teaching Materials 620 (2d ed. 1984); Brainsilver, Failing Banks: FDIC's Options and Constraints, 27 Ad. L. Rev. 327 (1975). The FDIC uses the first of these two options whenever possible. Penn Square Bank Hearings, supra note 3, at 57-58 (statement by then FDIC Chairman William Isaac).

\textsuperscript{24} At the time of the bank's closing, the FDIC estimated that between $2.5 and $2.9 billion in contingent claims already existed against Penn Square. Moreover, then chairman of the FDIC, William Isaac, stated that he was aware of other irregularities that could give rise to additional claims. Penn Square Bank Hearings, supra note 3, at 58.
a position to acquire the institution. Unable to effect a purchase and assumption transaction with a healthy bank, the FDIC elected to close Penn Square, establish a Deposit Insurance National Bank to assume Penn

25. The FDIC's unwillingness to support a possible merger or purchase and assumption transaction has been sharply criticized. See Chittum, Closing Penn Square Bank Only Choice, Says Isaac, J. Rec., Oct. 31, 1984, at 1, col. 1.

The Comptroller and the Federal Reserve, both fearing a general crisis of confidence in the nation's banking system, argued that Penn Square should not be allowed to fail. The FDIC, however, insisted that Penn Square's unascertainable liabilities made it legally impossible for the FDIC to keep the bank afloat. Mr. Zweig and other writers attributed the FDIC's course of action to then FDIC Chairman Isaac's insistence on using the Penn Square failure as a means of disciplining the financial markets. P. Zweig, supra note 1, at 395; Inter-agency Feuding and the Penn Square Fiasco, 14 INT'L CURRENCY REV. 31 (1982).

In testimony before a House Committee investigating Penn Square and discussing the ripple effects of the Oklahoma bank's failure, Mr. Isaac stated:

Much has been said and written about the impact of the Penn Square failure on other financial institutions that either participated in loans originated by Penn Square Bank or provided funding to the bank in amounts in excess of the [deposit] insurance limit.

Simply stated, a number of financial institutions regrettably have learned an expensive but important lesson. These financial institutions were attracted by the opportunity to obtain high yields on their investments but failed to take into account the degree of risk being undertaken. As a result some institutions will sustain losses.

It is indeed fortunate that these institutions have the ability to withstand these losses. If one can identify a silver lining behind the dark cloud of the Penn Square affair, we should expect that all financial institutions will be more prudent in the future.

Penn Square Bank Hearings, supra note 3, at 63; see also Isaac, The Role of Deposit Insurance in the Emerging Financial Services Industry, 1 YALE J. ON REG. 195 (1984) (discussing responses to the changing structure of the financial services industry and the role of insuring agencies).

In light of the government's efforts to save the failed Continental Illinois, the attempt to use the Penn Square liquidation as a means of disciplining the market lost much of its punch. Some believe that Continental and Penn Square taught borrowers not do business with a sound, well-managed bank, but with a bank likely to be bailed out in a time of crisis. See Inter-agency Feuding and the Penn Square Fiasco, supra, at 32; U.S. Won't Let 11 Biggest Banks in Nation Fail, Wall St. J., Sept. 20, 1984, at 1, col. 2.

26. See P. Zweig, supra note 1, at 388.

27. The merger or purchase and assumption transaction represents the most efficient and least disruptive form of liquidating a failed bank. To the extent that the purchasing bank acquires most of the failing institution's assets, accounts at the failed bank remain intact and the existing relationship between loans and deposits is preserved. Moreover, a merger preserves the going concern value of the failed bank. Most important of all, a purchase and assumption almost always provides depositors with complete protection for even those amounts on deposit above the insured maximum, thus minimizing the inevitable losses that accompany a bank failure while shoring up public confidence in the banking system.

Normally, it is the FDIC's goal to arrange a purchase and assumption transaction, which often gives the acquiring bank financial assistance in its acquisition of the failed bank. See E. Symons & J. White, supra note 23, at 623; Brainsilver, supra note 23, at 331. Such was not the case, however, with Penn Square.

Before it can proceed with a purchase and assumption, the FDIC must first find that the purchase and assumption will likely be no more costly than a deposit payoff. According to then Chairman William Isaac, the FDIC estimated its "maximum cost [for a Penn Square] deposit payoff would be as high as $240 million but would likely be very substantially less depending on recoveries from the receivership." Penn Square Bank Hearings, supra note 3, at 58. Isaac also said that the FDIC estimated Penn Square's contingent liabilities to be well in excess of $2.5 billion. Since the cost of indemnifying a purchasing bank, in the FDIC's view, would cost more than a deposit payoff, it was impossible for the FDIC to arrange a purchase and assumption transaction. Id. at 58-59.
Square's insured deposit liabilities, and liquidate the failed bank's estate to pay its creditors.

A. The National Bank Act

The National Bank Act provides the statutory blueprint for liquidating a national bank. The National Bank Act imposed several statutory obligations on the FDIC as Penn Square's receiver. The duty to liquidate the failed bank's assets, pay each depositor the amount of its deposit up to the insured maximum, and pay all creditors of the failed bank a "ratable dividend" from the liquidation proceeds ranks first among these obligations. For purposes of calculating insured deposits and reducing the number of creditors with valid claims against the estate, the FDIC set off the amounts a Penn Square borrower had on deposit at the bank when it was closed against the indebtedness.

28. 12 U.S.C. § 1823(h) (1982). The creation and use of a Deposit Insurance National Bank is a form of deposit payoff. At Penn Square, all the insured deposits were transferred to the DINB, which continued to honor checks drawn on Penn Square accounts up to the insured limit and to facilitate an orderly payoff of insured deposits. Uninsured depositors were issued receiver's certificates for the balance of their accounts over $100,000. Penn Square Bank Hearings, supra note 3, at 60; Martin, Penn Square: The Residue, N.Y. Times, July 23, 1982, at col. 1.

DINB's have been rarely used in the FDIC's recent history. Brainsilver, supra note 23, at 330-31. Typically, the FDIC organizes a DINB when continuation of banking services within a community is necessary. "An example of such a situation is a bank controlled by and serving a racial or other minority group." Id. at 331.

29. On this point the FDIC's actions were also harshly criticized. See Inter-agency Feuding and the Penn Square Fiasco, 14 INT'L CURRENCY REV. 31 (1982); Chittum, Closing Penn Square Bank Only Choice, Says Isaac, J. Rec., Oct. 31, 1984, at 1, col. 1. The Penn Square Bank failure was also unusual for the reason that the Oklahoma bank had an extremely high number of deposits in amounts over the insured maximum. See, e.g., P. Zweig, supra note 1, at 411 (some depositors with over $100,000 had their life savings wiped out); Penn Square Bank Hearings, supra note 3, at 270 (chart of federally insured credit unions with uninsured deposits in Penn Square). By deciding to liquidate the bank, the FDIC reversed its longstanding policy of insuring that depositors did not suffer losses when their depository bank failed. In effect, the FDIC decided that those depositors with amounts in Penn Square over the insured maximum lost money. See P. Zweig, supra note 1, at 411; see generally FDIC Action on Bank Failures Continues Step to Make Big Depositors Pay for Errors, Wall St. J., Mar. 21, 1984, at 14, col. 2 (discussing effects of FDIC action on larger depositors); Big Depositors at 2 Failed Banks May Lose Some Funds Due to New FDIC Approach, Wall St. J., Mar. 19, 1984, at 3, col. 2 (blaming FDIC's new approach for large depositors losses).


31. See 3 W. Schlicting & J. Cooper, Banking Law §§ 49.02 - 49.03, 49.05 (1985). Section 194 of the National Bank Act provides:

From time to time, after full provision has been first made for refunding to the United States any deficiency in redeeming the notes of such association, 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, and, as the proceeds of the assets of such association are paid over to him, shall make further dividends on all claims previously proved or adjudicated; and the remainder of the proceeds, if any, shall be paid over to the shareholders of such association, or their legal representatives, in proportion to the stock by them respectively held.

edness these borrowers owed on Penn Square loans. For example, if Penn Square loaned a borrower $5 million and that borrower had $1 million on deposit in Penn Square when the bank closed, the FDIC would calculate the insolvent bank's estate by setting off the full amount on deposit against the outstanding indebtedness the borrower owed the bank. As a result of this setoff, the FDIC extinguished the liability to the borrower for its deposit and reduced the borrower's obligation on the loan to the sum of $4 million.

Nowhere in the National Bank Act, however, does it specify that the FDIC enjoys the authority to make such borrower/depositor setoffs. Although the Federal Deposit Insurance Act calculates the amount of an insured deposit after deducting setoffs, the National Bank Act makes no such determination. On the contrary, the National Bank Act implicitly precludes such setoffs. The principal goal of the National Bank Act is to ensure that the assets of the receivership are used to pay the insolvent bank's creditors a pro rata amount of their claims. The Act clearly charges the receiver with the duty of distributing the failed bank's assets ratably among all creditors. The legislative intent clearly suggests that no one creditor is to be preferred over another. Moreover, any transfer or preference in derogation of this purpose is "utterly null and void."

The National Bank Act does not specifically mention setoff; moreover, it does not provide an explicit statutory basis for the FDIC's actions in the Penn Square liquidation. In fact, under the National Bank Act, the FDIC's liquidation of Penn Square fundamentally represents a collective proceeding designed to treat creditors equally, set aside preferences, and pay dividends ratably.38

32. The Federal Deposit Insurance Act, 12 U.S.C. § 1813(m)(1) (1982), defines an insured deposit as "the net amount due to any depositor . . . for the deposits in an insured bank (after deducting offsets) less any part thereof which is in excess of $100,000."

33. Id.

34. See 12 U.S.C. § 194 (1982); 3 W. Schlichting & J. Cooper, supra note 31, at §§ 49.02 - 49.03, 49.05.

35. Id.

36. 12 U.S.C. § 91 (1982) is the anti-preference provision of the National bank Act. Section 91 provides:

All transfers of the notes, bonds, bills of exchange, or other evidences of debt owing to any national banking association, or of deposits to its credit; all assignments of mortgages, sureties on real estate, or of judgments or decrees in its favor; all deposits of money, bullion, or other valuable thing for its use, or for the use of any of its shareholders or creditors; and all payments of money to either, made after the commission of an act of insolvency, or in contemplation thereof, made with a view to prevent the application of its assets in the manner prescribed by this chapter, or with a view to the preference of one creditor to another, except in payment of its circulating notes, shall be utterly null and void; and no attachment, injunction, or execution, shall be issued against such association or its property before final judgment in any suit, action, or proceeding, in any State, county, or municipal court.


37. Id.

38. See infra notes 39-72 and accompanying text.
B. Setoffs as Preferences

The National Bank Act's blanket prohibition of preferences and goal of equitable distribution to all creditors mirrors that of the Bankruptcy Code. Arguably under both the National Bank Act and the Bankruptcy Code, setoff constitutes a preferential transfer in favor of the borrower/depositor that operates to the detriment of the failed bank's general creditors. The following example illustrates this point:

At the time of a bank's insolvency, Borrower A and Borrower B each have $150,000 on deposit. Borrower A also has a balance of $75,000 outstanding on a loan it owes the bank. If Borrower A sets off its indebtedness against its deposit account, then Borrower A receives full and complete recovery.

Borrower B, however, fares less well. With no indebtedness owing to the bank, B receives the maximum insured amount ($100,000) and stands in line with all other general creditors for its pro rata share of the liquidation proceeds for the remaining amount of its claim ($50,000). As this example demonstrates, A and B, both having deposits of equal amount in the failed bank, receive unequal treatment if A sets off its deposit account against its loan obligations.

Setoffs, therefore, may not be entirely consistent with the aims and purposes of the National Bank Act. The Act specifies that no creditor is to be preferred over another. Borrower A in the example above, however, obtains immediate and total recovery on its investment, while Borrower B receives no more than a proportionate share of the amount of its claim after an indeterminate wait.

This result resembles that under the Bankruptcy Code. In enacting the Bankruptcy Code, Congress recognized that the right of setoff "effectively elevates an unsecured creditor into a superior class, thus treating [it] as though [it] held a functional security interest." Congress, nevertheless,
preserved the setoff remedy in the Bankruptcy Code.46 Congress' express preservation of setoff in bankruptcy, however, should not necessarily be applied automatically to the administration of failed banks.47

Although the National Bank Act and the Bankruptcy Code share many of the same goals and functions, contrasts in purpose and policy between the two regulatory schemes arguably exist. The Bankruptcy Code collectively achieves an equitable distribution of a debtor's assets to legitimate creditors. The same is true of the National Bank Act. But the National Bank Act constitutes more than just a collection or disbursement mechanism for administering insolvent estates: The National Bank Act establishes a federal legislative scheme designed to maintain the integrity of and the public's confidence in the national banking system.48 Its ultimate goal is the orderly regulation of the national banking system, the stabilization of the private sector, and the containment of the possible systemic effects of any one bank failure.49

The liquidation of a national bank, therefore, has a political purpose quite different than that of a private liquidation under the Bankruptcy Code. To analogize that the right of setoff exists when liquidating a failed bank simply because Congress included setoff in the Bankruptcy Code is, arguably, a bit tenuous.50 In order to determine the propriety of the borrower/depositor setoffs, this Article examines the judicial construction given the National Bank Act's anti-preference provisions.51

47. See E. SYMONS & J. WHITE, supra note 23, at 655. As Professors Symons and White explain:

When a bank becomes insolvent, what law governs priorities and the distributions of assets? . . . . The one clear thing in this entire area is that the lawyer cannot simply bring over Article 9 and the Bankruptcy Code and apply them to a bank. In the first place banking corporations are specifically exempted from the federal Bankruptcy Act. . . . Thus, any bankruptcy law that is applied to a bank's insolvency would have to be applied by analogy and not directly. Secondly, the National Bank Act is not as comprehensive as the Bankruptcy Act or Article 9, but it does have certain sections that would determine priority and would provide for example, for the setting aside of preferences. Id. As with the old Bankruptcy Act, the Bankruptcy Code expressly excludes banks from its coverage. 11 U.S.C. § 109(b)(2) (1982) (banks cannot be debtors under Code).

Despite Professors Symons and White's admonition, when interpreting the National Bank Act and its application to the liquidation of failed banks, the courts have applied the principles underlying bankruptcy law, if not the actual Bankruptcy Code. See infra notes 52-70 and accompanying text. Given the enactment of FIRREA, the massive savings and loan crisis and the restructuring of the financial services industry, and the need for certainty in transactions, it is very likely that the Bankruptcy Code will be followed more and more.

50. See E. SYMONS & J. WHITE, supra note 23, at 655; accord Comment, supra note 45, at 197.
51. Section 91 of the National Bank Act, however, is much less extensive than the anti-
C. Scott v. Armstrong

In *Scott v. Armstrong* the United States Supreme Court addressed the propriety of setoff under the National Bank Act. The Court recognized that the equitable right of setoff inures to the benefit of a borrower/depositor in the event of bank insolvency.

In *Scott* Fidelity National Bank made a loan to Farmers' and Merchants' State Bank. The loan proceeds were deposited in Farmers' account at Fidelity and soon thereafter Farmers' withdrew a portion from that account. Fidelity failed shortly thereafter, but before the note matured. When the note became due, Farmers' set off the amount remaining in its Fidelity account against the total amount owing on the loan and tendered the difference to Fidelity's receiver as payment in full.

The receiver argued the impropriety of the setoff because when Fidelity failed, the debt Farmers' owed was not yet due. Therefore, no mutual obligations existed that properly represented the subject of setoff. Moreover, the National Bank Act's regulatory provision forbid setoff. The receiver thus believed he was obligated to "hold [Farmers'] note in trust for the general creditors, including [Farmers'], to collect it and divide the proceeds ratably among them."

After reviewing the relevant statutes, the Court rejected the receiver's argument and differentiated between direct preferential conveyances by an preference provisions of the Bankruptcy Code and "has not been polished with a judicial gloss in the way the Bankruptcy Code and its predecessor Bankruptcy Act have." E. Symons & J. White, *supra* note 23, at 658.

52. 146 U.S. 499 (1892) (Fuller, C.J.) (9-0 decision).
53. *Id.* at 511.
54. *Id.*
55. *Id.*
56. *Id.*
57. *Id.* at 505-06. The receiver argued that:

The parties did not occupy the relation usual between bankers and their depositors, where one party deposits a sum in a bank, and borrows money from that bank, and when this loan is due pays it by checks on the money so deposited. The State Bank borrowed this money not to let it lie in the Fidelity Bank, but to be used by it in its own business. It paid a discount upon the entire amount, for the entire time the note had to run. The note and the deposit account were therefore wholly independent claims and were not the subject of set-off.

*Id.* at 504. In other words, the receiver believed that the Farmers' account at Fidelity was not a normal deposit account that created a mutual obligation that could be the subject of setoff even if setoff were permissible.

But where a national bank at the time of an act of insolvency, holds a discounted note not yet due, and the debtor has in the same bank not placed there on account of, or to meet that note, which the bank cannot take or hold for its debt, the national banking law . . . prohibits the receiver from receiving the deposit as payment in whole or in part of the note.

*Id.* at 505-06.

58. *Id.* at 506, 510. The receiver argued that equity favored an equal distribution of the assets of an insolvent bank. Farmers', he contended, was hurt no worse than any other creditor and, therefore, should suffer equally with them. The National Bank Act intended this result and equity should not stretch to benefit Farmers' and disadvantage the other creditors.

*Id.* at 506.

59. The provisions of the National Bank Act at issue in *Scott* were identical to the present statutes now codified at 12 U.S.C. §§ 91, 194 (1982).
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insolvent bank and those liens and equities arising prior to insolvency by either express or implied agreement.60 The Court reasoned that an implied agreement of setoff existed between Fidelity and Farmers' prior to Fidelity's insolvency.61 The Court further explained that equity long honored such agreements and, since they agreed prior to insolvency and not in contemplation thereof, nothing in the National Bank Act precluded Farmers' setoff.62

The Court stated:

The provisions of the [National Bank Act] are not directed against all liens, securities, pledges or equities, whereby one creditor may obtain a greater payment than another, but against those given or arising after or in contemplation of insolvency. Where a set-off is otherwise valid, it is not perceived how its allowance can be considered a preference, and it is clear that it is only the balance, if any, after the set-off is deducted which can justly be held to form part of the assets of the insolvent. The requirement as to ratable dividends is to make them from what belongs to the bank, and that which at the time of the insolvency belongs of right to the debtor does not belong to the bank.63

The Court consequently held that even though the setoff might cause Farmers' to receive a greater payment than another creditor, the setoff failed to constitute an unlawful preference.64 Indeed, in the Court's view, the application of Farmers' deposit toward payment of its debt could not constitute a preference because the deposit account was not an asset of Fidelity; rather, it represented an asset of Farmers'.65 Since ratable dividends are paid only from assets of the failed bank, Fidelity's receiver could not claim a right to those funds.66

The Court's analysis of setoffs in Scott, however, is anything but definitive. Rather than scrutinizing the results of the preference in favor of Farmers', the Court focused instead on natural justice, superior equities, and universal concessions,67 and thus concluded that the National Bank Act permitted setoffs.68 Given the Scott circumstances,69 the Court's lengthy discussion of

60. 149 U.S. at 510.
61. Id.
62. Id. at 512.
63. Id. at 510.
64. Id.
65. Id.
66. Id.
67. The Court was persuaded that
natural justice would seem to require that where the transaction is such as to raise the presumption of an agreement for a set-off it should be held that the equity that this should be done is superior to any subsequent existing equity not arising out of a purchase for value without notice.
Id. at 508.
68. Analogizing the ratable distribution of an insolvent bank's assets to that of any other entity in bankruptcy, the Court simply concluded that "the set-off of debts due has been universally conceded. The equity of equality among creditors is either found inapplicable to such set-offs or yields to their superior equity." Id. at 511. Unfortunately, the Court did not explain how the plain anti-preference language of the National Bank Act comports with this universal concession.
69. The Court gave no indication of the circumstances surrounding Fidelity's failure. But it is possible to infer that the Court, in this pre-deposit insurance bank failure, concerned itself
equities seems entirely appropriate and its ultimate holding completely correct. Unfortunately, it did not exhaustively analyze either the facts presented or the provisions of the National Bank Act. Not surprisingly, the Court's statements in support of setoffs have proved far more influential than its narrow holding.\(^7\)

After Scott, no one has disputed the right of a depositor of a failed bank to set off the amount of its general deposit account against the amount of indebtedness owed the failed bank.\(^7\) Yet whether the same borrower/depositor has the same right of setoff when a participant owns all or a portion of the loan was not addressed. Arguably, if a participant has an ownership interest in the debt and the collateral securing it, then courts should not allow a depositor/borrower to use the setoff to extinguish indebtedness owned by the participant bank. As in the Penn Square suits, the participants argued that they owned property rights in the debt and collateral conveyed to them by Penn Square.\(^7\)\(^2\) Allowing the depositor to extinguish its debt essentially allows the borrower to extinguish the participants' property rights.

The ultimate decision on the propriety of depositor setoff and the concomitant rights of a loan participant depends on the contractual structure of the particular loan participation, the relationship created between the lead bank and the participant, and the rights transferred to the participant bank. This Article suggests that the Penn Square courts misinterpreted the contractual relationships created by the Penn Square participations. Thus, the courts failed to recognize the rights of the participants in and to the underlying loan debt and supporting collateral.

**III. LOAN PARTICIPATIONS: THE CLASSIFICATION QUESTION**

A loan participation divides a loan among two or more financial institutions. Loan participations are used by:

- finance companies, mortgage bankers, banks, insurance companies, and many other lenders . . . as a way of enabling an originating lender to accommodate large customers which it could not otherwise handle, consequently increasing the volume of business, diversifying its risks, and in general improving its liquidity; conversely, those institutions which "participate" in loans see it as a way to invest profitably with a minimum of cost, effort, and risk.\(^7\)\(^3\)

with limiting the adverse effects of Fidelity's failure on Farmers'. This inference clarifies the Court's superior equities.

\(^70\). See infra text accompanying notes 428-82.

\(^71\). See W. SCHLICHTING & J. COOPER, supra note 31, at § 49.05; FDIC v. Mademoiselle of Cal., 379 F.2d 660, 663 (9th Cir. 1967); see also Brief in Support of Motion for Preliminary Injunction on Behalf of Hibernia National Bank in New Orleans, Hibernia Nat'l Bank v. FDIC, No. CIV-82-1051-R 1, 34 (W.D. Okla. filed Aug. 11, 1982) ("Hibernia is not seeking to enjoin any non-party borrowers from asserting even at this stage a right of setoff").

\(^72\). See infra text accompanying notes 284-427 (discussing participants' contentions).

\(^73\). Drake & Weems, Mortgage Loan Participations: The Trustee's Attack, 52 AM. BANKR. L.J. 23, 23 (1978). Another commentator explains the growth of loan participations as follows:

- Participations have developed rapidly in recent years as a means of developing
For the originating lender, the participating institution, and ultimately the borrower, these arrangements prove quite beneficial.\(^7\)

\section*{A. Structure}

Structurally, the originating lender or lead bank makes the loan to the borrower. Concurrently with or subsequent to the closing of the loan, the lead bank transfers an undivided portion or percentage of this loan to another financial institution, the participant. The terms of a participation agreement then govern the relationship between the lead bank and its participant.\(^5\)

In the Penn Square Bank participations, the Oklahoma bank originated and consummated the loans.\(^6\) All debt instruments, security documents, and accompanying loan documents showed Penn Square as the sole creditor in their writing and recordation.\(^7\) The note evidencing the borrower's indebtedness was payable to Penn Square, and all mortgages and financing statements named Penn Square as the secured party.\(^8\) Once the parties consummated the loan, Penn Square then transferred an interest in the loan to correspondent bank relations as larger banks share attractive loans with smaller country banks, join country banks in making large loans to country bank customers, and as a means of servicing the credit needs of factors, financing institutions and banks anxious to satisfy their customers' credit demands but unable to do so fully for reasons of lending limit ceilings, shortage of available cash, risk-spreading and the like. By "participating" their larger loans these institutions can continue to serve valuable customers on a more-or-less exclusive basis. Similarly, as purchasers of participations these same institutions can share in attractive loans which might not come to them in the usual course of their business.

Armstrong, \textit{The Developing Law of Participation Agreements}, 23 Bus. Law. 689, 689 (1968).\(^7\)

The loan participation benefits the lead bank by allowing it to:
1. meet the needs of its borrowers without violating lending limit regulations;
2. spread its risks and avoid excessive exposure to a particular borrower or industry;
3. provide increased liquidity and lending capacity; and
4. provide a higher return on invested assets by enabling the lead bank to retain deposits and management or other front end fees based on the full amount of the credit.

The loan participation assists the participant by allowing it to:
1. enter a new geographic market or expand into a new industry in order to diversify its portfolio or establish a base for further expansion;
2. obtain a more favorable return on assets than would otherwise be available;
3. employ capital with minimal administrative costs;
4. enhance correspondent and deposit or loan relationship with the originating bank; and
5. conduct lending activity in a geographic area in which it might otherwise be prohibited from conducting business.

See Baker, Okla. B. Assoc./CLE Banking Law II-2 to -3 (1985). \textit{See also} Revised Banking Circular 181 (Aug. 2, 1984) ("The purchase and sale of loans and participations in loans are established banking practices. These transactions serve legitimate needs of the buying and selling banks and the public interest.").\(^7\)


\textit{78.} \textit{Id.}
one or more of its participants.79

The borrower typically remained ignorant of the participation arrange-
ment.80 The financial institutions never recorded the documents81 evidenc-
ing the upstreaming of the loan. Furthermore, they never filed financing
statements reflecting the interest of the participant.82 The public, therefore,
received no notice of the participation transaction. Moreover, all the debt,
security, and other loan documents remained in the possession of Penn
Square.83 For all appearances, Penn Square was the only lender involved in
making the loan.84

To complicate the situation even further, the participation agreements and
certificates documenting and governing the transaction between Penn Square
Bank and the upstream banks did not explicitly define the nature of the par-
ticipation relationship.85 This proved a critical factor in the courts' exami-
nation of the nature of the legal relationship that existed between Penn
Square and its participants.86 Ultimately, the characterization of that con-
tractual relationship determined the propriety of the Penn Square deposi-
tor/borrower setoffs and the rights of the participant banks.

B. The Lead — Participant Relationship

Although the financial world regularly employs loan participations, prior
to the Penn Square failure the law left this type of relationship largely unde-
defined.87 The financial world tolerated this laxity in legal definition because of
the perceived invulnerability of national banks.88 Penn Square, however, radically altered that misperception.

The classification of the relationship between the lead and participant es-
tentially determines the rights of the participant in the event of the lead

79. See id.; infra text accompanying notes 284-427 (discussing Penn Square decisions).
80. Even though no Penn Square borrower received formal notice of the participation
transaction, that does not mean that the borrowers were uninformed about Penn Square's
participation practices. Quite to the contrary, many of Penn Square's largest borrowers solic-
tited participant involvement. See infra text accompanying notes 284-482.
1983). The nature of the participation transaction, Oklahoma's Article Nine of the Uniform
Commercial Code, and insolvency law arguably meant that the participants were not required
to make any type of filings in order to protect their interests in the loans. See infra text accom-
panying notes 166-265.
82. Typically, the participant bank received only a participation certificate. See infra text
accompanying notes ——.
83. Id.
84. These arrangements are all fairly standard for the typical loan participation. See Arm-
strong, supra note 73, at 689-90; Baker, supra note 74, at II-2 to -3; MacDonald, Loan
Participations as Enforceable Property Rights in Bankruptcy — A Reply to the Trustee's Attack,
53 AM. BANKR. L.J. 35, 38 (1979); Ryan, Interbank Problems: Buying Participations and Shar-
ing Setoffs, 4 ALI/ABA BANKING AND COMMERCIAL LENDING LAW 355 (1983).
85. See Essay, supra note 6, at 267-68.
86. See infra text accompanying notes 284-427.
87. Essay, supra note 6, at 262; Comment, Classification of Loan Participations Following
of Penn Square Bank: Protecting Loan Participants from Setoffs, 18 TULSA L.J. 261, 261
(1982)).
88. Essay, supra note 6, at 262.
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bank's insolvency. A uniform definition of the participation relationship is impossible because loan participations are contractual arrangements. The terms of the contract between the parties, therefore, govern the lead — participant relationship. The terms of the typical Penn Square certificate of participation, however, did not explicitly describe the nature of the legal relationship created between it and its participants. The courts thus turned to the existing body of case law for guidance in construing the Penn Square participation relationships. Unfortunately, the case law concerning participations is far from consistent.

Most of the previous decisions analyzing participations define the relationship under one of three classifications: (1) a sale and assignment of a fractional interest in the underlying loan by the lead bank to the participant; (2) a trust with the lead bank holding an interest in the underlying loan as trustee for the participant/beneficiary; or (3) a loan by the participant to the lead bank secured by the underlying loan. The implications for depositor setoff and the rights of loan participants vary with each of the theories or characterizations of the participation transaction.

1. **Sale and Assignment**

The language of most participation agreements supports the classification of a participation as a sale and assignment by the lead bank and a purchase by the participant of an undivided fractional interest in the underlying loan made by the lead bank. According to this theory, the participation agreement represents an assignment of an interest in the underlying loan and collateral from the lead bank to the participant. Therefore, the participant possesses an ownership interest in the underlying loan and collateral. The rights accorded that ownership interest, however, remain uncertain because the cases seemingly conflict. A comparison of the decisions in *Small Business Administration v. McClellan* and *In re Yale Express System, Inc.* strikingly illustrates the inconsistencies.

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89. See infra Appendices A, B, C, D, E (containing participation agreements).
90. See infra Appendix A (containing printed form participation certificate often used in Penn Square participation transactions).
92. See infra text accompanying notes 93-254.
93. See Baker, *supra* note 74, at II-2 to -3; Hutchins, *supra* note 75, at 463, 472 (discussing these and other possible classifications for participations); Ryan, *supra* note 84, at 355.
94. See infra text accompanying notes 95-164.
97. See Small Business Administration v. McClellan, 364 U.S. 446 (1960); Franklin v. Commissioner, 683 F.2d 125 (5th Cir. 1982); Delatour v. Prudence Realization Corp., 167 F.2d 621 (2d Cir. 1948); MacDonald, Loan Participations as Enforceable Property Rights in Bankruptcy — A Reply to the Trustee's Attack, 53 AM. BANKR. L.J. 35 (1979); infra text accompanying notes 166-265 (discussing applicability of Article 9 to energy loan participations).
98. 364 U.S. 446 (1960).

ingly illustrates this conflict. 99

In *McClellan* 100 the Small Business Administration ("SBA") purchased a seventy-five percent participation interest in a loan. As in the Penn Square participations, the promissory note was made payable to the lead bank only and it retained the note. 101 After the borrower was forced into bankruptcy, the SBA argued that as a governmental entity that was a creditor of the debtor it was entitled to priority over the claims of other creditors. 102 The lower courts, however, denied the SBA’s claim to priority, reasoning that the borrower owed no debt to the SBA at the time of the commencement of the bankruptcy proceeding. 103

On appeal to the United States Supreme Court, the trustee in bankruptcy argued that the borrower was not indebted to the SBA when it filed bankruptcy. The Court, however, rejected this contention and held that:

the debt due the Administration arises out of a loan made jointly by the [lead] bank and the United States nine months prior to the petition in bankruptcy. Since beneficial ownership of the three-fourths of the debt for which priority is asserted belonged to the Administration from the date of the loan, it is immaterial that the formal assignment of the note evidencing the debt was not made by the [lead] bank until after the filing of the petition. 104

The Supreme Court thus concluded that the SBA’s participation interest amounted to beneficial ownership of its participated portion of the loan and held that the SBA was a direct creditor of the borrower. 105 The SBA, therefore, could enforce its interest in the loan directly against the borrower.

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100. 364 U.S. 446.
101. Id. at 447.
102. Id.
103. Id. at 448. The referee in bankruptcy rejected the priority claim of the SBA by determining that the SBA was not a legal entity “entitled to the privileges and immunities of the United States.” Id. The district court rejected the priority claim by determining that “since the bankrupt’s note evidencing the loan was not assigned by the [lead] bank to the [SBA] until after the commencement of bankruptcy proceedings, the debt is not entitled to priority.” Id. In other words, no debt was owed the SBA until it became the actual holder of the note. The circuit court rejected the priority claim by determining that the SBA’s obligation to pay the lead bank, which had been “reverse participated” into the role of participant, 25% of any distributions that the SBA received vitiated governmental priority.

The Supreme Court granted certiorari in order to determine whether the denial of priority limited the SBA’s ability to perform its legislatively imposed duties. 364 U.S. at 448.

Justice Black framed the issue presented as follows:
The basic question this case presents is whether, when the Administration has joined a private bank in a loan and the borrower becomes a bankrupt, the Administration’s interest in the unpaid balance of the loan is entitled to the priority provided for “debts due to the United States. . . .”

Id. at 447.
104. 364 U.S. at 450.
105. Id.
106. If the loan were secured, the *McClellan* reasoning would grant the participant an ownership interest in the debt obligations and the collateral securing those obligations. Presumably, this interest would allow the participant to set off the borrower’s assets held by it in order to reduce the indebtedness owed to it. *But see* In re Yale Express System, Inc., 245 F. Supp. 790 (S.D.N.Y. 1965) (disallowing setoff by participant because bank was not creditor).
Implicit in the Court's opinion is the rationale that a participant has a separate and cognizable property right in the underlying loan to the borrower.

The ruling in In re Yale Express System, Inc.\(^\text{107}\) completely contrasts with that of the Supreme Court in McClellan. In Yale Express, Marine Midland Trust Company of New York purchased a forty percent participation in a loan made by First National City Bank to Yale. Yale also maintained a deposit account at Marine Midland. When Yale filed bankruptcy,\(^\text{108}\) Marine Midland attempted to set off Yale's account against the balance of the loan debt owed Marine Midland. After examining the terms of the loan documents\(^\text{109}\) and the participation agreement,\(^\text{110}\) the district court concluded without extended discussion\(^\text{111}\) that Marine Midland was not a creditor of Yale.\(^\text{112}\) Therefore, the court disallowed the setoff.\(^\text{113}\)

This decision makes no effort to distinguish McClellan. Instead, the district court simply stated that Marine Midland advanced money only to the lead bank, First National City Bank, which was the only creditor of Yale in the lending relationship.\(^\text{114}\) "Repayment of any amount advanced to [the lead bank] by [Marine Midland] under the participation agreement was made or to be made by [the lead bank], and [Marine Midland's] right to repayment would arise only upon the receipt by [the lead bank] of payment from Yale."\(^\text{115}\) In the court's view, Marine Midland was not a creditor of


\(^{108}\) The corporate reorganization aspects of the case are considered in Rosenberg, Beyond Yale Express: Corporate Reorganization and the Secured Creditor's Rights of Reclamation, 123 U. PA. L. REV. 509, 509 (1975).

\(^{109}\) The loan agreements were executed by only the lead bank, First National City Bank, and the borrower, Yale. The loan documents neither referred to the participation nor did Marine Midland sign them.

\(^{110}\) Unfortunately, the court did not include in its opinion the complete text of the participation agreement. The court did say, however, that Marine was obligated to "take an undivided 40% participation' in each advance" made to Yale Express and that the participation agreement provided that First National City Bank retained sole discretion to agree to amendments or extensions or to the loan terms (except for changes in terms of payment of principal, interest, premiums, or fees) and to exercise any collection remedy in the event of default. 245 F. Supp. at 791-92.

\(^{111}\) Unfortunately, the district court did not explain its decision. Either the court deemed an explanation of its rationale unnecessary or it believed the matter so simple that it did not need explanations. In its brevity the district court not only failed to distinguish McClellan, but it also failed to acknowledge the Supreme Court's opinion. The Yale court, therefore, never analyzed the issue central to this question — that of the nature of the participant's ownership interest in the loan. Unfortunately the Yale court is not alone in its failure or inability to make this critical determination. The Penn Square courts were similarly afflicted.

\(^{112}\) Id. at 792. The court stated that neither the loan documents nor the participation agreement gave Marine Midland any right to receive payments directly from Yale. "Essentially, Marine's only right was to be paid by [the lead bank] an agreed share of whatever funds, if any, were paid or repaid by Yale to [the lead bank]." Id.

\(^{113}\) Id. The Yale court concluded:

Without extended discussion, therefore, I hold that Marine was not and is not a creditor entitled to set off the bank account in the amount of $361,739.71 which Yale had with Marine at the time of the filing of the petition for reorganization.

\(^{114}\) 245 F. Supp. at 792.

\(^{115}\) Id.
Yale and therefore had no right to direct relief against Yale.\textsuperscript{116} On this point \textit{Yale Express} directly conflicts with the Supreme Court's finding in \textit{McClellan} that the participation transaction conveyed a beneficial ownership interest in the loan debt to the participant.\textsuperscript{117} \textit{McClellan} and \textit{Yale Express} appear irreconcilable because the two courts disagree on the nature of the property rights created and conveyed by a participation arrangement. The issue necessarily becomes whether the property right transferred to the participant is an undivided right in and to the loan, all debt instruments evidencing the loan, and all collateral securing the loan or whether it is merely a right to a portion of the future payments made by the borrower in repayment of the loan.\textsuperscript{118}

In a third case, \textit{Franklin v. Commissioner},\textsuperscript{119} the Fifth Circuit specifically addressed this issue and concluded that the participants involved owned property rights in the underlying loan. In \textit{Franklin} the lead bank, Capital Bank, sold a number of other banks participations in a loan it made to Franklin. As is common in participation transactions, Capital Bank retained the note and all other loan documents. The participation certificate, which referred to the transaction as a sale, specifically limited Capital Bank's responsibility to its participants to that of exercising the same care that it exercised in handling loans exclusively for its account and accounting to each participant for its pro rata share of all payments made on the loan.\textsuperscript{120}

\begin{flushleft}
\textsuperscript{116} As in the Penn Square loan participations, the participant argued that at the very least it was an "equitable creditor" of the borrower because the borrower was aware of the participant's involvement. In \textit{Yale}, Marine Midland produced evidence showing that "Yale was aware of, acquiesced to and indeed applauded Marine's participation." \textit{Id.} Yet, the court believed that these circumstances did not elevate Marine Midland to the status of creditor. \textit{Id.} at 792-93.

If Yale had permitted First National City Bank, the lead, the remedy of setoff as a presumable condition precedent to the making of the loan, then it is arguable that in acquiescing to and applauding Marine Midland's participation, Yale permitted Marine Midland the same right. This seems particularly true when the borrower knows that its loan depends on the funding of a participant bank. To permit otherwise, as did the \textit{Yale} court, allows the borrower to vitiate its implied agreement with the participant. See infra text accompanying notes 428-482 (discussing commercial expectations behind setoff).

\textsuperscript{117} 364 U.S. at 450 ("Since beneficial ownership of three-fourths of the debt for which priority is asserted belonged to the Administration from the date of the loan . . . .")

\textsuperscript{118} See infra text accompanying notes 284-427.

\textsuperscript{119} 683 F.2d 125 (5th Cir. 1982). \textit{Franklin} was decided just one month after Penn Square Bank was closed and the participation certificate involved in this case, see infra note 120, is very similar to Penn Square's printed form participation certificate used by, among others, The Northern Trust Company and Hibernia National Bank in New Orleans.

\textsuperscript{120} The participation certificate provided:

This certificate evidences your participation with us in a $— note to — dated —.

Said note matures — at the rate of —% from —. We have this date sold to you a participation in the amount of $— *** [at] —% with — accrued interest —.

The execution of this participation agreement shall not limit or affect our discretion in exercising without notice to you any and all rights afforded to us by the above mentioned note or any other document relating thereto, our sole responsibility to you being to exercise the same care that we exercise in the making and handling of loans for our own account and to account to you for your pro rata share of the net amount of all payments actually received by us with respect to the said note. The right to repurchase all, or any part of this Participation is reserved to the Capital National Bank in Austin, Texas.

683 F.2d. at 128 n.8.
\end{flushleft}
The issue of the nature of the participants' interest in the loan arose because Franklin paid the interest due on the participated loan with the proceeds of a subsequent non-participated loan from Capital.\textsuperscript{121}

Under the applicable tax laws, a debtor cannot deduct interest payments made to a creditor with funds borrowed from the same creditor. If, however, the debtor borrows from one creditor to pay interest to another creditor, the debtor can deduct the interest payment.\textsuperscript{122} Franklin deducted the portion of his interest payment that passed through Capital Bank to the participants.\textsuperscript{123} The Tax Court determined that the participants did not own the debt, and thus Franklin was not entitled to the deduction.\textsuperscript{124}

The Fifth Circuit, however, determined otherwise. The circuit court concluded that Capital Bank no longer owned those portions of the loan sold as participations in the Franklin loan.\textsuperscript{125} Regardless of the fact that Capital Bank still held the note, the sale of the participations converted Franklin's creditors from one bank to a group of banks.\textsuperscript{126} Each of the participants held an ownership interest in the loan and Capital Bank merely acted as the participants' servicing agent.\textsuperscript{127}

Like the Supreme Court in \textit{McClellan}, the Fifth Circuit found that the sale of the participation assigned ownership interests in the underlying loan to the participant.\textsuperscript{128} "It is immaterial whether the payments were collected directly by the banks to whom they were, in fact, legally due."\textsuperscript{129} The Fifth

\begin{itemize}
\item \textsuperscript{121} The proceeds of the second (non-participated) loan were deposited in Franklin's account at Capital Bank. Franklin then drew a check on that account, payable to Capital Bank, to pay the interest on the first (participated) loan. Capital Bank then disbursed these funds to the participating banks in accordance with their percentage interests in the loan. \textit{Id.} at 126 n.1.
\item \textsuperscript{122} The Fifth Circuit explained:
\begin{quote}
Interest paid to one lender by a cash basis taxpayer with funds borrowed from a second lender is deductible when the interest is paid. When, however, the taxpayer gives the lender his note, he has paid nothing; he has merely promised again to pay. Thus if the taxpayer has borrowed from Peter to pay Paul, the deduction is allowed; if he has borrowed from Peter to refinance what is due Peter, there is no real payment and hence no deduction.
\end{quote}
\textit{Id.} at 127.
\item \textsuperscript{123} \textit{Id.}
\item \textsuperscript{124} 683 F.2d at 127.
\item \textsuperscript{125} "In effect, the participants purchased an ownership interest in the loan, although the lead bank continued in possession of the note." \textit{Id.} at 128 n.9.
\item \textsuperscript{126} \textit{Id.} at 129. "Under the terms of the participation agreement in this case . . . the participant is an assignee of a percentage interest in the loan and the lead bank is the agent for servicing the entire loan." \textit{Id.} at 128 n.9.
\item \textsuperscript{127} 683 F.2d at 128 n.9.
\item \textsuperscript{128} \textit{Id.}
\item \textsuperscript{129} \textit{Id.} at 129.
\item The Tax Court opinion states that, in terms of tax policy, it is difficult to see why the deductibility of the taxpayer's interest should be affected by whether Capital Bank chose to sell participations. This myopia results from failure to perceive that this sale of participations was not an illusion or paper transaction. The sale of participations converted Franklin's creditors from one bank to a group of banks. Franklin could not have prevented Capital Bank from selling the entire loan to another bank and thereafter acting as merely servicing agent.
\item 683 F.2d at 129. The Fifth Circuit concluded that Franklin was not engaging in mere "'paper-shuffling'" and was entitled to the interest deduction. \textit{Id.}
\end{itemize}
Circuit thus determined that, regardless of which bank held the note, all the banks involved owned property interests in the loan.

The distinction between whether the participant has purchased a property interest in the underlying loan or whether it purchased merely a contractual expectation of repayment can be critical. If a participant has a direct ownership interest in the debt and security instruments, then it also has a direct relationship with the borrower. As stated in the McClellan and Franklin decisions, the participant bank is a direct creditor of the borrower. If, however, a participant holds a right to a pro rata portion of the payments made to the lead bank by the borrower to retire the debt owing exclusively to the lead bank, then no direct debtor-creditor relationship can exist between the borrower and the participant. Therefore, as stated in Yale, the participant cannot directly seek relief against the borrower. As demonstrated by McClellan and Yale, the economic consequences wrought by these two competing lines of thought can be significant. Determining which of these two characterizations of the assigned property right should prevail, therefore, becomes of considerable importance.

2. Trust

Courts have also characterized a participation as a partial assignment coupled with a trust wherein the lead bank acts as trustee for the participant. In some instances the participation agreement or certificate expressly provides for a trust. Thus, the lead bank remains obligated to hold the debt, security instruments and all payments in trust for the participant.

The classification of a participation as a trust often results in two major consequences. First, the lead bank, as a trustee, will be held to a higher standard of conduct in administering the loan. Second, under a trust relationship the participant’s interest would not be subordinated to the lead bank’s trustee or receiver in the event of the lead bank’s insolvency.

130. McClellan, 364 U.S. at 450; Franklin, 683 F.2d at 129. See supra notes 100-129 and accompanying text.
131. 245 F. Supp. at 792. See supra notes 107-118 and accompanying text.
132. See Baker, supra note 74, at II-6; Hutchins, supra note 75, at 472; MacDonald, Loan Participations as Enforceable Property Rights in Bankruptcy — A Reply to the Trustee’s Attack, 53 AM. BANKR. L.J. 35, 54-66 (1979); Ryan, supra note 84, at 382.
133. See Women’s Federal Savings and Loan Association v. Nevada National Bank, 811 F.2d 1255 (9th Cir. 1987); MacDonald, supra note 84, at 54 (discussing historical background of trusts, their express and implied formation, and their applicability to loan participations); Ryan, supra note 84, at 382-83 ("A participation agreement or certificate may provide for such a trust, requiring the lead bank to hold the evidences of debt and payments thereon ‘in trust’ for the participant.").
134. See Seafirst Participation Agreement.
135. See Hutchins, supra note 75, at 472. Typically, a loan participation agreement obligates the lead bank to exercise only the same degree of care that it exercises when dealing with non-participated loans.
136. A trustee or receiver acquires an interest in only the property of the debtor. See Scott v. Armstrong, 146 U.S. 499, 507 (1892); FDIC v. Mademoiselle of California, 379 F.2d 660, 663 (9th Cir. 1967). The lead’s trustee, therefore, would not acquire an interest in the participated portion of the loan. Section 541(d) of the Bankruptcy Code achieves the same result: Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real prop-
Therefore, any payments made on the loan would be held in trust for the participant and the participant would be entitled to receive those funds from the lead bank’s receiver.\textsuperscript{137}

In \textit{Stratford Financial Corp. v. Finex Corp.}\textsuperscript{138} the Second Circuit determined that a participation arrangement created a trust relationship between the lead bank and the participant. In that case the participant, Finex, purchased a one hundred percent participation interest in a loan made by Stratford.\textsuperscript{139} After Stratford filed bankruptcy, it continued to remit the borrower’s payments on its loan to Finex.\textsuperscript{140} As a result, the debtor in possession and the creditors, committee attempted to reclaim these payments to

\begin{itemize}
\item property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate \ldots only to the extent of the debtor’s legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.
\item 11 U.S.C. \textsection 541(d) (1982).
\item The Bankruptcy Code recognizes and protects the participant’s interest. When discussing the secondary mortgage market, a form of loan participations itself, the legislative history specifically demonstrates Congress’s intent that the trustee would be required under \textsection 541(d) to turn over the mortgages or interests in mortgages to the purchaser of those mortgages (i.e., the participant).
\item The seller of mortgages in the secondary mortgage market will often retain the original mortgage notes and related documents and the seller will not endorse the notes to reflect the sale to the purchaser. Similarly, the purchaser will often not record the purchaser’s ownership of the mortgages or interests in mortgages under State recording statutes. These facts are irrelevant and the seller’s retention of the mortgage documents and the purchaser’s decision not to record do not change the trustee’s obligation to turn the mortgages or interests in mortgages over to the purchaser. The application of section 541(d) to secondary mortgage market transactions will not be affected by the terms of the servicing agreement between the mortgage servicer and the purchaser of the mortgages. Under section 541(d), the trustee is required to turn the purchaser’s title to the mortgages or interests in mortgages and to turn this property over to the purchaser. It makes no difference whether the servicer and the purchaser characterize their relationship as one of trust, agency, or independent contractor.
\item The purpose of section 541(d) as applied to the secondary mortgage market is therefore to make certain that secondary mortgage market sales as they are currently structured are not subject to challenge by bankruptcy trustees and that purchasers of mortgages will be able to obtain the mortgages or interests in mortgages which they have purchased from trustees without the trustees asserting that a sale of mortgages is a loan from the purchaser to the seller.
\item Thus, as section 541(a)(1) clearly states, the estate is comprised of all legal or equitable interests of the debtor in property as of the commencement of the case. To the extent such an interest is limited in the hands of the debtor, it is equally limited in the hands of the estate except to the extent that defenses which are personal against the debtor are not effective against the estate.
\item 124 Cong. Rec. S17,413 (Oct. 6, 1978).
\item 137. The Seafirst Agreement contains this type of provision. \textit{But see infra} notes 399-427 and accompanying text (discussing Seafirst).
\item 138. 367 F.2d 569 (2d Cir. 1966).
\item 139. Stratford made a $50,000 loan to a borrower that was evidenced by ten promissory notes of $5,000 each, payable at monthly intervals. Stratford then entered into a letter agreement with Finex “whereby Finex was purportedly given an interest in the [borrower’s] notes in return for an advance to Stratford of $40,000.” \textit{Id}. Stratford, however, retained the notes.
\item 140. When the borrower made the payments required by the note to Stratford, Stratford’s president endorsed the borrower’s check and delivered it to Finex.
Finex as assets of Stratford. After considering the nature of the contractual relationship between Stratford and Finex, the terms of the letter agreement evidencing the participation and the course of dealing between the parties, the court concluded that the participation arrangement created a trust. Therefore, the court recognized Finex's beneficial ownership of the funds and protected its interest from the claims of the debtor in possession and Stratford's creditors.

The creation of a trust carries with it significant consequences, consequences possibly unintended by the parties to the typical loan participation arrangement. Moreover, the heightened duties and obligations imposed on a fiduciary could impose impracticalities for both the lead bank and its participant.

3. Debt of the Lead Bank

The third theory construes a participation arrangement as an extension of credit by the participant to the lead bank. In re Alda Commercial Corp. is the leading case supporting the argument that a participation creates a debtor-creditor relationship between the lead bank and its participant. In Alda the participants purchased undivided interests in secured loans that

141. Stratford received, endorsed and delivered five $5,000 checks to Finex after Stratford declared bankruptcy. The debtor in possession and the creditors committee argued that the participation arrangement simply represented a loan from Finex to Stratford. Therefore, Finex had no right to receive the borrower's checks (i.e., payments on the loan to Stratford) once the bankruptcy commenced. 367 F.2d at 570. In determining the impact of Stratford's bankruptcy on this arrangement, the Second Circuit was determined "whether the arrangement between Stratford and Finex created a trust for the benefit of Finex." Id.

142. The court found that Stratford had experience in the financing business and that Finex had none. Finex therefore relied on Stratford to draft the documents "to create and carry out a trust." Id. at 571.

143. The participation letter agreement provided that "[t]he loan shall be conducted solely in [Stratford's] name .... However, we shall hold all notes pertaining to this transaction 'in trust' for our mutual benefit." Id.

144. Among the other indicia of a trust relationship, the court included the fact that the borrower did not commingle its checks with Stratford's other funds, Stratford always remitted the checks to Finex promptly, two prior Stratford - Finex agreements used the language "in trust" and no promissory notes from Stratford payable to Finex were ever executed in this transaction or the two prior participation transactions. 367 F.2d at 570.

145. Id.

146. Stratford, therefore, was Finex's fiduciary, not its borrower. Id.

147. For example, it is unlikely that the lead bank intended to assume a duty of care for the participant's portion of the loan (as fiduciary) greater than its duty to protect its own interest.

148. However, banks will not easily accept a designation as "trustee." A trustee has formidable duties: fiduciary duties, prudent man duties, common law duties, and statutory duties. A bank may be willing to accept those duties when it is being paid a trustee's fee and is protected by extensive administration and exculpatory provisions, like those found in bond indentures. But a bank is understandably reluctant to accept a trustee's responsibilities in the normal sale of interbank participations. Further, such duties (like the duty to segregate trust property) may be impractical.

Ryan, supra note 84, at 384.

149. See Baker, supra note 74, at II-7; Drake & Weems, Mortgage Loan Participations: The Trustee's Attack, 52 AM. BANKR. L.J. 23 (1978); Hutchins, supra note 75, at 458-62; Ryan, supra note 86, at 386.

Alda agreed to make to two borrowers.\textsuperscript{151} The participation agreement limited each participant's investment to a maximum of $10,000 and further provided that Alda would pay to the participants a specified rate of interest on their participations.\textsuperscript{152} The participation agreement also specified that Alda would pay the participants interest at a rate of twelve percent. If, however, the interest charged on the underlying loans exceeded that amount, the participants would not share in the benefits of that higher interest rate. Instead, Alda retained all the benefits of the higher rate. Alda received the funds advanced by the participants and placed them in its general account; the security instruments collateralizing the loans named Alda as the only secured party. The borrowers, unaware of the participation of their loans, continued to make their payments directly to Alda.

After Alda's bankruptcy, the participants argued that they were joint venturers with Alda and, consequently, they owned an undivided ten percent interest in the collateral securing the loans. The referee in bankruptcy, however, concluded otherwise.

The referee found that the relationship between Alda and the participants resembled that of debtor-creditor, rather than agent-principal.\textsuperscript{153} To protect their interests, therefore, the referee concluded that the participants should have filed financing statements in accordance with the Uniform Commercial Code ("U.C.C.").\textsuperscript{154} Since they did not, the entire amount of the participated loans constituted property of Alda's estate.\textsuperscript{155} On appeal, the district court agreed with the referee's findings.\textsuperscript{156}

The Alda participations differed structurally from the typical participation arrangement. In fact, everything about the Alda participation relationship looked like a loan from the participant to the lead.\textsuperscript{157} Alda sold participation interests in a blind pool of loans, and Alda unconditionally had to pay interest to its participants and the participants even had recourse against Alda to collect the amount of their investment. In contrast, the usual bank participations cover separate and identified loans and do not provide for recourse against the lead bank. The participant bears the same risk as the lead

\textsuperscript{151} The loans were secured by the borrowers' accounts receivable and other collateral.

\textsuperscript{152} The participants purchased a 10% interest in the full amount of the loans up to a "maximum investment" of $10,000. 327 F.Supp. at 1316.

\textsuperscript{153} \textit{Id.} at 1317. The district court stated that if the participation arrangement created "a partnership for the factoring of the accounts receivable" of the borrowers, then the participants' interest was that of limited partner. Under New York law, therefore, the participants were required to file a notice of their interests as limited partners, which they did not do. \textit{Id.} at 1317-18.

\textsuperscript{154} \textit{Id.} at 1317.

\textsuperscript{155} \textit{Id.} "The arrangement was not brought to the attention of the creditors of the bankrupt, and their rights under the Bankruptcy Act should not be limited by reason of a secret agreement between [the participants] and the bankrupt." \textit{Id.}

\textsuperscript{156} The district court found that there was no basis for determining that Alda was an agent for the participants in the factoring of the borrowers' accounts receivable; furthermore Alda was not a trustee for the participants "since there was no segregation of these accounts and none was contemplated." \textit{Id.} at 1318. In short, the district court was satisfied that the participation arrangement represented at most a loan or an investment by the participants. \textit{Id.}

\textsuperscript{157} \textit{See} Baker, supra note 74, at II-7 ("Alda loses some of its in terrorem effect upon examining the participation in that case.").
If a court construed a loan participation as a loan from the participant to the lead, then the underlying loan represents the security for this extension of credit. If the lead becomes insolvent, then the interest in the underlying loan held by the participant/creditor, as demonstrated in *Alda*, becomes susceptible to attack by the lead/debtor's trustee and creditors. Therefore, Article Nine of the U.C.C. applies to participation transactions since the underlying loan constitutes the security for the loan.

The actual wording of most participation agreements and certificates fails to support the classification of a participation as an extension of credit to the lead. For very good business reasons, among them the desire to enhance its financial statement and avoid violating its lending limits, a lead bank obviously prefers structuring the participation as a sale. For equally compelling business reasons, a participant also prefers structuring loan participations as sales and assignments of assets. If, however, a court deems a particular participation transaction as creating a debtor-creditor relationship, then the participant faces an additional risk, the lead bank's insolvency. Most likely a participant bank would not compound its risk exposure by making a loan to the lead bank.

C. Participant as Owner or Creditor and Lead Insolvency

Essentially, the above three characterizations construe the participant's

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158. The following factors indicate a participation creates a debtor-creditor relationship:
   1. The participation contract grants the participant recourse against the lead bank for payment of the participant's share of the underlying loan;
   2. The payment arrangements of the underlying loan and the participation substantially differ;
   3. The participation lasts for a different term than the underlying loan; and
   4. A large discrepancy in interest rates exist between that received by the participant and the lead.

   *Accord Baker, supra* note 74, at II-8.

159. *Ryan, supra* note 84, at 355; *Drake & Weems, supra* note 73, at 45; *Essay, supra* note 6, at 265 n. 18. Penn Square's Oklahoma energy loan participations, however, did not require any type of perfective filing in order to recognize and preserve the participants' interests.


161. Penn Square originated over $2 billion in energy loans, which far exceeded its lending limits. It could not legally have originated and continued to carry these loans on its books as its assets. Furthermore, if these participations were classified as loans to Penn Square, then Penn Square's financial statements would have to reflect an additional $2 billion in debt.

   The debtor-creditor construction neither reflects nor furthers the commercial expectations and purposes that surround most loan participations. Moreover, when faced with what it considers a difficult or close decision, as admittedly the Penn Square courts were, the court should resolve the question or controversy in a way that furthers the commercial realities and expectations that surround the transaction.


163. In other words, if the court deems the participant a creditor of the lead bank with the participation as its security, then its risk has doubled. The participant runs the risk that the lead may default on its loan obligations to the participant. Moreover, if the underlying borrower defaults on its loan obligations to the lead, then the participant also runs the risk that its collateral has lost or will lose considerable value.
interest as either that of an outright owner\textsuperscript{164} of some portion of the loan or that of a creditor of the lead bank.\textsuperscript{165} If the participant is an owner, then it possesses a legally cognizable property interest in the underlying loan and its supporting collateral. Although the lead bank continues to retain the note and manage the loan after it conveys the ownership interest to the participant, the lead bank acts for the benefit of the participant as its trustee or agent. The other view, however, construes the participation not as the purchase of a property right in the lead bank's loan to its borrower, but as a separate loan from the participant to the lead bank. In the context of the lead bank's insolvency and borrower/depositor setoff, this distinction proves critical. If a participant owns a property interest in the underlying debt, then the setting off of deposits in the insolvent lead bank should not affect the portion of the debt owned by the participant. If, however, the participant is merely a creditor of the lead bank and it failed to perfect its security interest in its collateral (\textit{i.e.} the underlying loan to the borrower/depositor), then the participant arguably remains powerless to stop the setoff.


Some commentators view all participations as loans from the participant to the lead bank.\textsuperscript{166} This author disagrees. The structure and intent of the participation transaction ultimately determines whether a participation is either the conveyance of outright ownership of an asset or simply security proffered for a loan. The Penn Square participations were definitely structured as and intended to be sales and purchases of ownership of the underlying loan.\textsuperscript{167}

Those who believe that all participations constitute loans equally insist that Article Nine of the U.C.C. requires all participants to perfect their participation interests or risk losing them.\textsuperscript{168} This viewpoint is also questionable. Regardless of whether the Penn Square participation transactions were sales or loans, the participants were not required to perfect their participation interests in accordance with Article Nine.\textsuperscript{169}

Finally, some argue that if the participants have failed to perfect their interests when the lead fails, then the trustee in bankruptcy can avoid the

\textsuperscript{164} See supra notes 95-138 and accompanying text (similar conclusion in case of sale and assignment or trust).
\textsuperscript{165} See supra notes 139-68 and accompanying text (similar conclusion in the case of classifying the participation as simply a loan to lead bank); see also Drake & Weems, supra note 73, at 43.
\textsuperscript{166} See infra notes 238-245 and accompanying text (discussing Drake and Weems's views)
\textsuperscript{167} See infra notes 284-427 and accompanying text.
\textsuperscript{168} See Drake & Weems, supra note 166, at 45.
\textsuperscript{169} See infra notes 180-265 and accompanying text.
participants' interests in the loans.\textsuperscript{170} Here, too, this author disagrees. By the express terms of the Bankruptcy Code, the interests of loan participants in the underlying loans originated by the lead are recognized and protected.\textsuperscript{171}

To prove these assertions, the structure of the Penn Square participations must be analyzed under the U.C.C., particularly Article Nine, and the Bankruptcy Code. To correctly understand the participation transaction, and therefore, the requirements of Article Nine and the Bankruptcy Code, one must accurately understand the underlying Penn Square loan transaction.

\textit{A. Oil and Gas Finance}\textsuperscript{172}

Oil and gas loans represented the majority of the Penn Square participated loans.\textsuperscript{173} The following example reasonably typifies the mechanics of oil and gas loans in general and the Penn Square oil and gas loans in particular.

Ewing Oil, an independent oil and gas exploration and production company, has under lease 10,000 "can't miss — you gotta' see it to believe it — guaranteed to produce — only problem is I need $20 million in a hurry" acres in Oklahoma's Anadarko Basin. Armed with a phalanx of geological data and a battery of reserve reports sporting conservative escalation figures predicated on the latest New York estimates of future gas values which scientifically prove that Ewing Oil's interest in the 10,000 acre leasehold estate is worth twice the national debt, Ewing Oil approaches Penn Square Bank for the $20 million. As security for the loan, Ewing Oil agrees to mortgage its interest in the oil and gas leasehold estate and have the production proceeds paid directly to the bank. Penn Square, after reviewing Ewing Oil's data and consulting with an upstream bank, agrees to make the loan. The parties sign the loan agreements and Penn Square disburses the funds.

As this example demonstrates, a lender bases an oil and gas loan on the determination that oil and/or gas is in the ground, it can be extracted, and its value will suffice to repay the loan as scheduled.\textsuperscript{174} To calculate the loan value of a borrower's interest in an oil and gas producing property, the bank and its petroleum engineers and geologists calculate the amount and value of

\textsuperscript{170}. See Drake \& Weems, supra note 166, at 57.

\textsuperscript{171}. See infra notes 252-79 and accompanying text (discussing effect of Bankruptcy Code on loan participation).

\textsuperscript{172}. Because of the special nature of the oil and gas industry and the special nature of the relationships that are created by substantive oil and gas law, oil and gas finance has many special aspects. In order to understand the nature of the participants' interest in the Penn Square energy loans, it is first necessary to understand some of the special aspects of Oklahoma energy loans.

This portion of the Article is not intended to be an exhaustive discussion of the law of oil and gas or the law of oil and gas finance. It explains and highlights some of the more important aspects of oil and gas finance, however, especially as they affect the obligations and interests of the participants.

\textsuperscript{173}. See P. Zweig, supra note 1, at 409; M. Singer, supra note 2, at 106.

the property's recoverable reserves.\textsuperscript{175} The borrower often mortgages to the bank its interest in the oil and gas leasehold estate as security for the loan.\textsuperscript{176}

The phrase "mortgages to the bank its interest in the oil and gas leasehold" appears deceptively simple because that interest really represents a collection of interests in realty, personality, tangibles, intangibles, accounts and contract rights;\textsuperscript{177} the bank usually wants it all. Therefore, the bank first sifts through this collection to determine how to encumber or mortgage each of these interests.\textsuperscript{178} Then it determines how to perfect its security interest in all these interests in order to secure the transaction.\textsuperscript{179}

B. Applicability of the U.C.C. — The Underlying Loan\textsuperscript{180}

Using the Ewing Oil loan example, some of the rights and interest that commonly collateralize an oil and gas loan include the following:
1. Ewing Oil's rights and interests in the oil and gas leases, and, therefore, its interest in the hydrocarbons in place;
2. Ewing Oil's rights and interests in the hydrocarbons once they have reached the wellhead;
3. Ewing Oil's rights and interests in the drilling and production equipment;
4. Ewing Oil's rights and interests in the contractual agreements with the operator and the other working interest owners; and
5. Ewing Oil's rights and interests in the proceeds of production.

Penn Square must, therefore, classify each of these rights and interests in order to determine how to encumber them.

1. Classification of Collateral

a. The Oil and Gas Leases and Hydrocarbons in Place

Professor Lowe describes the nature of the oil and gas lease in the following way:

A modern oil and gas lease is a unique instrument. Essentially, it transfers a mineral owner's right to search for, develop and produce oil and gas from leased lands during the leased term. It is difficult to fit into existing legal categories. It is both a conveyance and a contract, more a deed than a lease, and it creates rights in the lessee that have proved hard to classify.\textsuperscript{181}

\textsuperscript{175} See Brennan, \textit{supra} note 174, at 16-2 to -4.
\textsuperscript{176} See \textit{id.}; Vagts, \textit{supra} note 174, at 827.
\textsuperscript{178} See infra notes 180-213 and accompanying text.
\textsuperscript{179} See infra notes 214-41 and accompanying text.
\textsuperscript{180} The term "underlying loan" means the loan made to the borrower, Ewing Oil in the continuing example, by Penn Square Bank.
\textsuperscript{181} J. Lowe, \textit{Oil and Gas Law in a Nutshell} 152 (1983). Professor Kuntz writes:

The oil and gas lease is unique. It is a conveyance of an interest in real property, with conditions and special limitations, which creates a continuing relationship between the parties. It is also an executory contract in that it contains
This classification confusion regarding the oil and gas lessee’s rights seems particularly true in Oklahoma. 182

In the substantive realm of oil and gas law, Oklahoma is a nonownership theory state. 183 That is, the owner184 of oil and gas rights does not own the hydrocarbons in the ground. Rather, the owner possesses an exclusive right to explore for and produce oil and gas from the lands subject to its rights. 185

elaborate contractual provisions which continue in force between the lessor and the lessee during the life of the interest granted. In addition, many rights and duties arise as between the lessor and lessee by virtue of their special relationship and their common objectives with respect to a fugitive substance, which rights and duties do not arise between the vendor and purchaser nor between landlord and tenant. In states which follow the common law, difficulty is encountered in any attempt to identify the property rights and relationship between the parties created by the oil and gas lease with any single established concept.

2 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 18.2 (1964).

182. See Continental Supply Co. v. Marshall, 152 F.2d 300, 305-08 (10th Cir. 1945) (discussing confusing nature of Oklahoma oil and gas lessee’s interest), cert. denied, 327 U.S. 803 (1946)

In general, the oil and gas lease and the rights created thereby have been variously classified by the courts for different reasons. 2 E. KUNTZ, supra note 181, § 18.2, at 5; Lowe, The Rule of Capture and Theories of Ownership of Oil and Gas, FUNDAMENTALS OF OIL & GAS LAW & TAXATION 43, 56-58 (J. Lowe ed. 1984). These characteristics include:

- a profit a prendre, a corporeal hereditament, an estate in land, not an estate in land, an estate in oil and gas, not an estate in oil and gas, a servitude, a chattel real, real estate, an interest in land, not an interest in land, personal property, a freehold, a tenancy at will, property interest, and the relation of landlord tenant.


For extensive discussions of the nature, characteristics, and aspects of oil and gas leases, see 1 E. BROWN, THE LAW OF OIL AND GAS LEASES (2d ed. 1984); PRINCIPLES OF THE OIL AND GAS LEASE (J. Lowe & K. Myles eds. 1985).


Note, however, that the term “nonownership” does not mean the absence of property rights.

1 E. KUNTZ, supra note 181, § 2.4, at 66.

184. The term “owner” includes both the owner of the mineral estate, if there is no oil and gas lease covering the property, and the lessee, Ewing Oil in the example, if there is an oil and gas lease covering the property. See generally J. LOWE, supra note 181, at 171 (mineral owner who grants lease transfers all rights to property).

185. 1 H. WILLIAMS & C. MEYERS, supra note 183, at § 203.2; 2 E. KUNTZ, supra note 181, at § 23.23; 1 E. BROWN, supra note 182, at § 3.02; J. LOWE, supra note 172, at 239; LOWE, supra note 182, at 51. The Oklahoma Supreme Court explained the significance of the nonownership theory in the following manner:

[Owners in fee simple have] no absolute right or title to the oil or gas which might permeate the strata underlying the surface of their land, as in the case of coal or other solid minerals fixed in, and forming a part of, the soil itself.

But with respect to such oil and gas, they [the owners] had certain rights designated by the same courts as a qualified ownership thereof, but which may be more accurately stated as exclusive right, subject to legislative control against waste and the like, to erect structures on the surface of their land, and explore therefore by drilling wells through the underlying strata, and to take therefrom and reduce to possession, and thus acquire absolute title as personal property to such as might be found and obtained thereby. This right is the proper subject of sale, and may be granted or reserved. The right so granted or reserved, and held separate and apart from the possession of the land itself, is an incorporeal hereditament; or more specifically, as designated in the ancient French, a profit a
Title to the oil and gas vests in the owner only when the oil and gas are reduced to the owner's possession.186

In the Penn Square Bank loan hypothetical, Ewing Oil owns this exclusive exploratory right under the Anadarko oil and gas leases. The Oklahoma courts have characterized this ownership right as a profit a prendre, a right to go on to the land of another and take from it either some part of the land or a product of it.187 For the purpose of determining how to encumber Ewing Oil's profit a prendre, however, Ewing Oil's interest requires classification as either realty or personalty.188

In Oklahoma, however, that classification has proved particularly diffi-
The Oklahoma courts have construed the oil and gas lessee's interest as neither real property nor personal property, but as an interest in both. As a leasehold estate for a term of years, it is a statutory "chattel real".

As a leasehold estate for a term of years, it is a statutory "chattel real".

In classifying the interest created by an oil and gas lease in Oklahoma, it is necessary to take into account the exclusive right to take theory of ownership adopted. It is clear that ownership of oil and gas does not vest in the lessee upon the execution of a lease and such lessee does not acquire an estate in the oil and gas, even though the granting clause purports to convey title to the oil and gas in place. Despite statements in earlier cases that the lessee does not acquire an interest or an estate in the land, although he does not acquire absolute title to the oil and gas. Such interest in the land is a profit a prendre, an incorporeal hereditament. Such an interest is said to be classified by statute as a "chattel real." It constitutes an interest or an "estate" in land for purposes of conveyancing, but it is not "real estate" as that term is used in certain statutes. Thus, it has been held that the execution and the assignment of an oil and gas lease must comply with the statute of frauds; an assignment of a lease by a corporation is an instrument affecting real estate and must be executed in the manner prescribed by statutes for deeds and other instruments affecting real estate; that the lease or an assignment or a mortgage of a lease must be acknowledged and recorded to be valid against third persons; that an oil and gas lease on the homestead requires the joint consent of husband and wife; that the owner of a lease who is in possession may maintain an action in equity to quiet title; that the general rule of implied warranty in the sale of chattels does not apply to an oil and gas lease; that a lessee from the state acquires such an interest in the land that he is subject to municipal regulation although the lessor would not be so subject.

On the other hand, it has been held that the granting of an oil and gas lease is not a conveyance of real estate by an administrator or executor, or by a guardian; that an oil and gas lease is not "real estate" within the meaning of a statute providing for a judgment lien, and that such a lien is not created either upon the rendering and recording of a district court judgment, or upon the filing of the judgment for record with the county clerk; that a lease is not "real property" within the contemplation of statutes governing partition; that a lease is not "real property" with the meaning of statutory provision requiring that foreclosure suits be filed in the county where the property is located; that an oil and gas lease is not subject to ad valorem taxation as land; that the granting of an oil and gas lease is not the granting of a corporeal interest or hereditament in the land within the meaning of the statutes defining champerty. Probably an oil and gas lease is not "land" within the meaning of a statute requiring appraiserment of "lands and tenements" before sale on execution.

2 E. KUNTZ, supra note 181, § 23.23, at 192-93 (footnotes omitted). See also 1 H. WILLIAMS & C. MEYERS, supra note 183, at §§ 215-213.9 (discussing consequences of realty/personalty classification question).
in Oklahoma... it is a hybrid estate deriving its legal characteristics from both real and personal property, yet it is actually neither. Although logic dictates that this “chattel real” be treated as real property, the Oklahoma courts have consistently treated it as personalty. Thus, Ewing Oil’s rights and interests in the Anadarko leases and the oil and gas in place constitute personal property.

b. Extracted Hydrocarbons

Fortunately, once the hydrocarbons are extracted, the analysis becomes less complicated and Ewing Oil’s ownership interest easier to classify. Once the hydrocarbons come into Ewing Oil’s possession at the wellhead, they definitely constitute personal property. Ewing Oil’s interest in the extracted oil and gas, therefore, represents an ownership interest in tangible personalty.


In Continental Supply, the lessee/borrower mortgaged to the bank its interest in the leasehold and the proceeds of the oil and gas produced and sold. Judge Murrah determined that the borrower’s interest in the oil and gas leasehold estate is an interest in real estate. Id. at 307. Therefore, the mortgage on that particular interest should be treated as a real estate mortgage. The same is not true, however, of the mortgage on the oil and gas produced and sold.

The mortgage on the oil and gas and their production proceeds, Judge Murrah held, was a mortgage on “personalty not yet acquired nor in existence.” Id. at 307. The mortgage on these particular interests, therefore, constituted a chattel mortgage on “after acquired personal property.” Id.

191. As mentioned earlier, see supra note 188, at common law the distinction between realty and personalty was one of duration. Interests conveyed for “life or longer,” in the form of a life estate or a fee interest, are classified as realty. Interests of a lesser duration are classified as personalty. Because most oil and gas leases convey interests with the potential for perpetual duration (“This Lease shall be for a term of X years and so long thereafter as oil or gas are produced”), these interests should be classified as realty. Lowe, supra note 182, at 57; 1 H. Williams & C. Meyers, supra note 183, § 215, at 173 (realty classification preferable).

192. See 1 H. Williams & C. Meyers, supra note 183, § 214.2, at 166-67 (“The Oklahoma courts have been consistent in treating interests in oil and gas, whether a severed mineral or royalty interest or an interest arising from an oil and gas lease as personal property rather than real property.”). But see Emery, Real Property Mineral Interests in Oklahoma, 24 Okla. L. Rev. 337, 339 (1971) (stating that “real estate” or “real property” as used in any Oklahoma statute embraces the right to oil, gas and other minerals).

193. This leaves the question of how the bank perfects its security interest in the lessee’s oil and gas related personal property.

194. Professor Kuntz explains:

Although there are differing views regarding the character of ownership of oil and gas as they reside in the earth, there is uniformity in the conclusion that once oil or gas is extracted from the earth, it becomes tangible personal property and is subject to absolute ownership. Upon capture, the oil or gas becomes the personal property of the landowner or of the person having the right to capture the oil or gas. Where an oil and gas lessee captures the oil, it becomes his property, unless the landowner is entitled to a specific part of the oil produced, in which case, the landowner and the lessee own the oil jointly until a division is made.

1 E. Kuntz, supra note 181, § 2.5, at 68-69 (footnotes omitted) (citing Carpenter v. Shaw, 134 Okla. 29, 272 P. 393, 398 (1928)); see Continental Supply Co. v. Marshall, 152 F.2d 300 (10th Cir. 1945), cert. denied, 327 U.S. 803 (1946).
c. **Drilling and Production Equipment**

Drilling and production equipment also constitute personal property. Ewing Oil's ownership interest in these items of collateral, therefore, represents an interest in personality.

d. **Contractual Agreements**

Along with the original oil and gas lease agreements, Ewing Oil probably entered into a number of other contracts in connection with the exploration for and the production and sale of oil and gas. The joint operating agreement and the production sales agreement represent two of the most important of these contracts. Ewing Oil's interests in and rights under these contractual agreements constitute Article Nine general intangibles.

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195. The category "Drilling and Production Equipment" broadly includes casing, pipes, pumps, gathering systems, drilling rigs, and all other kinds of machinery used in connection with production, treatment, storage, and transportation of hydrocarbons.

196. This analysis assumes that the items listed in supra note 186 are still equipment and have not, through use on the leasehold, become fixtures. Unfortunately, the line that is crossed when an item ceases being equipment and becomes a fixture is not a bright one. Section 9-313 of the U.C.C. offers little help since it defers to non-Code real estate law and state law has never been particularly clear.

Nonetheless, the assumption that these items are still equipment seems an accurate one, especially in light of the standard practices of the oil and gas industry. For example, almost all oil and gas leases permit the lessee to remove all equipment (even the casing). Further, operators constantly move everything from pumps and separators to drilling rigs from one well to another. See Ryan, supra note 177, at 409-10; Vagts, supra note 174, at 848-51. None of these factors supports the idea that the equipment has become fixtures. See infra notes 197-215 (even if items were fixtures, would be secured by oil and gas mortgage).

197. See Houghton, supra note 174, at 335-40.

198. When a leasehold is concurrently owned, as is often the case, the concurrent owners enter into an operating agreement before beginning exploration and development activities that govern the relationship among the owners, specifies their rights and liabilities, and designates an operator. For a discussion of operating agreements, see 2 H. Williams & C. Meyers, supra note 183, § 503.2; 1 E. Kuntz, supra note 181, § 17.4; Houghton, supra note 175, at 337-38; Young, Oil and Gas Operations: Who Does What to Whom, For Whom and Who Pays, How and When, 27 Rocky Mt. Min. Inst. 1651 (1981) (discussing AAPL Form 610 — Model Form Operating Agreement — 1977); Kinzie & Daney, The Statutory Oil and Gas Lien in Oklahoma, 20 Tulsa L.J. 179, 187-90 (1985) (discussing lien rights under operating agreements).


200. U.C.C. § 9-106 provides:

"General Intangibles" means any personal property, including things in action, other than goods, accounts, chattel paper, documents, instruments and money. All rights to payment earned or unearned under a charter or other contract involving the use or hire of a vessel and all rights incident to the charter or contract are accounts.

U.C.C. § 9-106 (OKLA. STAT. tit. 12A, § 9-106 (1985)). Unless otherwise specified, all cita-
e. Proceeds of Production

When the purchaser takes the oil and gas produced from the leasehold estate, the lessee has a right to be paid. The U.C.C. classifies this right as an account. In effect, the sale of production ripens some of Ewing Oil's general intangibles into accounts.

Along with the oil and gas leasehold estate, production proceeds typically constitute the most valuable item of collateral. Hydrocarbons, however, are a finite resource. As such, their production decreases the reserve base supporting the loan. Lenders seeking to ensure that these accounts are used to pay loan debt typically require the borrower to assign to the lender the right to receive these account payments directly from the purchasers. In that way, Penn Square Bank can ensure that Ewing Oil production proceeds help retire Ewing Oil's Penn Square debt.

Prior to the adoption of the 1972 Amendments, Ewing Oil's interests and rights in the sales contracts and many other agreements were classified as contract rights. U.C.C. § 9-106 (1961 Code). For example, the producer who is a party to a gas purchase contract has a right to receive payment when gas is sold. Until the sale occurs, all the producer has are contractual expectations. The 1972 Amendments, however, deleted the contract rights classification and thereby incorporated these contractual expectations into the classification of general intangibles. See J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 22-8, at 893 (2d ed. 1980) (general intangibles is "catchall" category).

201. U.C.C. § 9-106 (OKLA. STAT. tit. 12A, § 9-106 (1985)). Section 9-106 defines an account as follows:

"Account" means any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance.

U.C.C. § 9-106.

202. Ryan, supra note 177, at 396 (lessee's rights change from contract rights into accounts when gas is sold and delivered).

203. And, therefore, the lessee's interests in and rights to the hydrocarbons in the ground.

204. Through an assignment of production, the borrower assigns to the lender the oil, gas, and other minerals produced, saved, and sold from the mortgaged property and authorizes and directs any purchaser of such production to pay to the lender the amounts due to be paid for such production. This is not a contingent assignment which becomes effective only after default but is a currently effective assignment, the basic premise in oil and gas loans being that the proceeds currently received by the lender will be available for use and will be used to retire the loan.

Johnson, Legal Aspects of Oil and Gas Financing, 9 INST. ON OIL & GAS L. & TAX'N 141, 158-59 (1958); Vagts, supra note 174, at 845-46; Hoagland, A Form of Mortgage and Assignment of Oil and Gas Production, 34 DICTA 226 (1957); Clark & Sachs, supra note 177, at 157 ("The usual pattern in production payment financing is for the bank to take an assignment of proceeds of production and to execute transfer and division orders providing for payment of the specified cash proceeds directly to the bank until the indebtedness is satisfied.").

205. The purchasers of production are usually authorized and instructed to pay the bank directly. As these payments are received, they are deposited in a collateral collection account. Monthly, if the amounts in the collateral collection account total or exceed a specified amount, then the lender transfers to the borrower's deposit account a specified portion (10% to 20%) of the total proceeds for operating expenses. The remainder of the funds are emptied from the collateral collection account and applied toward the loan indebtedness. Baker, Real and Personal Property Aspects of Secured Financing in the Oil and Gas Industry, OKLA. CITY U./CLE BANKING LAW 45, 52-53 (1982).
2. **Penn Square's Perfection — The Oklahoma U.C.C.**

   a. **The Realty/Personalty Distinction**

   After classifying each of these property interests, Penn Square must determine how to secure this lending transaction. In particular, Penn Square wants to be certain that it has created and perfected a security interest in the two most valuable items of collateral: the leasehold estate and the production proceeds. Moreover, the bank wants the additional protection of having the production proceeds paid directly to it and not to the borrower.

   As demonstrated above, all the property interests collateralizing the loan, even the chattel real interest in the oil and gas leases, are personalty.\(^\text{206}\) Therefore, Article Nine of the U.C.C., which governs the creation and perfection of security interests in most items of personal property, should govern all aspects of the Ewing Oil loan transaction.\(^\text{207}\) That is not the case, however, in Oklahoma. As previously mentioned, the Oklahoma courts consistently classify the lessee's interests in oil and gas and the production proceeds therefrom as personalty.\(^\text{208}\) For financing purposes, however, they consistently treat these same interests as realty.\(^\text{209}\) The courts reason that the oil and gas leasehold estate and production proceeds are so related to and identified with real estate that a security interest in that leasehold and an assignment of those proceeds fall within the scope of those statutes requiring "interests in" or instruments "relating to" real estate to be recorded as real estate.\(^\text{210}\) As a result, even though all the items of collateral are technically

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\(^{206}\) See supra text accompanying notes 181-205 (discussing classification of collateral).

\(^{207}\) U.C.C. § 9-102(1), (2) provides:

(1) Except as otherwise provided in Section 9-104 on excluded transactions, this article applies:

   (a) to any transaction, regardless of its form, which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts; and also

   (b) to any sale of accounts or chattel paper.

(2) This article applies to security interests created by contract including pledge, assignment, chattel mortgage, chattel trust, conditional sale, trust receipt, other lien or title retention contract and lease or consignment intended as security. . . .

\(^{208}\) See supra in notes 192-96 and accompanying text.


\(^{210}\) In Continental Supply Co. v. Marshall, 52 F. Supp. 717 (W.D. Okla. 1943), rev'd, 152 F.2d 300 (10th Cir. 1945), cert. denied, 327 U.S. 803 (1946), the district court held that a mortgage of a lessee's interest in an oil and gas lease was governed by Oklahoma's mortgage statute, which required "[e]very instrument purporting to be an absolute or qualified conveyance of real estate or any interest therein, but intended to be defeasible or as security for the payment of money, shall be deemed a mortgage and must be recorded and foreclosed as such." Id. at 721 (quoting Okla. Stat. tit. 12A, § 9-102 (1) & (2) (1985)). On appeal, the Tenth Circuit affirmed this portion of the district court's decision although it appeared to base its conclusion on another Oklahoma statute, Okla. Stat. tit. 16, § 15 (1941), which provides that "no deed, mortgage, contract, bond, lease or other instrument relating to real estate . . . shall be valid as against third parties unless acknowledged as herein provided." Id. (emphasis added) (statute still in effect). The Tenth Circuit held that under this statute a
personalty, the lender has to create and perfect its security interest in the most valuable items of collateral as if they were realty.\textsuperscript{211}

Thus, under the U.C.C. (as adopted by Oklahoma in 1961) and non-U.C.C. state mortgage law, Penn Square had to bifurcate the perfection process to secure all the Ewing Oil loan collateral. To perfect its interest in Ewing Oil's leasehold estate and production proceeds, Penn Square had to record a mortgage on those interests in the county land records where Ewing Oil's leasehold estate was located.\textsuperscript{212} To secure the remainder of the collateral, the bank had to file a separate financing statement in the state's central filing office in accordance with Article Nine.\textsuperscript{213}

This dichotomy of perfection under both 1961 U.C.C. and non-U.C.C. law, particularly as it related to the security interest in the accounts (production proceeds) and the assignment to the bank of those accounts, created doubt about whether Article Nine or state mortgage law governed the creation and perfection of the security interests in the proceeds and their assignment to the bank.\textsuperscript{214} As a practical solution, most banks filed a combination mortgage and financing statement in both the county clerk's office and the state's central filing office.\textsuperscript{215} Because of this doubt, a bank would not only make dual filings, recording its security interest in certain items of collateral in one place and filing its security interest in other items elsewhere, but it would also perfect its security interest in particular items of collateral by filing in both places. Oklahoma resolved this doubt when it adopted the 1972 Amendments to the U.C.C.

\textbf{b. Oklahoma's 1972 Amendments to the U.C.C.}

Oklahoma's 1972 Amendments to the U.C.C. greatly simplified the mortgage of an oil and gas lease must be recorded as a real estate mortgage to give notice to third parties. 152 F.2d at 306.

Similarly, in an earlier case, Stone v. Wright, 75 F.2d 457, 460 (10th Cir.), cert. denied, 295 U.S. 754 (1935), the Tenth Circuit found that an assignment of money to be paid out of the proceeds of an undivided working interest, although not a conveyance of an interest in real estate, was so related to real estate as to be a proper instrument for recording under Okla. Stat. § 9672 (1931) (now Okla. Stat. tit. 16, § 15 (1985)).

These decisions conform to the Oklahoma Supreme Court's holding in Davis v. Lewis, 187 Okla. 91, 94, 100 P.2d 994, 997 (1940), that an assignment of proceeds of a working interest was an "instrument relating to real estate' and was required to be acknowledged and recorded in order to be valid as to third persons under the law on the subject of recording." See Tulsa Comment, \textit{supra} note 209, at 173-75.

211. See Tulsa Comment, \textit{supra} note 209, at 173-75.

212. See Ryan, \textit{supra} note 177; Vagts, \textit{supra} note 174; Tulsa Comment, \textit{supra} note 209, at 171-75.

213. Tulsa Comment, \textit{supra} note 209, at 171-75.


215. The debtor usually executed a single document denominated as a Mortgage, Security Agreement, Financing Statement and Assignment that was recorded both locally and centrally. Perhaps because of this prudent practice, no Oklahoma court ever addressed the issue of whether assignments of production and production payments were governed by the U.C.C. \textit{See id.; see also} Baker, \textit{supra} note 205, at 57 (form of Mortgage, Deed of Trust, Security Agreement, Financing Statement and Assignment).
lender’s task of securing an oil and gas loan. The Oklahoma U.C.C. now specifies that the proper place to file in order to perfect a security interest in all of the above Ewing Oil property interests is where the real estate mortgage would be recorded. The Oklahoma U.C.C. further provides:

When a writing constituting a mortgage upon lands, or interests in lands such as oil and gas leasehold estates, also covers minerals to be severed from such lands, equipment used in mining, storing, treating and marketing such minerals and the accounts and proceeds to be derived from disposition of such minerals contains a legal description of such lands sufficient to comply with [the Oklahoma real estate mortgage statutes], has been validly executed, acknowledged and recorded in the office of the County Clerk for the county in which such lands are located, such mortgage shall constitute a financing statement covering such collateral and no other filing or recording shall be required to perfect such security interests in such collateral covered by the mortgage. The mortgage shall remain effective to perfect such security interests until it shall be released or satisfied of record or its effectiveness as to lands or other interests in lands described therein shall be otherwise effectively terminated.

Under the Oklahoma U.C.C., a mortgage on the borrower’s realty interests also perfects the bank’s security interest in the borrower’s intangible and tangible personal property ownership interests in extracted oil and gas, equipment, and accounts.

Oklahoma thus simplified perfection by allowing a mortgage of realty to secure the bank’s interest in property that formerly required perfection as chattels or personalty. Oklahoma no longer requires central filing or dual filing. The recording of a single document in the county real estate records perfects the bank’s security interest in all of the borrower’s oil and gas related collateral.

In effect, the Oklahoma U.C.C. has specified that all oil and gas related interests are to be treated like realty. Therefore, non-U.C.C. Oklahoma mortgage law governs the creation and perfection of a lien against or a secur-

217. U.C.C. § 9-401 (1)(b) provides:

(1) The proper place to file in order to perfect a security interest is as follows:
(b) when the collateral is timber to be cut or is minerals or the like, including oil and gas, or accounts subject to subsection (5) of section 9-103(1) of this title . . . then in the office where a mortgage on real estate would be filed or recorded.

U.C.C. § 9-401(1)(b).


219. Or, at least for perfection purposes, those personal property interests such as the chattel real that are treated like real property interests.

221. Id.; see Tulsa Comment, supra note 209, at 175-77.
222. Typically, that document is a combination Mortgage, Deed of Trust, Security Agreement, Financing Statement and Assignment. Baker, supra note 205.
C. Applicability of the U.C.C. — The Participation

Once the parties execute the loan documents, disburse the funds, record the security documents and sign the participation agreement, the following questions are raised: Must the Penn Square participant now record its participation interest? Does Article Nine apply to the participation transaction? Has the participant purchased an interest that it must perfect to protect itself? Regardless of whether the Penn Square participations were structured as sales or loans, Article Nine did not apply to the Penn Square energy loan participation transactions and the participant did not need to perfect its interest in the loans.

1. The Participation as a Sale

Article Nine governs the creation of security interests; it is completely inapplicable to sales, including the sale of loans. And for very good business reasons, banks, both leads and participants, rarely structure participations as loans. In this respect, Penn Square and its participants followed the norm.

Undeniably, the Penn Square participation transactions constituted outright sales of interests in the underlying oil and gas loans. In the Ewing Oil participation example, Penn Square does not sell Ewing Oil's chattel paper nor does it simply factor Ewing Oil's accounts receivable. Instead, the Oklahoma bank sells the participant a property interest in the Ewing Oil loan debt and the collateral pledged to secure that debt.

As official comment Four to U.C.C. § 9-102 states, Article Nine is inapplicable "to a sale of the note by the mortgagee [Penn Square], even though the mortgage continues to secure the note." Article Nine, therefore, does not

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224. U.C.C. § 9-104(j) specifies that Article 9 does not apply to "the creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder." See also Official Comment 4, U.C.C. § 9-102 (Article 9 inapplicable to creation of real estate mortgage); Vagts, supra note 174, at 840-41.
225. The Penn Square participations were definitely sales and purchases.
227. For example, the lead bank does not want to look like a debtor in its financial statements as a result of the participation. Nor does the participant want to compound its risk by making a loan to one party (the lead) that in turn depends on that party's loan to another (the underlying loan).
228. It is doubtful that Continental Illinois, when it was purchasing all of its participations, thought it was making over a billion dollars worth of loans to a small shopping mall bank.
229. Indeed none of the parties involved in the Penn Square litigation characterized the Penn Square participations as anything other than a sale. The focus of the dispute is on the nature of the interests sold.
230. Official comment Four to U.C.C. § 9-102 states the following:
   The owner of Blackacre borrows $10,000 from his neighbor, and secures his note by a mortgage on Blackacre. This Article [Article Nine] is not applicable to the creation of the real estate mortgage. Nor is it applicable to the creation of the real estate mortgage. Nor is it applicable to a sale of the note by the mortgagee, even though the mortgage continues to secure the note.
apply to the Penn Square participation transactions nor does it require the participant to perfect its interest.

2. The Participation as a Loan

Even assuming that the Penn Square participations, instead of being sales and assignments of interests in the underlying loans, were actually loans themselves, with the participant's extension of credit to Penn Square based on Penn Square's pledge of the underlying oil and gas loan as security, the outcome remains the same. Article Nine still does not apply. The reasoning for this result is best demonstrated by assuming that Penn Square pledged the Ewing Oil note and mortgage as collateral for the participation.

All items of the Ewing Oil collateral, both real\textsuperscript{231} and personal, tangible and intangible, stem directly from the rights and interests in the oil and gas lease and the production of oil and gas thereunder. Many of these items of personalty, existing apart from an Oklahoma oil and gas loan, would require a filing under Article Nine in order to perfect the participant's interest if sold, assigned, or pledged to a participant.\textsuperscript{232} Under the Oklahoma U.C.C., however, the Ewing Oil loan participation transaction does not require an Article Nine filing.

For perfection purposes, the Oklahoma U.C.C. scheme expressly treats all the oil and gas related collateral as interests in realty. Thus, recording a mortgage in the real estate records of the counties where the oil and gas leasehold estate is located all the collateral.\textsuperscript{233} By its own terms, Article Nine does not govern the creation, perfection, or enforcement of security interests in real property.\textsuperscript{234} Therefore, Article Nine does not govern the sale, assignment, and pledge of security interests in real property.\textsuperscript{235} As a result, Article Nine does not govern the sale, assignment, or pledge of security interests in oil and gas related collateral. Article Nine expressly excludes the conveyance to the participant of Penn Square's security interest in the Ewing Oil collateral.\textsuperscript{236} The participant, therefore, is not the assignee of an

\textsuperscript{231} Technically, none of the Ewing Oil interests is realty. Nevertheless, Oklahoma's decisional law and Article 9 (§ 9-402(5)) treat many of these interests as realty.

\textsuperscript{232} The sale, assignment, or pledge of non-oil and gas accounts, for example, requires the purchaser (the participant) to perfect its interest as against the seller (the lead) by filing a financing statement evidencing the transaction and the purchaser's interest. See U.C.C. § 9-405.


\textsuperscript{234} U.C.C. § 9-104(j). See also Stahl, Loan Participations: Lead Insolvency and Participants' Rights (Part I), 94 BANKING L.J. 882, 892-93 (1977).

\textsuperscript{235} U.C.C. § 9-102 official comment 4.

\textsuperscript{236} Indeed, this is the express result under the Oklahoma U.C.C. § 9-405(2). Again Oklahoma's § 9-405(2) differs from the Model U.C.C. This Oklahoma U.C.C. section which requires that all assignments of security interests be evidenced by the filing of a financing statement adds a second paragraph which provides:

\textquote{Notwithstanding the provisions of the subsection of assignment of record of a security interest contained in a mortgage as provided in subsection (5) or (6) of Section 9-402 of this title may be made only by an assignment of the mortgage in the manner provided by the law of this state other than this act.}

interest that must be recorded in accordance with Article Nine.237

On this point, official comment 4 to U.C.C. § 9-102, which indicates that Article 9 applies to the security interest created in the note and mortgage, has misled some commentators, most notable Messrs. Drake and Weems.238 These commentators argue that, taken together, the pledge of the note and mortgage of realty interests suddenly becomes a pledge of a general intangible, which requires Article Nine perfection.239 The proponents of this theory confuse the pledge of a note and mortgage of personalty interests (i.e., chattel paper) with the pledge of a note and mortgage of realty.240 In addition to its analytical shortcomings, this argument completely lacks a foundation in light of the U.C.C.'s express disclaimer of any effect on security interests in real property.241

Over twenty years ago, in an article discussing participations and other topics on the "outer fringes of Article 9,"242 Messrs. Peter Coogan, Homer Kripke and Fredric Weiss addressed the issue of whether Article Nine "requires a filing to perfect a pledge of a note secured by a real estate mortgage."243 They reviewed both official comment 4 to U.C.C. § 9-102(3) and the Drake and Weems' theory considering the overall structure, language and intent of the U.C.C. and concluded that this view is incorrect.244

237. See infra notes 238-252 and accompanying text.
239. Id. at 46. "The trustee in bankruptcy would contend that the promissory notes and mortgages given by the original mortgagors taken together constitute a general intangible as envisioned by Article Nine." Id.
240. Drake and Weems rely heavily on their analogy of the note and real estate mortgage to chattel paper. This analogy, in my view, should not be made.
241. In short, Drake and Weems misinterpret the U.C.C. Drake and Weems's very perception of participation transactions and the participation process troubles this author. In their view, all participations are nothing more than loans by the participant to the lead and the participation in In re Alda Commercial Corp. represents all participation arrangements in general. Drake & Weems, supra note 238. As demonstrated above, Alda certainly does not represent the participation norm; as demonstrated below, Drake and Weems' interpretation of the U.C.C. is wrong.
243. 79 HARV. L. REV. at 231.
244. Id. at 270-71. In discussing arguments identical to those raised by Drake and Weems, Coogan, Kripke, and Weiss state:

Insofar as we understand the argument . . . it rests on two separate bases:

(a) The persons demanding clarification argue that, even though Section 9-104(3) excludes from the Code the transfer of an interest in or lien on real estate, the matter is not clear because of three facts: the real estate mortgage is itself personal property, presumably a general intangible; the pledge of the note is expressly brought under article 9 by Section 9-102(3); and Official Comment 4 to that section specifically states that article 9 is applicable to the security interest created in the note and mortgage.

(b) Another argument is that the note and real estate mortgage together are something more than they are separately. Just as a note and chattel mortgage together constitute a new form of collateral to which the Code applies the title "chattel paper" and for which it sets special rules, so the note and real estate mortgage together may constitute a
The clear intent of section 9-104(j) to exclude transfers of liens on real estate would be completely nullified if the argument were accepted that the lien, as a form of wealth, is personal property, a security interest in which is subject to article 9. Likewise, we feel that the argument that a note and real estate collateral could, in combination, be a general intangible under the Code is inconsistent with the fact that, when the Code intended to give special status to a combination of this nature (the chattel paper case) it expressly provided for it. If the [Drake and Weems] theory . . . were sound, it would apparently drag back into the Code all the other matters excluded by Section 9-104, when transferred with a note for which they were collateral. There is, in our opinion, no danger that a court could read the statute in any such fashion. Because of the express language of Section 9-104(j), we do not feel that Official Comment 4 to Section 9-102 should cause any real confusion or doubt. . . .

The clear intent of U.C.C. § 9-104(j) is to exclude the creation and perfection of security interests in realty. The Oklahoma U.C.C. treats oil and gas rights and interests as realty. To argue that a note secured by an oil and gas mortgage becomes a general intangible like chattel paper ignores the express intent and language of Article Nine.

This analysis indicates that even in the unlikely event that the parties expressly contracted for a loan from the participant to the lead, with an oil and gas loan as security for the participant’s extension of credit, Oklahoma law does not require the participant to make an Article Nine filing in order to perfect its security interest in the collateral. More importantly, this analysis also demonstrates that, in the much more probable event that the lead contracted to sell the participant an interest in the oil and gas loan, as in the Penn Square transactions, Article Nine still does not apply. In neither case does the Oklahoma U.C.C. require the participant to make a central filing evidencing and perfecting its interest in the oil and gas loan debt and collateral.

The primary focus for determining the character of a participation transaction is, and should be, the intent of the parties and the language of the contract. In the Penn Square participation transactions, both the intent of the banks and the language of the agreements support the classification of these participations as sales and assignments of the loan debt and collateral. Further, a review of the Oklahoma U.C.C. shows that Article Nine does not

"general intangible," which is defined to include all personal property not otherwise classified. If either of the arguments is sound, a security interest in the mortgage could be perfected only by filing.

We are satisfied that this view is unduly fearful.

Id. (footnote omitted)(emphasis in original).

245. Id. at 271 (footnotes omitted). The authors note that this view also applies to collateral consisting of real estate leases or rents thereunder, either alone or in connection with a real estate mortgage. Id. at 271 n.80. I think it fair to conclude, therefore, that their view also applies to Oklahoma oil and gas leasehold interests and assignments of production. See supra notes 182-212 and accompanying text.

246. See supra notes 222-41 and accompanying text.

247. See supra notes 222-41.
require the participant to file a financing statement in the state’s central filing records in order to protect its interest. But what happens in the event of the lead’s insolvency? By failing to make a filing, Article Nine or otherwise, the lead’s receiver avoid the participant’s interest in the participated loan? In answering these questions, a review of the result under the Bankruptcy Code proves quite useful.

The Bankruptcy Code by its own terms does not govern the liquidation of failed banks and should not automatically (and unthinkingly) apply to a failed bank’s receivership administration. Even if the courts do not directly apply the Bankruptcy Code in administering bank insolvencies, however, they definitely resolve liquidation disputes according to many of the same notions and principles that provide the theoretical underpinnings for the Bankruptcy Code. Accordingly, a review of whether the Bankruptcy Code would require the Penn Square participant to perfect the ownership interest assigned to it in order to withstand the strong-arm provisions of the trustee proves helpful in answering this question.

D. The Effect of the Bankruptcy Code on Participations

When Penn Square sold a participation in a loan to another bank, it essentially transferred an ownership interest in that loan. Although Penn Square retained possession of the loan documents and security agreements, it transferred an equitable ownership interest in the loan debt and collateral to the upstream bank through the participation. The terms of the participation contracts specifically required that Penn Square hold for the participant’s benefit its pro rata portion of the loan debt and collateral in return for the participant’s funding.

Both the intent of the parties and the structure of the contracts indicate sales and purchases of interests in loans. The participants owned their portions of the loans, thus, Penn Square retained legal title to the entire loan, but assigned the beneficial ownership of the participated portion of the loan to the participant. Once the loan is participated, the participated portion of the loan is no longer an asset of the lead bank, but an asset of the participant. At the time of Penn Square’s insolvency, Penn Square no longer

248. None of the Penn Square participants ever filed or recorded any document evidencing its participation in a loan.
250. See supra notes 22-72 and accompanying text.
251. See supra notes 52-72 and accompanying text (discussing Supreme Court’s decision in Scott v. Armstrong).
252. This section assumes that the receiver of a national bank (the FDIC) has the avoiding powers accorded a bankruptcy trustee under the Bankruptcy Code, particularly those of 11 U.S.C. §§ 544 and 547 (1988).
253. See supra notes 73-103 and accompanying text.
254. Id.
255. For support of the proposition that the participant is the beneficial owner of its pro rata portion of the underlying loan, see notes 73-165, 284-427 and accompanying text. See also MacDonald, Loan Participations as Enforceable Rights in Bankruptcy — A Reply to the Trustee’s Attack, 53 AM. BANKR. L.J. 35 (1979).
256. In many participation transactions, for practical business reasons the participated por-
fully and completely owned the participated portions of the loans. Instead the participants equitably owned them.\textsuperscript{257}

As a general rule, the trustee or receiver of a debtor succeeds only to the titles and rights that the debtor possessed at the time of its insolvency.\textsuperscript{258}

The participation of the loan must be characterized in the financial records of both the lead and participant as an asset belonging to the participant. For example, assume that the total amount of the underlying loan exceeds the lead bank’s legal lending limit. If the lead bank classifies the entire loan as its asset, then it violates applicable banking laws.

Another more compelling reason for treating participations in general and the Penn Square participations in particular as assets of the participant concerns both the legal lending and borrowing limits imposed on Penn Square and the legal lending limits imposed on the participant banks. Penn Square originated over $2 billion in energy loans. The vast majority of these loans were participated to upstream banks. Typically, 90\% to even 100\% of an underlying loan was sold to a participant. If Penn Square were required to show that it owned a loan portfolio of over $2 billion on its financial statements, then Penn Square most assuredly would have violated its lending limits. Further, if Penn Square were required to classify the $2 billion in participations as money that it borrowed from other banks, then the Oklahoma bank also would have violated its borrowing limits. Finally, if the participants were required to classify participations as million of dollars of loans to Penn Square Bank on their financial statements the, then at least some of the participants, Hibernia National Bank in New Orleans for example, would have violated their legal lending limits. It is uncertain whether Continental Illinois could have loaned over $1 billion to Penn Square Bank without violating its lending limits. I do know, however, that Penn Square could not have legally borrowed that amount from the Chicago bank. Moreover, this point about bank lending and borrowing limits complements and reinforces the expectation of ownership that all the parties, both Penn Square and its participant banks, brought to the participation relationship.

\textsuperscript{257} See McDonald, \textit{supra} note 255, at 37-51 (citing G. GLENN, MORTGAGES \textsection 317 (1943) at 37 n.7). In discussing mortgage participations, Glenn writes:

\begin{quote}
We have learned that the mortgagee [Penn Square] can create a trust in his security in simple form or by way of participation certificates . . . . To adopt a broader terminology, we have here the partial assignment of a chose in action; and our present case is governed by the rules that have been worked out as to that phenomenon.

The first of these rules was presented above. When one sells a share of interest in a mortgage, two things are apparent as to the intention of the parties. First, no specific part of debt or mortgage is allocated to the purchase, and so he gets an undivided share, as tenant in common with the mortgagee-assignor. Needless to say, this undivided share is a vested right and so it will survive the bankruptcy of the mortgagee or assignee indefinitely . . . .

Whatever may be the order of sharing, however, one thing is clear as to the mortgage and its proceeds. The mortgagee who has transferred an interest in the security holds the proceeds of collection as trustee of his partial assignee to the extent of the latter’s interest, and is accountable accordingly.
\end{quote}

\textit{Id.} (emphasis in original).

In essence, the participation transactions established a constructive trust for the benefit of the participant. Penn Square, as lead bank, was obligated to receive and pass along to the participant, as beneficial owner, the participant’s pro rata share of all monies applied toward payment of the participated loan. \textit{See} McDonald, \textit{supra} note 255, at 40-43; \text{	extsc{1 A} SCOTT, THE LAW OF TRUSTS} \textsection 16, at 162 (3d ed. 1967) (If assignor authorized by assignee to collect entire claim then turn over to assignee its proceeds, then assignor is express trustee of proceeds, although no formal trust arrangement). Thus, Penn Square’s participants were the equitable owners of the participated portions of the loans that they purchased from the Oklahoma bank.

\textsuperscript{258} Professor Scott states:

\begin{quote}
A partial assignee of a chose in action, like the beneficiary of a trust of a chose in action, has an equitable interest in the chose in action, and not merely a personal claim against the assignor. Thus, the partial assignee prevails over the general creditor of the assignor, and if the assignor becomes bankrupt, the partial assignee is entitled to his share of the chose in action and is not relegated to the position of a general creditor of the assignor.
\end{quote}
Accordingly, Penn Square's receiver succeeded only to the legal title of the participated portions of the loans since Penn Square owned only that when it failed.\footnote{259}

This represents a well-established rule and, not surprisingly, is codified in the Bankruptcy Code. Section 541(d) of the Bankruptcy Code provides:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.\footnote{260}

Section 541(d) clearly recognizes the participant's ownership interest in the underlying loan. Moreover, it states with clarity that the participant's portion of the loan does not comprise a part of the debtor's estate.\footnote{261}

Indeed, § 541(d)'s legislative purpose involves protecting the secondary mortgage market,\footnote{262} which resembles the Penn Square loan participations.

In describing the purpose of § 541(d), Collier's states:

It is expressly provided that the property interests included in the estate pursuant to subsection (d) include a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title in order to service or supervise the servicing of the mortgage or interest. Subsection (d), therefore, confirms the former status under the [Bankruptcy] Act of bona fide secondary mortgage market transactions as the purchase and sale of assets. Mortgages or interests in mortgages which are sold in the secondary market should not be considered as property of the debtor's estate. The seller may frequently retain mortgage notes and related documents in the interest of the efficient servicing of the mortgages or interests in mortgages. And the purchaser might not record his ownership of the mortgages or interests in mortgages under state recording statutes. Pursuant to section 541(d) the seller's retention of the mortgage documents and the failure of the purchaser to record will not impair the asset sale character of the secondary mortgage market transactions. Neither of these factors will change any obligation of the trustee to turn the mortgages or interests in mortgages over to the purchaser.\footnote{263}

Collier's concludes with the observation that the characterization of the

\footnote{1} A. Scott, supra note 257, § 16, at 160. See also W. Alderson, A Practical Treatise on the Law of Receivers 214 (1905).

Penn Square's receivership estate, therefore, excludes the portions of loans participated to and owned by other banks.

\footnote{259} Id.


\footnote{262} 4 Collier on Bankruptcy § 541(d) (15th ed. 1985).

\footnote{263} Id. at 541-105, -106 (footnotes omitted) (discussing legislative intent behind § 541(d)).
lead-participant relationship is irrelevant because the outcome remains the same. The participant's ownership interest is unaffected.

The application of §541(d) to secondary mortgage market transactions will not be affected by the terms of the servicing agreement between the purchaser and the mortgage servicer. It makes no difference whether the parties characterize their relationship, for example, as one of trust, agency, or independent contractor. Whatever the characterization adopted by the parties, it will not affect the status in bankruptcy of bona fide mortgage market purchases and sales.264

Congress understood the purposes and mechanics of participation transactions and recognized the possible damages if the trustee in bankruptcy could avoid the participants' ownership interests.265 Congress crafted Section 541(d), therefore, with particularity and with the intent of ensuring that the economically important secondary mortgage market remain undisturbed by the Bankruptcy Code. The statute and the intent are clear—the Bankruptcy Code does not affect the participants' interests in the underlying loans.

Whether one views the Penn Square Bank transactions as a sale or as a loan, Article Nine is inapplicable. The nature of the judicial construction of Oklahoma oil and gas rights and Oklahoma's adoption of the 1972 amendments to the U.C.C., which aimed to simplify the mechanics of oil and gas finance, expressly remove the creation, perfection, and assignment of security interests in oil and gas collateral from the control of Article Nine. This is particularly clear when, as in the Penn Square transactions, the parties structure and intend the participations to be sales and purchases. Article Nine simply does not apply.

Just as Article Nine has no affect on the participation transaction, the Bankruptcy Code does not disturb the interests of the participants. Congress clearly intended to protect the participants and the participation market. The litmus test indicates that Article Nine does not require energy loan participants to perfect the interests they purchase from the lead bank. Moreover, even without the benefit of such perfection, the transactions and the participants' interests withstand the acid test of bankruptcy.

V. THE MADEMOISELLE DECISION

Prior to the Penn Square cases, FDIC v. Mademoiselle of California266 represented the only reported decision concerning borrower/depositor setoff against participated loans. In Mademoiselle the Ninth Circuit Court of Appeals held that the borrower/depositor still had a right of setoff even when the lead had sold an interest in the loan to a participant.267 But Mademoiselle, like Scott,268 was not grounded on traditional legal principles. Instead,

264. Id. at 541-106 (footnotes omitted).
265. For a portion of the legislative history of § 541(d) See supra note 136.
266. 379 F.2d 660 (9th Cir. 1967).
267. Id. at 664; see also Essay, supra note 6, at 268.
the Ninth Circuit in *Mademoiselle* based its decision primarily on a number of equities believed to favor the borrower.

In *Mademoiselle* San Francisco National Bank loaned Mademoiselle of California $60,000 and later sold and assigned an eighty percent participation interest in the Mademoiselle note to Union Bank. Mademoiselle never learned of the participation and when San Francisco National was declared insolvent, Mademoiselle sought to set off the amount of its deposit account at San Francisco National against its indebtedness remaining on the loan. Union Bank sought to prevent the setoff by arguing that its ownership of an undivided portion of the loan debt deprived the debts between Mademoiselle and San Francisco National of their mutuality. While the court recognized the general principle that a separate debt cannot be set off against the property of another, it nevertheless concluded that the extraordinary circumstances created by a bank insolvency may necessitate findings that are not dictated by general legal principles.

In upholding Mademoiselle's setoff, the court explained:

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269. 379 F.2d at 661. Although the participation certificate did not explicitly state the legal relationship it created, the parties and the court characterized the participation as a sale and assignment. *Id.* at 664. The participation certificate provided as follows:

SAN FRANCISCO NATIONAL BANK, San Francisco, California hereby certifies that UNION BANK has a participation of $46,400.00 being a portion of the following described note made payable to the order of SAN FRANCISCO NATIONAL BANK

<table>
<thead>
<tr>
<th>Maker</th>
<th>MADEMOISELLE OF CALIFORNIA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>7/31/64</td>
</tr>
<tr>
<td>Amount</td>
<td>$58,000.00</td>
</tr>
<tr>
<td>Interest Rate</td>
<td>7%</td>
</tr>
<tr>
<td>Maturity</td>
<td>7/31/65</td>
</tr>
</tbody>
</table>

Interest accruing on the Participation amount from date of this agreement at the rate of seven percent per annum is due monthly —— have deposited with us as pledgeholder the following collateral in which —— has a pro rata interest to the amount of their participation:

Guarantors: Nancy Wieger and Wendell R. Carlson. No withdrawals, substitutions, releases of collateral or extensions, renewals or compromises of the note or releases or substitutions, of co-makers or guarantors will be made without the consent of all participants.

*Id.* at 662 n.1.

270. *Id.* at 661.

271. 379 F.2d at 661-62. When San Francisco National Bank closed, Mademoiselle's deposit there totalled $7,473.01. *Id.* at 662.


273. 379 F.2d at 663, 664. As the Ninth Circuit explained, the insolvency of the lead bank raised several inequities. "'[I]t is well settled that the insolvency of a party against whom a set-off is claimed constitutes a sufficient ground for the allowance of a set-off not otherwise available.'" *Id.* at 664 (quoting People v. California Safe Deposit & Trust Co. 168 Cal. 241, 141 P. 1181, 1185 (1914)).

Like the *Scott* court, the Ninth Circuit simply stated that depositor setoff is permissible under the National Bank Act. In fact, the court cited *Scott* as establishing this point of law. *Id.* at 663.

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As assignee of part of the claim, Union takes it subject to any counter-claims and defenses against it. Therefore, the assignment does not operate to defeat the maker's claims against the assignor, especially since Mademoiselle was never notified of the assignment and continued to make its payments on the note directly to SFNB, and since SFNB retained possession of the note.\textsuperscript{274}

The court, therefore, concluded that:

So far as Mademoiselle was concerned, the note was due solely to SFNB, and the unannounced transfer of an interest or sale of a participation certificate should not dilute the uninformed depositor's ordinary right of set-off.\textsuperscript{275}

Once the Ninth Circuit determined that the existing circumstances permitted Mademoiselle's setoff, it still had to determine whether the participant had a preferred claim for its pro rata share of the setoff amount.\textsuperscript{276} Recognizing that no statutory preferences explicitly covered the participant's interest,\textsuperscript{277} the court stated that "a direct recovery against the receiver in preference to the general pro rata distribution of assets 'is authorized in situations where the facts are such that the court must say in equity that the property is not that of the bank but that of the claimant.'"\textsuperscript{278} To establish a preferred claim, however, the participant bears the burden of identifying "a specific fund or payment in the possession of the receiver cognizable in equity as [its] own property."\textsuperscript{279}

The fact that the fund the participant claimed as its own\textsuperscript{280} was created by a deposit setoff troubled the circuit court. If a payment had created the fund, an infusion of new money, then the participant was definitely entitled to a pro rata share of such a payment.\textsuperscript{281} But a deposit setoff is neither the

\textsuperscript{274} \textit{Id.} at 664 (emphasis added).
\textsuperscript{275} \textit{379 F.2d} at 664 (emphasis added). In the eyes of the \textit{Mademoiselle} court, depositor setoff was a justifiable judicial method of reapportioning the burdens caused by a bank failure. The court apparently believed that Mademoiselle, unaware that a portion of its loan debt was owned by Union, was shouldering an inequitably large portion of these burdens. Therefore, Union Bank should bear a greater portion of the loss.
\textsuperscript{276} \textit{Id.} at 664.
\textsuperscript{277} \textit{Id.} (citing 12 U.S.C. § 194).
\textsuperscript{278} \textit{Id.} (quoting from John L. Walker Co. v. Alden, 6 F. Supp. 252, 267 (E.D. Ill. 1934)).
\textsuperscript{279} The same result is recognized in bankruptcy. 11 U.S.C. § 554.
\textsuperscript{279} \textit{Id.} at 665. "In establishing a preferred claim against the bank's assets, the claimant 'has a heavy burden of proof, and unless [it] clearly and certainly identifies the fund [it] must fail.'" \textit{Id.} at 664-65 (quoting Converse Rubber Co. v. Boston-Continental Nat'l Bank, 12 F. Supp. 887, 893 (D. Mass. 1935), aff'd, \textit{87 F.2d} 8 (1st Cir. 1936)).
\textsuperscript{280} Actually, Union Bank claimed only its 80\% pro rata share of the setoff amount. \textit{379 F.2d} at 665.
\textsuperscript{281} \textit{Id.} The same is also true, the court stated, in an assignment of the right to receive
injection nor the creation of new money. Therefore, the court reasoned: [T]here is . . . only a shifting of credits within the accounts of [the failed bank]. The set-off has not augmented the assets in the hands of the receiver or created a specific fund to which equity will attach property rights. The use of notes or checks to offset assets or liabilities of the insolvent bank does not establish a preferred claim.\footnote{282}

In other words, a setoff merely represents a shifting of credits, nothing more than a bookkeeping transaction. Since the addition and erasure of other bookkeeping entries does not add funds to the estate, a deposit setoff creates nothing that the participant can claim as its own.\footnote{283}

This rationale, however, focuses on the pluses and minuses the setoff exhibits on the failed bank’s books. It completely ignores the participant’s ownership interest in the underlying debt. If the funds on deposit in the failed lead bank reduce the borrower’s total indebtedness, including debt owned by a participant, then arguably a court should recognize those funds that pay participant-owned debt as belonging to that participant.

The \textit{Mademoiselle} ruling is anything but definitive in determining the nature of the lead-participant relationship. \textit{Scott} focused on such easily definable legal principles as natural justice and universal concessions and the same notions turned the \textit{Mademoiselle} court’s head. This makes fascinating reading, but certainly does not define a loan participation or bring any measure of certainty to the marketplace.

Even assuming the permissibility of setoff under the National Bank Act, \textit{Scott} and \textit{Mademoiselle} leave several questions unanswered. For example, what if parties word the participation certificate differently than in \textit{Mademoiselle}? What if the participation contract specifies that all payments received on or funds applied to the loan be applied in a pro rata fashion? What does the participant actually own, if anything? What if the borrower/depositor is not uninformed? What if the borrower/depositor is in fact informed and solicitous of the participation? What if the setoff deposit account holds proceeds of collateral securing the loan? What if the deposit account itself constitutes security for the loan? What about deposit insurance? Does it affect the setoff decision? Should it?

Courts must limit \textit{Mademoiselle} to its particular facts and circumstances. \textit{Mademoiselle} leaves too many questions unasked and far too many unanswered for it to possess controlling precedential value in participation transactions that are not identical to those facts presented to the Ninth Circuit. In this unfortunate swamp of precedential confusion and doctrinal difficulties with the classification of loan participations, the propriety of bor-

\footnote{1990] 801

\begin{itemize}
  \item future payments typically in the form of accounts receivable. Then the assignor is merely a collection agent and the proceeds of such payments in the hands of the receiver belong to the assignee. \textit{Id.} (citing Estes v. E.B. Estes & Sons, 24 F. Supp. 756 (D. Mass. 1927)).
  \item 282. \textit{Id.}
  \item 283. 379 F.2d at 665. The Ninth Circuit simply believed that the setoff did not augment the insolvent estate. Therefore, no money that the participant could claim as its own was generated. Not only does this analysis overlook the participant’s ownership interest in the debt, it completely fails to take into account the role of deposit insurance in injecting new money into the estate.
\end{itemize}
rower/depositor setoff, the rights of loan participants, and the implications of Mademoiselle, the Penn Square courts made their decisions. Finally, a chance emerged to reevaluate universal concessions and sacred truths in the light of the Penn Square failure. The Penn Square courts had an extraordinary opportunity to interpret and mold the law surrounding loan participations in a way that would fulfill and further commercial expectations. Unfortunately, the Penn Square courts did not seize this opportunity.

VI. THE PENN SQUARE DECISIONS

The six largest Penn Square participants filed separate suits contesting the FDIC's setoff actions.284 Although each suit has a procedural life of its own, several similarities exist. Many of these participants, particularly those that filed suit within a short time after Penn Square Bank's closing, sought to enjoin the borrower/depositor setoffs.285 Furthermore, all of the participants sought to share the benefits of the setoffs.286 They argued that the FDIC should pay each participant its pro rata share of the amounts set off against a borrower's indebtedness.287 The FDIC, challenged the participants' requests,288 but it countered by giving the participants receiver's certificates in the face amount of their pro rata share of each setoff.289 The FDIC also agreed to remit to each participant its pro rata share of all payments made by the borrowers on loans in which it had participated.290

Each of the participant suits resembles the other in that each involves two central issues: (1) the propriety of borrower/depositor setoffs against participated loans; and (2) the right of the participant to an undiminished pro rata

284. Continental Illinois, Chase Manhattan, Seafirst, Northern Trust, Michigan National, and Hibernia filed suit. In the two years following Penn Square Bank's closing, thirteen suits concerning Penn Square participation agreements were filed. Merritt, 465 Suits Related to Penn Square Bank Filed at Federal Court in Two Years, J. Rec., July 11, 1984, at 1, col. 1.


For example, if a Penn Square borrower had $500,000 on deposit when the bank closed and an outstanding loan debt of $1 million, 90% of which had been upstreamed to a participant, the FDIC setoffs applied the deposit balance toward the loan balance. The participants argued that, in this example, the participant bank was entitled to receive 90% of the deposit account ($450,000). In order to ascertain the extent of the setoffs, the participants sought an accounting of all setoffs from the FDIC. See, e.g., Chase, 554 F. Supp. at 252.

288. The FDIC responded by moving to dismiss or, alternatively, for summary judgment.

289. See, e.g., Chase, 554 F. Supp. at 253. Using the example set forth in supra note 287, rather than receiving $450,000 in cash from the FDIC, the participant received a receiver's certificate in the face amount of $450,000. Id.

share of any such setoff. The two suits filed by Chase Manhattan Bank and Hibernia National Bank in New Orleans\textsuperscript{291} forged influential decisions that proved dispositive of these issues for the Penn Square courts because they were the first cases decided. The suits filed by Seattle-First National Bank and The Northern Trust Company also represent important new decisions, not for their result (in that regard they are identical to Chase and Hibernia\textsuperscript{292}), but for the hint of outcome-determinative political and economic factors.\textsuperscript{293}

\textbf{A. Chase Manhattan Bank, N.A. v. FDIC\textsuperscript{294}}

In \textit{Chase} the court denied Chase's attempt to enjoin the setoffs.\textsuperscript{295} Chase then amended its complaint to allege that the funds set off by the FDIC constituted collateral for the participated loans and, therefore, Chase had a preferred claim to its pro rata share of those funds.\textsuperscript{296} Again the FDIC denied Chase's contentions.\textsuperscript{297} The case thus cleared a procedural path for the United States District Court for the Western District of Oklahoma to begin substantive work on the law of participations.

\textit{1. Setoffs Against Participated Loans}

The determination of the propriety of permitting borrower/depositor setoffs against participated loan debt constituted the threshold issue. Both Chase Manhattan and the FDIC briefed and argued this issue extensively.\textsuperscript{298} Chase attempted to distinguish the Penn Square insolvency from the \textit{Scott} and \textit{Mademoiselle} insolvencies. The Penn Square failure did not present the equities that dictated the results in \textit{Scott} and \textit{Mademoiselle}. To the contrary, Chase Manhattan urged that the equities present in the Oklahoma bank failure should not allow borrowers to set off their deposits against their partici-
pated loan debt.\textsuperscript{299}

Like the Ninth Circuit Court in \textit{Mademoiselle}, Chase Manhattan attached great importance to whether the borrower had knowledge that an upstream bank had participated in its loan. As previously discussed,\textsuperscript{300} a fair reading of the \textit{Mademoiselle} opinion indicates that the fact that no one notified \textit{Mademoiselle} of the participation of its loan concerned the Ninth Circuit. “So far as Mademoiselle was concerned,” the Ninth Circuit stated, “the note was due solely to [the lead bank], and the unannounced transfer of an interest or sale of a participation certificate in the note should not dilute the uninformed depositor's ordinary right of set-off.”\textsuperscript{301}

In many of the Chase Manhattan participations, however, the transactions were not unannounced and the depositors were far from uninformed.\textsuperscript{302} Indeed, in the large majority of the bank’s participations the opposite held true. In several instances not only did the borrowers know of Chase’s involvement, but they actually solicited the New York bank’s involvement in the loan.\textsuperscript{303} The borrowers often knew that Penn Square could not even make the requested loan unless Chase or another participant agreed to fund the transaction.\textsuperscript{304} One equity that weighed heavily in favor of setoff in \textit{Mademoiselle} was either missing in \textit{Chase} or, more likely, present but favored precluding setoff.\textsuperscript{305}

\textsuperscript{299} See, e.g., Plaintiff’s Brief in Opposition to Defendant’s Alternative Motion to Dismiss or to Deny Leave to File a Second Amended Complaint at 8-10, \textit{Chase}, 554 F. Supp. 251 (W.D. Okla. 1983).
\textsuperscript{300} See supra notes 266-283 and accompanying text.
\textsuperscript{301} FDIC v. \textit{Mademoiselle} of California, 379 F.2d 660, 664 (9th Cir. 1967) (emphasis added).
\textsuperscript{302} See Affidavit of Edward G. Moran in Brief of Plaintiff, The Chase Manhattan Bank, N.A., in Opposition to Defendant’s Motion to Dismiss or for Summary Judgment at 2, \textit{Chase}, 554 F. Supp. 251 (W.D. Okla 1983) (“Most ... borrowers acknowledged that they knew that a participation in the loan had been sold to Chase.”).
\textsuperscript{303} Id. at 2-3.

Some borrowers even proposed loans to Penn Square to be funded in part by Chase. . . . Many borrowers were personally introduced to Chase loan officers by Penn Square as part of Penn Square’s effort to sell loans to Chase. In fact, Penn Square was widely acknowledged to be largely a loan brokerage operation.

\textit{Id.}


In deciding whether to purchase a given loan participation, Northern Trust routinely conducted an independent credit evaluation of the borrower based on financial documentation made available by Penn Square Bank supplemented, in many cases, by information obtained by Northern Trust through direct contact with the loan applicant.

Most if not all borrowers whose loans were participated to Northern Trust knew at the time of negotiating their loans or shortly thereafter that participation interests in such loans would be or were in fact sold by Penn Square Bank.

\textit{Id. }\S\S 5,6.

\textsuperscript{305} Chase isolated four other significant differences between these facts presented in \textit{Mademoiselle} and those in the Penn Square-Chase participations. Brief of Plaintiff, The Chase Manhattan Bank, N.A., in Opposition to Defendant’s Motion to Dismiss or for Summary Judgment at 14-20, \textit{Chase}, 554 F. Supp. 251 (W.D. Okla. 1983). First, the \textit{Mademoiselle} participation certificate did not contain a contractual provision that the participants would share pro rata in the proceeds of any property applied to reduce the loan. Second, the \textit{Mademoiselle} participant did not claim that the deposit account was used to hold funds that would be used
The FDIC responded to this alleged distinction by denying its relevance.\footnote{306} According to the FDIC, "it is the knowledge of an assignment, coupled with knowledge of the transfer of a note evidencing indebtedness and further coupled with knowledge of the proper party to pay, i.e., the assignee, that could have had a bearing on the [Mademoiselle] court's reasoning if such knowledge had been shown."\footnote{307} The characterization of "the 'knowledge' issue" as requiring "knowledge of the transfer of a note" misinterprets the Mademoiselle opinion. The Ninth Circuit specifically predicated at least a portion of its decision on Mademoiselle's ignorance of the participation transaction.\footnote{308} The Ninth Circuit's discussion implicitly recognizes that a borrower's awareness of the participant's interest and its knowledge of the participation transaction might dilute the equities in favor of setoff.\footnote{309}

As previously noted, several of the borrowers in Chase participated loans were not ordinary uninformed depositors.\footnote{310} Many of the borrowers in Chase participated loans were Penn Square insiders who understood very well not only that the funding of a particular loan often depended on an upstream bank, but that the Oklahoma bank's existence depended completely on cash infusions from Chicago, Seattle, New York and elsewhere.\footnote{311} The Ninth Circuit certainly did not have this type of bank insolvency nor this type of borrower/depositor in mind when balancing the equities in Mademoiselle.

The district court, however, ignored the borrower's awareness of or involvement in the participation relationship. In applying the Mademoiselle analysis to the Penn Square participations, the district court emphasized the

to make payments on the loan debt. Third, there was no contention in Mademoiselle that the funds in the deposit account were the proceeds of collateral securing the borrower's indebtedness. Fourth, the setoff in Mademoiselle did not irreparably harm the participant because the amount set off was less than the lead bank's retained share of the loan. In the Penn Square participations, however, Chase made all these contentions. \textit{Chase}, 554 F.Supp. at 253-55.


\footnote{307} Id. at 16 (emphasis in original).

\footnote{308} The Ninth Circuit held that [a]s assignee of part of the [lead bank's] claim, [the participant] takes it subject to any counterclaims and defenses against it. Therefore, the assignment does not operate to defeat the maker's claims against [the lead bank], especially since Mademoiselle was never notified of the assignment. . . . So far as Mademoiselle was concerned, the note was due solely to [the lead bank], and the unannounced transfer of an interest or sale of a participation certificate in the note should not dilute the uninformed depositor's ordinary right of set-off.

\footnote{379} F.2d at 664 (emphasis added).

\footnote{309} Id.

\footnote{310} The awareness of and the involvement of the borrower/depositors in the Penn Square participations is discussed in \textit{supra} notes 311-313 and accompanying text. See Affidavit of Edward G. Moran in Brief of Plaintiff, The Chase Manhattan Bank, N.A., in Opposition to Defendant's Motion to Dismiss or for Summary Judgment, \textit{Chase}, 554 F. Supp. 251.

\footnote{311} See Affidavit of Edward G. Moran in Brief of Plaintiff, Chase Manhattan Bank, N.A., in Opposition to Defendant's Motion to Dismiss or for Summary Judgment at 2-3, \textit{Chase}, 554 F. Supp. 251 (W.D. Okla. 1983) ("Several of the loans in which participations were sold to Chase were to Penn Square's officers or directors, who themselves were responsible for the participation transaction.").
fact that the lead bank continued to hold the note and service the debt.\(^\text{312}\) Just as it unquestioningly accepted the universal truth of Scott,\(^\text{313}\) so the Chase court misconstrued the true nature of the equities described in Mademoiselle. The court found that the equities in Mademoiselle would have favored the participant only if the lead had actually transferred the note to the participant and instructed the borrower to make all further payments directly to the participant.\(^\text{314}\) Such a reading of Mademoiselle, however, is somewhat mystifying. A fair reading of the Ninth Circuit's opinion simply fails to support the court's black letter statements, particularly when facts and equities play such an important role.

On this point,\(^\text{315}\) the district court's analysis not only is wrong, but also self-serving. Many of the equities that protect the ordinary uninformed depositor in Mademoiselle cut the other way in Chase. Although certainly important considerations, the equities surrounding the knowledge of the borrower should not solely determine the propriety of depositor setoff against a participated loan. Rather, the critical analysis must focus on the legal relationship between the lead bank and the participant. If the participant can prove an ownership interest in the debt and the collateral that is cognizable either in law or equity, then arguably the courts should allow the participant to either stop the depositor's setoff against that portion of the

\(^{312}\) In discussing the teaching of Mademoiselle, the Chase court indicated what it found to be the most important part of the Ninth Circuit's opinion when it addressed the competing interests at stake in that particular setoff:

"Therefore, the assignment does not operate to defeat the maker's claims against the assignor, especially since Mademoiselle was never notified of the assignment and continued to make its payments on the note directly to SFNB, since SFNB retained possession of the note. So far as Mademoiselle was concerned, the note was due solely to SFNB and the unannounced transfer of an interest or sale of a participation certificate in the note should not dilute the uninformed depositors' [sic] ordinary right to set-off."

554 F. Supp. at 255 (emphasis in original). As the emphasized language indicates, Judge Russell focused exclusively the holder of the note and the receiver of the payments. See id. at 256 ("Most importantly, Penn Square Bank retained the notes themselves which evidenced the loans and collected the payments on the notes from the borrowers.")

\(^{313}\) If the underscored language indicates the Chase court's understanding of the equities created by the borrower/depositor's knowledge or ignorance of the participation, then the district court's analysis contains no "knowledge issue" at all. The borrower's understanding of, indeed its involvement in, the participation transaction seems irrelevant. The court considers no equities, only facts. Who holds the note? Who receives the payments? Once these two factual questions are answered, there is no need to go further under the district court's understanding of Mademoiselle. Certainly the Ninth Circuit did not intend this result.

Chase made a telling argument. Judge Russell inexplicably chose, however, to ignore it. \(^{314}\) "The borrower's right to offset is not in issue." Id. at 254 (citing Scott v. Armstrong, 146 U.S. 499 (1592)).

\(^{315}\) Id. at 255.

According to Mademoiselle, it is the knowledge of an assignment, coupled with knowledge of the transfer of a note evidencing indebtedness and further coupled with knowledge of the proper party to pay, i.e., the assignee, that could have had a bearing on the court's reasoning if such knowledge had been shown.

Chase, 554 F.Supp. at 225. The court held that Chase was powerless to stop the setoffs. It seems clear, however, that Mademoiselle does not require this result. Moreover, to do all that the district court requires diminishes, and perhaps defeats entirely, the utility and practicability of loan participations.

\(^{315}\) Id.
debt owned by the participant or to share in an undiminished pro rata amount of the deposit set off against the debt.\footnote{316}

2. Lead-Participant Relationship

The district court's characterization of the lead-participant relationship determines the justification of its decision allowing setoffs. After reviewing the terms of the Chase participation certificates,\footnote{317} the district court con-

\footnote{316} This analysis follows this Article's characterization of the district court's analysis of the Mademoiselle equities as one not considering equity at all. If a participant owns a property right in debt, then it should be compensated when that right is taken from it.

This characterization does not imply, however, that the district court correctly believed that the borrower's awareness of or involvement in the participation arrangement is of no consequence. A proper analysis of the contractual relationship between the lead and the participant, and recognition of the rights of the participant, translates into a lesser necessity to dwell on equities. As a result, the contractual definition of participations comes into clearer focus.

\footnote{317} The Chase certificate of participation provided:

Said participation has been sold on the following terms, to which the participant, by acceptance thereof, agrees:

1. The Bank [Penn Square] will promptly credit the account of, or remit to, the participant, the participant’s pro rata share of all payments of principal of or interest on the abovementioned loan (hereinafter called “the loan”).

2. The Bank makes no representation or warranty, and shall have no responsibility, as to the validity or collectibility of the loan or of any note or other instrument evidencing the loan, or of any loan agreement relating thereto or as to the validity, sufficiency of, or title to, any security therefor, or as to the financial condition of the borrower. The same care has been exercised by the Bank in making the loan, and will be exercised in handling the loan and any security, as the Bank exercises with respect to loans in which no participations are sold, and the Bank shall have no further responsibility to the participant except as specifically provided herein.

3. So far as the rights of the participant are concerned, the security, if any, for the loan shall be deemed to be that hereinafore specifically listed or described, together with any substitutions therefor, and any additional security specifically pledged to the Bank to secure the loan. The participant shall have no interest in any property taken as security for any other loan or loans made to the borrower by the Bank, or in any property now or hereafter in the possession or control of the Bank which may later become security for the loan by reason of the general description contained in any general loan and collateral agreement or collateral note held by the Bank, except that if any property or the proceeds thereof shall be applied in reduction of the loan, then the participant shall be entitled to share pro rata in such application.

4. The Bank agrees that without the prior consent of the participant, the Bank will not (a) modify or waive any of the terms of any loan agreement or note or other instrument relating to or evidencing the loan, or give or withhold consents or approvals to any action or failure to act by the borrower thereunder, if the same, participant, the participant’s pro rata share of all payments of principal of or interest on the abovementioned loan (hereinafter called “the loan”).

5. The Bank reserves the sole right to enforce the obligations of the borrower, but so long as the participant’s share in the loan, together with any shares the participant may have in any other loans made by the Bank to the same borrower, is more than 50% thereof in the aggregate, then the Bank will take such action as may be requested by the participant to enforce the terms of, or to exercise the rights given in, any loan agreement or note or other instrument relating to or evidencing the loan or the security therefor, provided the participant first indemnifies the Bank to the Bank’s satisfaction against the participant’s pro rata share of any expense or liability which the Bank may incur in so doing.

6. The participant shall pay the Bank on demand its pro rata share of any ex-
cluded that Penn Square neither totally nor partially assigned the participated loan and collateral to Chase. Consequently, Chase merely received “contractual rights and no property rights in the participated loans or the collateral securing them.” Although the court admitted that Penn Square sold a participation to Chase, it failed to elaborate on the nature of the participation interest that Chase purchased. The court simply stated that it is “clear that Penn Square Bank did not assign, either in whole or in part, the participated loans or the collateral securing such loans to Chase.”

The district court, therefore, left the issue unresolved. For the purposes of deciding whether to permit the setoffs, the Chase court deemed it unnecessary to define or clarify the relationship created between the Oklahoma bank and its New York participant. Quite simply, the court found that Chase did not have property rights that could preclude or affect the results of setoffs. In the court’s view, Chase possessed contractual rights subordinate to the rights and interests of the depositor.

Briefly, the district court said that Chase's participation relationship with Penn Square vested the New York bank with nothing more than a contractual expectation of repayment. The Chase participation actually constituted the sale of an interest in the underlying energy loan, instead it was actually a loan itself. Accordingly, the Chase court misinterpreted the commercial relationship between Penn Square and Chase.

3. Participants' Claim to Set Off Deposits

Once the Chase court decided that the Penn Square borrower/depositor was entitled to set off cash on deposit in Penn Square against debt owing on participated loans, the final issue was whether the participant had a preferred claim to an undiminished pro rata amount of the deposit applied toward payment of the debt. Once again, however, the district court misunderstood and misapplied Mademoiselle.

a. Augmentation of the Insolvent Estate

Chase attempted to distinguish Mademoiselle on the basis of the dollar
amounts set off against the debt.\textsuperscript{323} In Mademoiselle the portion of the debt retained by the lead bank exceeded the deposit account balance.\textsuperscript{324} Therefore, the liabilities of the borrower/depositor and the insolvent bank were set off dollar for dollar.\textsuperscript{325} The Mademoiselle setoff, Chase argued, merely represented a "shifting of credits."\textsuperscript{326} If the balance in the set off account exceeds the borrower's liability to the lead bank, then arguably a setoff results in an augmentation of the receiver's estate.

Penn Square Bank carried the loan on its books as an asset.\textsuperscript{327} Penn Square's liability to the borrower/depositor, which is the subject of the setoff, is the amount of the deposit account. When the deposit account balance that the lead bank applies toward reduction of the loan debt exceeds the unparticipated portion of the debt, then the lead bank's estate gains the benefit of reducing its liabilities in an amount greater than the concomitant reduction in its assets. This is no mere bookkeeping transaction or shifting of credits because the setoff augments Penn Square's estate by reducing its liabilities (the deposit) in an amount that exceeds the dollar amount of its assets (the unparticipated portion of the loan).\textsuperscript{328} Again misconstruing Mademoiselle, the district court stated, "[the Mademoiselle court] held, as a matter of law, that an offset of a deposit against a participated loan does not augment the insolvent estate and therefore does not generate funds which could become the basis for a preferred claim."\textsuperscript{329}

The Chase court dismissed the bank's alleged distinctions between the

\textsuperscript{323} See, e.g., Brief of Plaintiff, The Chase Manhattan Bank, N.A., in Opposition to Defendant's Motion to Dismiss or for Summary Judgment at 21-23, Chase, 554 F. Supp. 251.

\textsuperscript{324} In Mademoiselle the participant purchased an 80% participation in a $60,000 loan. On the date of the lead bank's failure, the balance due on the Mademoiselle loan was $58,000. Of that total, $46,400 belonged to the participant and $11,600 belonged to the insolvent lead's estate. Mademoiselle's account balance on deposit in the lead bank when it failed totaled $7,473.01. 379 F.2d at 661-62.

\textsuperscript{325} Mademoiselle's deposit account balance ($7,473.01) was set off against the debt still owed the lead bank ($11,600). Even after the setoff, Mademoiselle was still indebted to the lead bank's estate. More often than not, the deposit account balances of Penn Square borrowers far exceeded the amount of their debt retained by Penn Square. The FDIC simply used funds contained in Penn Square deposit accounts to extinguish debt owned not only by Penn Square, but also by the participant that actually funded the loan.

\textsuperscript{326} Brief of Plaintiff, The Chase Manhattan Bank, N.A., in Opposition to Defendant's Motion to Dismiss or for Summary Judgment at 21, Chase, 554 F. Supp. 251.

\textsuperscript{327} See, e.g., id.; Reply Brief of Defendant in Support of Its Alternative Motion to Dismiss or for Summary Judgment at 21-22, Chase, 554 F. Supp. 251.

\textsuperscript{328} Brief of Plaintiff, The Chase Manhattan Bank, N.A., in Opposition to Defendant's Motion to Dismiss or for Summary Judgment 21-22, Chase, 554 F. Supp. 251.

To illustrate this point, assume the Mademoiselle lead bank debt and deposit account figures were reversed. That is, exceeds the amount of the deposit account (the lead's liability) the unparticipated portion of the loan retained by the lead bank (the lead's asset). The lead bank then retains $7,473.01 of the loan debt and Mademoiselle $11,600 on deposit in the lead. The participant bank still owns $46,400 of loan debt.

Using these figures, the setoff extinguishes the entire amount of the lead bank-owned debt and over $4000 of the participant-owned debt. Through the setoff, the insolvent bank's estate pays an $11,600 liability with a $7,473.01 asset. The setoff allows the lead's estate to extinguish a liability by capturing the benefit of a $4000 asset that belongs to the participant. As a result, the setoff augments the lead's estate by over $4000.

\textsuperscript{329} Chase, 554 F. Supp. at 254.
Penn Square setoffs and the *Mademoiselle* setoff as "without merit."330 Irrespective of how slight a portion of a loan Penn Square retained, how large a portion Penn Square conveyed to Chase and how large a dollar sum Penn Square set off against the total debt, the court concluded that setoffs could not augment the Penn Square estate. The receiver, in the court's view, was simply carrying out paper transactions that constituted shifting of credits. "By its very nature," the court stated, "an offset cannot augment the receiver's estate."331

The circumstances that led the Ninth Circuit to focus on the question of augmentation, however, differed from those presented by the Chase participations. In *Mademoiselle* the participant bank claimed no prior interest in the deposit account that was the subject of the setoff.332 More importantly, the *Mademoiselle* participant's only basis for a preferred claim was the simple application of the deposit account against the participated loan.333 Under circumstances that greatly differed from those in *Chase*, the Ninth Circuit thus examined whether the setoff itself augmented the insolvent estate or otherwise generated a trust *res over which a constructive trust could be imposed.334

Judge Russell's decision on this point of augmentation,335 therefore, failed to determine whether Chase was entitled to a preferred claim. Regardless of whether the setoffs augmented the insolvent estate, Chase argued that its contractual agreement with Penn Square Bank granted Chase an interest in the borrower's deposit accounts.336 As stated in *Mademoiselle*, if a participant bank identifies a specific fund in which it has an ownership interest cognizable in equity, that entitles the participant bank to a preferred claim to those funds.337

b. Rights in Borrowers' Deposit Accounts

Chase's argument on this issue focuses on the nature of the deposit account and its interest in that deposit account. The bank rested its contention on two conclusions: one legal, the other factual. First, Chase must prove

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330. *Id.* at 255.
331. *Id.* at 254. Unfortunately, the district court did not analyze the net effect on the Penn Square estate when reviewing these "paper transactions."
332. This contrasts with Chase's claim of an ownership interest in the funds contained in the deposit accounts that were the proceeds of collateral. See infra notes 337-348 and accompanying text.
333. *Mademoiselle*, 379 F.2d at 664-65. As discussed previously, the *Mademoiselle* setoff differed from the *Chase* setoff because the amount on deposit in the failed lead bank was less than the loan debt retained by the lead. The net effect of the *Mademoiselle* setoff, therefore, was neutral. The *Mademoiselle* setoff did not enhance the insolvent estate because it reduced the insolvent estate's assets and liabilities by an equal amount. See supra in notes 325-326.
334. Because the *Mademoiselle* setoff was net neutral in its effect on the lead's estate, no fund that the participant could claim as its own was generated in the hands of the receiver. See 379 F.2d at 665; supra notes 178, 179.
335. The *Mademoiselle* decision appears incorrect especially when the setoff actually yielded a net positive effect on the failed bank's estate.
that the participation agreement gave it property rights in the collateral for Chase to have a preferred claim. Second, it must prove that the deposit accounts set off against the loans constituted collateral for the loans or contained the proceeds of collateral securing the underlying loans.

This argument, however, parallels and depends upon the nature of the relationship between Penn Square and Chase.338 On that point, the district court held that Chase did not have any property rights in the loan and collateral.339 Also, the court held that Chase had no property rights in the general deposit accounts of the borrower/depositors. In short, the district court determined that Chase had no property rights in any account, loan, debt, or property of the borrower.340 The court concluded, therefore, that Chase was not entitled to an undiminished pro rata share of the deposit amounts set off against the participated loans.341

The participation certificate used for the Chase transactions provides in pertinent part:

3. So far as the rights of the participant are concerned, the security, if any, for the loan shall be deemed to be that hereinabove specifically listed as described, together with any substitution therefore, and any additional security specifically pledged to the Bank to secure the loan. The participant shall have no interest in any property taken as security for any other loan or loans made to the borrower by the Bank, or in any property now or hereafter in the possession or control of the Bank which may be or become security for the loan by reason of the general description contained in any general loan and collateral agreement or collateral notes held by the Bank, except that if any such property or the proceeds thereof shall be applied in reduction of the loan, the participant shall be entitled to share pro rata in such application.342

The language of the participation certificate states that the participant's security for the loans is all property described in the certificate and any additional security specifically pledged to secure that loan.343 Although Chase was not the holder of the debt and security instruments, the language of the participation certificate indicates that Penn Square Bank conveyed to Chase an interest in the collateral and that Penn Square acted as Chase's agent for collection.

As part of the typical Penn Square oil and gas financing arrangement, borrowers executed a form Mortgage, Security Agreement, Financing Statement and Assignment granting Penn Square a security interest in all oil and gas produced from the mortgaged property and in all proceeds thereof.344

338. See supra notes 317-321 and accompanying text.
340. Id.
341. Id. at 257.
342. Id. at 256.

[M]any of the accounts being offset by the FDIC are special accounts of the borrowers specifically maintained for purposes of receiving payments from third
This represented collateral for the loan and Penn Square listed these mortgages in the participation certificates. Moreover, Chase asserted that in several instances the oil and gas production proceeds were on deposit at Penn Square when Penn Square made the setoffs.\textsuperscript{345}

Furthermore, the contractual agreement between Chase and Penn Square provided that each bank would share in the benefits of the reduction of the loan. The participation certificate specifically stated that if the lead bank applied any collateral or the proceeds thereof to reduce the loan, then "the participant shall be entitled to share pro rata in such application."\textsuperscript{346} Significantly, the Mademoiselle participation contract contained no such similar sharing provision.\textsuperscript{347} Here, however, the parties expressly contracted that they would share the proceeds of the collateral on a pro rata basis. If the Oklahoma bank had collateral proceeds on deposit were used to reduce the borrower's loan, then Chase had a right to its pro rata share of those proceeds.\textsuperscript{348}

Chase argued that it possessed a contractually created property interest in the borrower/depositor's funds to the extent of its participation interest.\textsuperscript{349}

Significantly, the Mademoiselle participation contract contained no such similar sharing provision.\textsuperscript{347} Here, however, the parties expressly contracted that they would share the proceeds of the collateral on a pro rata basis. If the Oklahoma bank had collateral proceeds on deposit were used to reduce the borrower's loan, then Chase had a right to its pro rata share of those proceeds.\textsuperscript{348}

Chase argued that it possessed a contractually created property interest in the borrower/depositor's funds to the extent of its participation interest.\textsuperscript{349}

party oil and gas purchasers in reduction of the borrowers' indebtedness in respect of Participated Loans. Other accounts which may be the subject of offsets contain proceeds from oil and gas runs which were pledged as collateral for Participated Loans.

\textit{Id.}

As this Article explained in Section IV, when structuring an oil and gas loan, it is fairly common for the lender to require that the revenues generated from the mortgaged properties' production be paid by the purchaser of production directly to the lender. The lender then places the funds in a separate collateral collection account. For a detailed explanation of the mechanics of oil and gas finance and the assignment of production proceeds, see \textit{supra} notes 166-265 and accompanying text.

Chase argued that the participation contract conveyed to it an interest in the collateral for the loan (the oil and gas producing properties and their proceeds). The argument follows that Chase also has an ownership interest in the oil and gas production proceeds held for the borrowers in accounts at Penn Square Bank. In other words, a portion of the production proceeds equal to Chase's participation percentage belongs not to Penn Square, but to Chase.

345. Section 9-306(2) of the Uniform Commercial Code provides:

\[\text{A security interest continues in collateral, notwithstanding sale, exchange or other disposition thereof... and also continues in any identifiable proceeds including collections received by the debtor.}\]

Okla. Stat. tit. 12A, § 9-306(2) (1985). Even if Penn Square commingled the proceeds with other funds in an unrestricted Penn Square account, the original security interest, of which Chase is a partial owner or beneficiary, remains attached to the production proceeds. Chase's interest in those funds, therefore, remains intact.

It should be noted, however, that 9-306(4) is applicable in the context of a debtor's insolvency and a secured party's continued perfection in commingled proceeds. Under 9-306(4) the perfected security interest is subject to any rights of setoff.

346. \textit{See infra} note 342.

347. \textit{Mademoiselle}, 379 F.2d at 662 (the \textit{infra} text of the participation agreement is set forth in full in note 269).

348. For example, assume Chase was a 90% participant in an oil and gas loan to a Penn Square borrower that had $100,000 in production proceeds on deposit in the Oklahoma bank. By virtue of the participation terms, Chase had an interest in $90,000 of those funds. If that $100,000 is then applied toward the borrower's Chase-participated loan, then Chase should receive $90,000 in cash or in the form of a preferred claim, not a $90,000 general claim against the Penn Square estate. The effect of the FDIC's setoff practices, therefore, takes Chase's assets and uses them to retire Penn Square liabilities.

349. The court seemingly thinks pulling back on the question of the collateral collection
Chase argued that because it owned equitable title to these funds, they constituted a specific fund or trust res over which Chase could impose a constructive trust. The FDIC, therefore, had a duty to pay Chase its undiminished share of these funds.

The district court, however, viewed the issue differently. In spite of the specific language of the contract, the district court concluded that:

Although the Plaintiff has attempted to factually distinguish Made-moiselle from the present action, it is the conclusion of this Court that the Mademoiselle rationale is controlling with respect to the legal issues presented in Plaintiff's Amended Complaint. First the offsets were proper. In addition, the offsets being carried out by the FDIC were not augmenting the assets in the hands of the FDIC as receiver of Penn Square Bank. By way of offsetting the deposits against indebtedness to Penn Square Bank, the FDIC was receiving no "funds" but was merely carrying out "paper transactions" which constituted "a mere shifting of credits." In short, there was no res to which Chase's claim as a preferred creditor could attach. Further Plaintiff has no property interest in the collateral securing the participated loans which might entitle it to a preferred claim. 350

B. Hibernia National Bank v. FDIC

Hibernia National Bank v. FDIC 351 represents an important decision for two reasons. First, the Tenth Circuit endorsed and adopted the results and rationale of Chase. Second, the artificial distinctions drawn between the two different groups of Penn Square-Hibernia participations by the district court below, and again approved by the circuit, highlight the basic problems of the Chase opinion.

Hibernia National Bank in New Orleans purchased eighty-four loan participations from Penn Square Bank for a total exceeding $26 million. Hibernia purchased eighteen of these eighty-four participations pursuant to certificates of participation substantially similar to those certificates in Chase. 352 Under the Hibernia certificates, as in Chase, Penn Square retained all the original loan documentation, continued to service the loans and re-

accounts and whether Chase is entitled to any of the funds on deposit in one of these "special accounts." Chase, 554 F. Supp. at 256. The court apparently attempted to avoid the question by stating that the issue was not properly raised and granting Chase leave to file an amended complaint. Id. But the court's decision that Chase had no property rights in the loans or their collateral effectively answers the question. Regardless of how, where, or why collateral proceeds are held, in the district court's view the participant has no property interest in them, nor does it have right to share in their application to the borrower's loan debt. Id. at 256-57.

350. Id. at 256-57.
352. The certificate of participation used in the eighteen Hibernia participations provided:

So that you will have a complete description of the subject loan, we are attaching hereto a true copy of the note and a true copy or a description of all security taken by us.

We hereby confirm that in consideration of your payment to us, we are holding for your account a pro rata interest in the unpaid principal of the subject note, together with the same proportionate interest in any and all interest to
mitted to Hibernia its pro rata portion of all payments made on the loan.\(^3\) Hibernia purchased the remaining sixty-six loan participations pursuant to certificates of participation and a Loan Pool Purchase Agreement.\(^4\) Penn Square again continued to hold all loan documentation, service the loan and remit to Hibernia its share of all payments made on the loans.\(^5\)

1. The District Court Opinion

Once again, the borrower/depositor setoff issue faced the district court. Hibernia asserted that it owned the loans\(^6\) and the FDIC countered that Chase had disposed of this issue.\(^7\) The district court, however, distinguished between the two groups of loan participations and agreed with the FDIC that the first group of eighteen participations, documented only by the participation certificates, practically mirrored the Chase participations.\(^8\) The FDIC could, therefore, set off deposit accounts against loan balances\(^9\) and Hibernia was not entitled to a preferred claim to a pro rata share of the

accrue on the note from and after date, and in any and all collateral securing the same, together with any guaranties thereof.

It is expressly understood that we do not make any representations or assume any responsibility with respect to the validity, genuineness or collectibility of said note, or the collateral securing the same, or guaranties thereof, and that we are entitled . . . to take or assert under the terms of our note and that, although we will exercise the same care to protect your interest as we do to protect our own, we shall not, so long as we exercise such care, be under any liability to you with respect to anything which we may do or refrain from doing in the exercise of our judgment or which may seem to us to be necessary or desirable in the premises. We reserve the right to release collateral and to permit substitutions of new collateral.

This participation may not be assigned or transferred in whole or in part without our prior written consent. Also it is the understanding that we shall have the exclusive option and privilege of repurchasing this entire participation at any time by paying to you your pro rata share of the unpaid principal and accrued interest or less unearned discount, as the case may be.

We further understand that you will reimburse us in proportion to your participation in this loan for all expenses, attorneys fees, and other liabilities incurred by us in connection with this loan.

Hibernia, 733 F.2d at 1409.
353. Hibernia, 733 F.2d at 1404-05.
354. Id.
355. Id. at 1405.
356. See, e.g., Complaint for Injunctive Relief and/or Declaratory Judgment at 3, Hibernia Nat'l Bank v. FDIC, No. CIV-82-1051-R (W.D. Okla. filed July 15, 1982) (participated portions of the loans "were, and at the present time, are the sole and exclusive property of Hibernia . . . .").
358. "After careful examination of the Certificate of Participation form used to memorialize the purchase by Hibernia from Penn Square Bank of participations in the loans, the Court concludes that the loan participations covered solely by the Certificates of Participation are controlled by [Chase]." Order, Hibernia Nat'l Bank v. FDIC, CIV-82-1051-R (W.D. Okla. filed April 5, 1983) (Russell, J.) [hereinafter Hibernia District Court Order]. See supra note 352.
359. Hibernia District Court Order supra note 358, at 3 ("[In Chase] this Court held that the depositor in an insolvent bank has the right to offset any deposits against his debt owing to the bank and that this right extends to situations involving loan participations.").
set off deposits.\textsuperscript{360} Again, the district court believed that Penn Square had conveyed its participant ephemeral contract rights, not property rights, subordinate to the rights of the borrower/depositor.\textsuperscript{361}

In the district court's construction of the second group of sixty-six loan participations, however, the district court sided with Hibernia. Despite the arguments of both Hibernia and the FDIC that the two groups of participations were indistinguishable,\textsuperscript{362} the district court decided that the added factor of the Loan Pool Purchase Agreement distinguished these participations from those in the first group.\textsuperscript{363} The court believed that the terms of the Loan Pool Purchase Agreement created an agency relationship between Penn Square and Hibernia.\textsuperscript{364} Penn Square, therefore, held the loan documents and serviced the loans as agent for Hibernia; the Oklahoma bank also had a fiduciary duty to receive payments on the loans in trust and remit these sums to Hibernia.\textsuperscript{365}

The court was further persuaded of Hibernia's ownership interest in these sixty-six loans because the "loan pool was a special type of transaction in which Hibernia sent representatives to examine the individual credit files for the loans."\textsuperscript{366} Moreover, the district court noted that these loans were "carried on Hibernia's books as assets belonging to Hibernia and as loans made directly to the various borrowers themselves rather than as loans made to Penn Square Bank."\textsuperscript{367} Judge Russell concluded that most, if not all, of the borrowers whose loans had been packaged in the loan pool had actual notice of Hibernia's participation interest.\textsuperscript{368} Finally, the district court held that since "Hibernia's showing of probable success on the merits of its claim to the ownership of the loans within the Loan Pool Purchase Agreement is sufficiently strong, when combined with the relative balance of potential harm to the parties,"\textsuperscript{369} the FDIC should be enjoined from effecting setoffs against this second group of loan participations.\textsuperscript{370}

These purported distinctions, however, simply possess no merit. In one instance, the district court dismissed Hibernia's claim as on all fours with that of Chase Manhattan in the \textit{Chase} decision. In the next instance, however, the district court discovered additional facts and circumstances that removed one set of loan participations from the "controlling effect" of \textit{Mademoiselle} and \textit{Chase}. Ironically, Chase argued many of the newly revealed facts and circumstances; this same court expressly ignored or rejected the

\textsuperscript{360} Id. at 4. The district court once again cited \textit{Mademoiselle} and \textit{Scott v. Armstrong} as its authority for these propositions. \textit{Id.}

\textsuperscript{361} See \textit{id.}

\textsuperscript{362} Hibernia District Court Order, supra note 358, at 8-9.

\textsuperscript{363} \textit{Id.} at 9.

\textsuperscript{364} Hibernia District Court Order, supra note 358, at 9.

\textsuperscript{365} \textit{Id.} at 7, 9.

\textsuperscript{366} \textit{Id.} at 9. Whether this participation arrangement was truly "special" is discussed \textit{infra} notes 372-379 and accompanying text.

\textsuperscript{367} Hibernia District Court Order, supra note 358, at 8.

\textsuperscript{368} \textit{Id.} at 8-9. The issue of the borrowers' knowledge of Hibernia's involvement is discussed in notes 362-374 \textit{infra} and accompanying text.

\textsuperscript{369} Hibernia District Court Order, supra note 358, at 10 (emphasis added).

\textsuperscript{370} \textit{Id.} at 10-12.
arguments in its *Chase* opinion. This inconsistency appears especially glaring when the court discusses the nature of the loan pool purchase transaction and the Penn Square borrowers' state of mind.

The district court conveyed the impression that all parties, Penn Square Bank, Hibernia, and the borrower/depositor, jointly labored through intensive, face-to-face bargaining and credit review sessions. The court suggests by implication that such contact and familiarity among all three parties was unique to this transaction. This alleged distinction, however, simply is not true. In many instances involving loans other than the ones bundled off to Hibernia in this particular loan participation pool, considerable interaction spanning several years existed among Penn Square Bank, the participant banks and many Penn Square borrowers. The fact that Hibernia interviewed some of the borrowers and reviewed their financial statements prior to buying the participations involved nothing unique.

The district court also stated that most, if not all, of the borrowers had actual notice that Hibernia was a participant. Again by implication, the court focused on the uniqueness of this heightened state of mind or borrower awareness. Again, however, this alleged distinction simply is not true. Penn Square insiders or entities controlled by insiders who knew all too well that their loans entirely depended on the involvement of money center banks constituted many of the largest Penn Square borrowers. One chronicler of the Penn Square failure asserts that in several instances some of Penn Square’s largest and most active borrowers entertained the money center bankers when they visited Oklahoma and, moreover, often flew to New York, Chicago, and Seattle to solicit and smooth the participation process.

*Chase Manhattan* asserted many of these same arguments in its participation suit. Yet there the same court dismissed these arguments as “without...”

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371. See *supra* notes 308-316 and accompanying text.
372. The district court explained that “[i]n many cases, Hibernia contacted the borrowers, interviewed them and reviewed their financial statements prior to making the decisions on the loans which were ultimately included in the loan pool covered by the supplemental Loan Pool Purchase Agreement.” *Hibernia District Court Order, supra* note 358, at 9.
373. This point directly parallels and entirely depends on the borrower’s awareness of the participant’s involvement. See *supra* notes 308-316 and accompanying text.

Most [Penn Square] borrowers [of Chase participated loans] acknowledged that they knew that a participation in the loan had been sold to Chase. In some cases, borrowers had been told by Penn Square loan officers that funding of their loans depended on Penn Square’s ability to sell a participation in the loan to another bank. Some borrowers even proposed loans to Penn Square to be funded in part by Chase. Many borrowers were personally introduced to Chase loan officers by Penn Square as part of Penn Square’s effort to sell loans to Chase. In fact, Penn Square was widely acknowledged to be largely a loan brokerage operation.

Several of the loans in which participations were sold to Chase were to Penn Square’s officers or directors, who themselves were responsible of the participation transactions.
Here, however, the court is beguiled by the mere existence of a supplemental agreement — the Loan Pool Purchase Agreement. Despite the fact that both the FDIC and Hibernia insisted that the participations in the loan pool should not be treated differently because of the agreement, the court nonetheless deemed that a “hidden reason” existed behind the consummation of this additional agreement.

The district court, contrary to the parties’ express statements, believed that “[t]he parties must have desired to further define or modify certain aspects of the relationship between Hibernia and Penn Square Bank and of the transactions regarding this group of loans.” The district court held, by implication and contrary to the express intent and statements of both parties, that the parties intended to imbue Hibernia with ownership rights in the loans and collateral. Because Hibernia owned the loans sold to it in the loan pool, the FDIC could not set off the borrowers’ deposits against the debt owing on these loans.

Id.

Other indicia of ownership advanced by both Chase and Hibernia in their respective suits concerned the manner in which the loans were recorded on Penn Square’s books. No one, not even the FDIC, disputed the fact that Penn Square carried only the unparticipated portions of the participated loans as assets on its books. See id. at 3 (Penn Square carried as asset on its books only that portion of borrower’s indebtedness not sold to Chase). The participated portions of the loans, accordingly, constituted assets of the participant banks. The same is true of both groups of participations in Hibernia.

Incongruously, the district court found that in one instance (the Chase participations and the first group of eighteen Hibernia participations) the participations, if not outright loans to Penn Square, at least did not constitute assets owned by the participants. Yet in the other instance (the second group of participations contained in the loan pool), the court determined that the unparticipated portions of the loans represented the unmistakable property of the participant. As support for this determination, the district court seemed intrigued with the notion that if it were to conclude otherwise (that the participations were simply loans to Penn Square Bank), then both Penn Square Bank and Hibernia violated their statutory borrowing and lending limits. Hibernia District Court Order, supra note 358, at 8. Intriguing though it may be, this observation defines or distinguishes scarcely contractual relationships. This point is better understood as an indicia of participant ownership of the participated portion of the underlying loan.

Hibernia purchased millions of dollars in participations from Penn Square. In light of the stated intent of both parties, to determine arbitrarily that Hibernia used the participations as a means to purchase millions in loans while it also used the participations as a vehicle to loan Penn Square several more million certainly seems inconsistent. Moreover, I doubt that Chase thought it was lending Penn Square over $200 million when it purchased its participations. I think this inconsistency is emblematic of where the Penn Square courts’ analysis would be most criticized: The district court’s reasoning defies the commercial realities that surround the transaction. This is discussed at length in Section VII.


378. The court stated:

It is recognized by the Court that the attorneys for both Plaintiff and Defendant persistently stated that the [two groups of Hibernia] loans . . . were not distinguishable and should not be treated differently. However, the Court is convinced that the express contractual language of the Loan Pool Purchase Agreement is distinguishable from the language contained in the Certificates of Participation.

Hibernia District Court Order at 8-9, supra note 358.

379. Id. at 9. “Perhaps a significant distinction between the loans covered solely by Certificates of Participation and the Loan Pool Purchase Agreement is the mere fact that such a supplemental agreement was executed.” Id. (emphasis added).

380. Hibernia District Court Order, supra note 358, at 10.
The *Hibernia* district court confused rather than clarified the issues raised by the participations. Its distinctions between *Hibernia* and *Chase*, particularly those made between the two groups of *Hibernia* participations, are not distinctions at all; furthermore, the district court's reasoning is difficult to follow. Unfortunately, however, the circuit court did not correct the problems.

2. *The Tenth Circuit Opinion*\(^{381}\)

On appeal *Hibernia* urged that the same facts, considerations and conclusions that led the district court to determine that *Hibernia* owned all or part of the loans packaged in the loan pool equally applied to the eighteen individual loan participations.\(^{382}\) The FDIC countered that the *Chase* rationale dictated otherwise.\(^{383}\) The sole issue raised for the Tenth Circuit's determination was whether "Penn Square's participation to *Hibernia* of part or all of the [eighteen individual] loans transferred ownership in such loans to *Hibernia*."\(^{384}\) The circuit court thus had the opportunity to correct the district court's inaccurate construction of the loan participations and faulty determinations of the ownership rights conveyed thereby, but the court failed to seize this opportunity. Instead, the Tenth Circuit complicated matters by applauding the *Chase* rationale in the majority opinion while, in a partially concurring and dissenting opinion, recognizing a participant's ownership of the participated portion of the loan but permitting borrower/depositor setoff anyway.\(^{385}\)

\(a\). *The Majority Opinion*

Not only did the circuit court approve the district court's distinctions between the two groups of *Hibernia* loan participations, it adopted the *Chase* opinion's construction of *Mademoiselle*.\(^{386}\) In its less than two page majority opinion, the Tenth Circuit classified the participations as creating "'assign-
ments without recourse' coupled with agency," 387 construed Scott, 388 approved Chase 389 and borrower/depositor setoffs against participated loans, 390 held that setoffs do not augment the insolvent's estate, 391 and denied loan participants preferred claims to their share of the deposit amounts set off against their debt. 392 Fortunately, the companion opinion offers a little more in the way of analysis.

b. The Hibernia Concurrence/Dissent 393

In a separate opinion, Judge Logan disagreed with the majority's characterization of Hibernia's rights in the underlying loans. As he saw it, "the participations constitute assignments of ownership of the loans to Hibernia to the extent of the percentages it acquired." 394 In Judge Logan's analytical scheme, however, Hibernia's ownership of all or at least a portion of the debt did not preclude borrower/depositor setoff, 395 nor did it entitle the partici-

387. Id. The court stated:

Although nothing in the participation agreement indicates that the participations were anything other than "assignments without recourse" coupled with an agency, Hibernia contends that it intended and treated each participation as a transfer of ownership, and that, accordingly, the FDIC could not offset the... loan borrowers [sic] deposits against the participated portions of the loans. We disagree.

Id.

The Tenth Circuit's characterization of the participation as an assignment coupled with an agency seems reasonable. The terms and intent of the relationship indicate that Penn Square assigned ownership of the loans to Hibernia and that Penn Square retained the loan documents and continued to service the loans as the New Orleans bank's agent. The circuit court, however, never clarified what rights were the subject of this assignment.

The Tenth Circuit's opinion directly conflicts with the Supreme Court in SBA v. McClellan 364 U.S. 446, 449 (1960), and the Fifth Circuit in Franklin v. Commissioner, 683 F.2d 125, 126 (5th Cir. 1982).

388. Hibernia, 733 F.2d at 1407.

389. Id. at 1408 ("The district court properly relied on its decision in Chase... wherein it adopted Mademoiselle...”).

390. Again the court summarily concluded:

Nothing in the participation agreements... was in derogation of the borrower-depositors' offset rights. The agreement, as we have noted, cannot be read to transfer the ownership of the loans to Hibernia. Nor are we able to read into the participation agreements Hibernia's proposition that its treatment and intent should control on this issue. Hibernia is, in our view, attempting to rewrite the participation agreements in order to afford it the ability to enjoin the borrower-depositors' established right of offset. We cannot rewrite the participation agreement for Hibernia's benefit.

Id.

391. Id. Like the district court, the Tenth Circuit subscribed to the notion of a setoff as "a mere shifting of credits," nothing more than a simple "bookkeeping transaction." Id. Also like the district court, the circuit court believed that the setoff neutrally affected the receiver's estate. Id.

392. Id. The circuit court fell into lockstep with the district court's misunderstanding and misapplication of Mademoiselle. Once the circuit court agreed that Hibernia did not own the participated portions of the loans, it led, in the court's view, to the inexorable conclusion that the participant was not entitled to a preferred claim. Id.

393. Hibernia, 733 F.2d at 1409 (Logan, J.) (concurring in part and dissenting in part).

394. Id. at 1410 (emphasis in original) (citing SBA v. McClellan, 364 U.S. 446, 449 (1960) and Mademoiselle 379 F.2d. 660, 665 (9th Cir. 1967)).

395. Id. "As the majority recognizes, the borrower-depositor in Penn Square may offset
pant to a preferred claim to the deposit proceeds set off against the debt it owns.396

If the depositor chooses to offset against a loan in which Hibernia has participated, the offset should first apply to that portion of the loan retained by Penn Square. If the amount of the offset exceeds the portion of the loan retained by the insolvent bank, Hibernia does not become a preferred claimant as to the excess. However, because of Hibernia's ownership interest in the loan to the extent of its participation, Hibernia does become a general creditor of Penn Square as to that amount.397

Judge Logan's conclusion that Hibernia owned its share of the loan debt contradicts his denial of Hibernia's right to its share of the reduction in debt generated by the setoff. This inconsistency becomes apparent when evaluating the setoff of a $100,000 deposit account against a $100,000 loan in which Hibernia was a ninety percent participant. Under Judge Logan's rationale, Hibernia owned $90,000 of the debt. Yet when all the deposit account funds are used to pay the entire amount of the loan debt, including Hibernia-owned debt, Judge Logan denies Hibernia one of the principal rights for which it presumably contracted with Penn Square and one of the basic attributes of ownership: the right to receive payment.398

At least the separate opinion affirmatively stated that a loan participant actually owns its portion of the total loan debt, but the court articulated no additional reasoning and thus failed to assist Hibernia. Regardless of the express terms of the contract and the intent and expectations of the parties, the Tenth Circuit forced Hibernia and the other Penn Square participants to content themselves with receiver's certificates for general claims, any dividends to be paid on those certificates at the discretion of the FDIC and, ultimately, after six or seven years, perhaps sixty cents on the dollar.

C. The Seafirst and Northern Trust Decisions

Not surprisingly, in the decisions in Seattle-First National Bank v. FDIC399 and Northern Trust Company v. FDIC400 the district court followed the same approach used in the earlier participation suits.401 In many ways, the Northern Trust result was quite predictable. The participation cer-
Certificate used by Northern Trust mirrored that construed in *Hibernia*. Consequently, the district court followed the result of its earlier decision and held that Northern Trust could neither stop the setoffs nor receive a preferred claim. In the *Seafirst* suit, however, the district court construed yet another form of a participation agreement, one that seemed even plainer than the *Hibernia Loan Pool Purchase Agreement* in conveying to the participant the ownership of property rights in the underlying loans. The court, however, thought otherwise. The result, but not the rationale, was predictable.

Like the other participants, Seafirst claimed that its participation agreements, the FDIC's contentions remained the same and the results of Judge Russell's decisions predictably paralleled those in *Chase and Hibernia*. The participation certificate used by Northern Trust was a printed form certificate. Following its earlier findings in *Hibernia*, the district court held that Northern Trust had no ownership or property interests in the participated loans. *Id.*

402. *Id.* at 1342. The participation certificate used by Northern Trust was a printed form certificate. Following its earlier findings in *Hibernia*, the district court held that Northern Trust had no ownership or property interests in the participated loans. *Id.*

403. *Id.* at 1345.

404. See *Hibernia Loan Pool Participation Agreement*. 
conveyed to it property rights or trust estates in the loans and their supporting collateral. The court surprisingly agreed. Although the language of the order does not state unequivocally that the participation agreement conveyed a property interest to Seafirst, it nonetheless communicates that the court believed that Seafirst owned the participated portion of the loan. Such an impression, however, did not suffice to carry the day.

405. In pertinent part, the Seafirst participation contract provided as follows:

1. Sale of Participations. Seller [Penn Square] hereby agrees to sell and Purchaser [Seafirst] agrees to purchase participations in the loans described on Exhibit A attached hereto and by this reference incorporated herein. The amount of the Purchaser's participation is also indicated on Exhibit A .... To the extent the terms of this Agreement vary from or are in conflict with the terms of any certificate, the terms of this Agreement shall control.

2. Owner Trustee. To the extent of its participation in the loans, Purchaser shall be the owner of an undivided fractional interest in each such loan, including, but not limited to all notes and other instruments evidencing indebtedness of the borrower, together with all collateral securing such indebtedness. To the extent of Purchaser's interest therein, including, but not limited to, its pro rata share of all funds and payments received and/or to be received by Seller from the borrower, Seller shall be a trustee for the benefit of and accountable to Purchaser, and shall hold all such notes, mortgages, and collateral security instruments together with all such funds and payments in trust for Purchaser for its sole and exclusive benefit.

3. Administering and Servicing. Seller shall ... receive and collect all payments of principal and interest that become due and payable on the loans and shall immediately place all such funds in a reserve account as soon as the same are collected, to be held for disbursement as provided below.

4. Marketing of Records, Inspection. Seller represents, warrants, covenants and agrees to mark all notes, mortgages, security agreements, trust deeds and other instruments evidencing the loans and the collateral securing same, in a conspicuous manner so as to clearly identify Purchaser's participation in each loan and further agrees to mark all credit files, ledgers and/or computer printouts and other records pertaining to the loans ....

5. Monthly Reports. Not later than ten days following the end of each month in which Purchaser has a participation interest in any loan hereunder, Seller shall transmit to Purchaser a computer printout or report on which Seller will indicate with respect to the immediately preceding month: [List of numerous items about the participated loans such as outstanding balance and amount of payments received].

6. Payments. Seller will pay to Purchaser its pro rata share of the aggregate amount of payments of principal and interest paid by the borrower during each month when received.

10. Instructions. Seller agrees that so long as the Purchaser's share in any loan is more than fifty percent thereof in the aggregate, then the Seller will take any action as may be requested by Purchaser to enforce the terms thereof ....

407. Id. at 1356.
408. Although the district court concluded that the participation "agreement is ambiguous as to the existence of ... property interests," the court nevertheless found that "the agreement arguably created and conveyed property rights in the participated loans." Id. at 1355 (empha-
for Seafirst.\textsuperscript{409}

The court's denial of Penn Square's fiduciary status presents a particularly bewildering problem. The district court admitted that a "trust relation is suggested"\textsuperscript{410} by the contract terms declaring that Penn Square "'shall be a trustee for the benefit of and accountable to'"\textsuperscript{411} the Seattle bank for its pro rata share of the participated loans. This also required Penn Square to hold Seafirst's share of payments in a separate reserve account and obligated Penn Square to consult Seafirst before changing the loan terms.\textsuperscript{412}

The court remained unconvinced. It stated:

On the other hand, the first paragraph of section 3 indicates that Penn Square remains sole manager of the loans and collateral; paragraph 7 represents Penn Square, not Seafirst, as the sole secured party; and paragraph 9 indicates that while Penn Square will defer to Seafirst's requests regarding enforcement or foreclosure of security interests in participated loans, Penn Square is entitled to indemnity from Seafirst for "any expense or liability incurred in so doing." These terms suggest that Penn Square retains the status of primary creditor and secured party.\textsuperscript{413}

The court apparently failed to comprehend the fact that the terms which "suggest" that Penn Square retain the status of primary creditor are entirely consistent with Seafirst's beneficial ownership interest and Penn Square Bank's duties as trustee. In short, the district court believed that the rights and duties stemming from Penn Square's fiduciary position necessarily worked against Seafirst's ownership interests. Once again the analysis is off the mark.

Even if Seafirst were the unquestionable owner of the participated portion of the loan or the fact that Penn Square Bank held Seafirst's interest in trust, the district court continued, that does not necessarily preclude borrower/depositor setoff against the entire loan.\textsuperscript{414} As long as Penn Square's status as lead creditor survived the loan participation, the district court explained it could setoff against the participated portion of the loan.\textsuperscript{415} Suffi-

\textsuperscript{409} Id.
\textsuperscript{410} Id. at 1356 (emphasis added).
\textsuperscript{411} Id.
\textsuperscript{412} Id.; see infra Appendix D.
\textsuperscript{413} Id.
\textsuperscript{414} The court explained:

The finding of a possible property interest and/or trust relation, however, does not end the inquiry into offsets; it merely brings us to the second prong of our consideration, viz, the legal import of such an interest. Even if Seafirst prevails on its property or trust theory, the Receiver can prevail .... if it proves beyond doubt that the offsets were nonetheless proper.

\textsuperscript{415} Id. at 1356-57.

The court stated that its "crucial concern is not whether Penn Square's creditor status survived its insolvency but whether its creditor status survived the participation agreement."
cient mutuality of obligations exists for the court to order setoff provided that the loan debt is owed solely to and owned entirely by Penn Square. In other words, if the loan debt is owed solely to and owned solely by Penn Square, then, in the court's view, sufficient mutuality of obligations exists for the court to order setoff.

Under the terms of the [participation] agreement, Penn Square remained the manager, sole secured party and sole authority for collection on the loan. There is no evidence of a multi-lender agreement or any other instrument conferring direct creditor status of Seafirst. The Court finds as a matter of law that Penn Square retained sufficient creditor status to satisfy mutuality and effect offset.416

The court excluded Seafirst from the debtor-creditor equation.417 Once excluded, the district court simply overlooked Seafirst's property rights, trust relations and its rights to share in the reduction of the loan debt. The oversight seems inexplicable because the terms of the Seafirst participation contract recognized the Seattle bank's ownership interest. The Seafirst agreement expressly stated that Seafirst owned an undivided fractional interest in each participated loan, all instruments evidencing the loan and all collateral securing it.418 Second, to the extent of Seafirst's pro rata share of each loan, Penn Square agreed to act as "trustee for the benefit of" and was to hold all instruments and funds "in trust for Seafirst for its sole and exclusive benefit."419 Third, although Penn Square continued to manage and service the loans, the agreement required Penn Square to consult with Seafirst on any matter that would affect Seafirst's interest in the loan.420 Fourth, the agreement specified that before permitting any material changes in the terms of the underlying loan, Penn Square first had to obtain Seafirst's written consent.421 Fifth, the agreement required Penn Square to mark and identify all documents to evidence Seafirst's participation in the loan.422 Sixth, the agreement obligated Penn Square to make detailed monthly reports to Seafirst and deposit all payments received from borrowers in a reserve account pending the distribution of the funds to Seafirst.423 Finally, the contract also provided that so long as Seafirst owned a majority of the loan, Penn Square had to take any action requested by Seafirst to enforce the terms of the loan.424

Although the Seafirst result parallels the Chase and Hibernia non-Loan

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416. Id.
417. Although the district court's "guiding precept...continue[d] to be the borrower's right to offset," the Seafirst setoff analysis took a new direction, one different than that in Chase. Id. at 1358. Mutuality was the key to the Seafirst setoffs; none of the Ninth Circuit's equities even entered the equation. This different direction is not entirely surprising. In many respects, it represents the logical extension of the district court's misunderstanding of Mademoiselle.
418. See infra Appendix D ¶¶ 1,2 (containing Seafirst Participation Agreement).
419. Id. ¶ 2.
420. Id. ¶ 3.
421. Id.
422. See infra Appendix D ¶ 4 (containing Seafirst Participation Agreement).
423. Id. ¶ 5.
424. Id. ¶ 10.
Pool Purchase Agreement results, the plain language of the Seafirst bargain requires a result identical to that of the Hibernia Loan Pool Purchase Agreement. Seafirst had as much of an ownership interest in its participations as Hibernia had in its loan pool participations. Penn Square Bank was agent for Hibernia; it was trustee for Seafirst. Penn Square had a fiduciary duty to collect and remit trust funds in which Hibernia had a beneficial interest; Penn Square owed an identical duty to Seafirst. The loan participations purchased by Hibernia became the exclusive assets of the New Orleans bank; the same was true of the participations purchased by Seafirst.

Never does the district court satisfactorily explain the inconsistencies of its findings. Instead, the court abruptly concludes:

[T]he "ownership interest" acquired by Seafirst through participation was merely its share of an expectation generated, managed, enforced and collected by the lead bank, Penn Square. Seafirst took this interest subject to the borrower's and the bank's rights of offset. Absent terms in the participation agreement barring the assertion of such offsets, they remained enforceable by either the borrower or the bank.

Not only did the district court misinterpret the transaction, it also failed to comprehend the significance of Seafirst's ownership interests. The comparison with the Hibernia Loan Pool Purchase Agreement could not have been much clearer. Seafirst owned its share of the debt and supporting collateral and Penn Square Bank was its trustee. Moreover, once the borrower/depositor was allowed to set off its deposit balance against the entire loan debt (including that portion owned by Seafirst), Penn Square Bank, as trustee, was contractually obligated to remit to the Seattle participant its pro rata share of the funds used to reduce the loan debt.

VII. THE PENN SQUARE DECISIONS: COMMENTS, CRITICISMS, AND CONCLUSIONS

The structure and style of the Seafirst and Northern Trust opinions indicate that after two years of reflection the district court began to doubt its analytical approach set forth in its previous participation decisions. Perhaps the court waited to retreat somewhat from its earlier Chase extreme. On the other hand, the court's apologists, can argue that in the Seafirst and Northern Trust decisions the court simply construed other contracts, ones with different provisions creating different relationships. Nothing in the court's orders indicates a weakened resolve, a changed mind, or a reconsideration of past positions. The truth of the matter is, I suspect, most likely somewhere in between. Yet I am inclined to view the Seafirst and Northern Trust decisions as a step in a new direction; despite the identical results, the approach has changed.

425. Indeed, the language of the Seafirst contract is much more explicit in that regard than the Hibernia Loan Pool Purchase Agreement. Compare infra Appendix D (Seafirst Agreement) with infra Appendix C (Hibernia Loan Pool Purchase Agreement).


427. Moreover, once the borrower/depositor was allowed to set off its deposit balance against the entire loan debt (including that portion owned by Seafirst), Penn Square Bank, as trustee, was contractually obligated to remit to the Seattle participant its pro rata share of the funds used to reduce the loan debt.

428. This statement seems particularly true in the case of the Northern Trust decision. The participation certificate involved in that case was the Penn Square printed form.
The Seafirst and Northern Trust decisions indicate that the court, to use its own words, "must have desired to further define or modify certain aspects of the relationship between [the participant] and Penn Square." But even if this assumption is correct, the question arises: How much or in what way did the district court recast certain aspects of its earlier rulings?

A. The Significance of Seafirst and Northern Trust

Seafirst offers several striking examples of the court's analytical and interpretive errors. In particular, the court ignored the similarities between the Seafirst contract and the Hibernia Loan Pool Purchase Agreement. The court purposely disregarded the express language of the Seafirst participation contract and found that Seafirst did not own property rights in the underlying loan. Moreover, the court determined that the fiduciary obligations imposed on Penn Square to care for Seafirst's interest in the participated loans somehow worked to defeat, rather than protect, Seafirst's ownership interests. These analytical inconsistencies do not represent true departures from the problems in Chase and Hibernia. The significance of Seafirst and Northern Trust is the new, seemingly self-contradictory analytical approach taken by the court to justify its decisions. The district court broke new ground by rearranging its analysis of the equities of borrower/depositor setoff. The court frankly states that equity no longer plays a part in the determination of the propriety of borrower/depositor setoff. Yet for the first time the court addresses the competing interests of the parties affected most by the setoff issue. The court seemingly confessed that something other than strict legal principles and precedent dictated its decisions.

1. The Departure from Equities

In FDIC v. Mademoiselle the Ninth Circuit emphasized that it predicated a large part of its decision on Mademoiselle's ignorance of the sale of the participation. The borrower in Mademoiselle remained completely

429. Hibernia District Court Order, supra note 358, at 9 (ascertaining intent behind execution of Loan Pool Purchase Agreement). This assumption unlike the district court in Hibernia, does not have to overcome the difficult obstacle of the express language of a contract and the stated intent of both of the parties to that contract.

430. The court also committed a grave error in overlooking Seafirst's (as well as the other participants') rights to share in the benefits of the setoff. The contractual sharing provisions entitling participants to a pro rata share of the setoffs is discussed infra notes 438-79 and accompanying text. Moreover, a proper analysis of the rights of the Penn Square participants recognizes their rights to receive a preferred claim for their share of any setoffs. Id.

431. See the discussion of the new irrelevance of the borrower's knowledge of the participation transaction in notes 433-65 and accompanying text.

432. See the discussion of the court's balancing of competing interest in infra notes 446-50 and accompanying text.

433. 379 F.2d 660 (9th Cir. 1967).

434. Id. at 664. The court held:

So far as Mademoiselle was concerned, the note was due solely to [the lead bank], and the unannounced transfer of an interest or sale of a participation certificate should not dilute the uninformed depositor's ordinary right of set-off. Id. (emphasis added).
uninformed about the participation transaction and had no reason to question whether the lead bank had transferred a portion of its loan. This lack of knowledge greatly contributed to the equities that weighed in favor of Mademoiselle's specific setoff.

In *Chase* many of the borrowers knew of the participations. Yet the district court inexplicably ignored this shifting of equities in favor of the participant. Further, the *Chase* court distorted the Ninth Circuit’s analysis to such an extent that the Penn Square borrower’s awareness of the participation mattered little.

Indeed, in the *Chase* court’s analytical scheme, the equities created by the borrower’s knowledge were irrelevant. The *Chase* court asked but two factual questions: Who holds the note and who does the borrower pay? Regardless of the intent and statements of the Ninth Circuit to the contrary, for Judge Russell these questions represented the extent of the *Mademoiselle* based equities inquiry.

In both *Seafirst* and *Northern Trust*, as in *Chase*, the participants alleged that many of the borrowers understood that an upstream bank actually funded all or portions of their loans. This time, however, the court did not justify its decision with a *Chase*-influenced multi-page misanalysis of *Mademoiselle* and its equities. Rather, the court ignored *Mademoiselle* entirely.

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435. See id.
438. According to Judge Russell’s reading of *Mademoiselle*:
   [I]t is the knowledge of an assignment, coupled with knowledge of the transfer of a note evidencing indebtedness and further coupled with knowledge of the proper party to pay, i.e., the assignee, that could have had a bearing on the court’s reasoning if such knowledge had been shown.
   *Id.* at 255. In other words, the equities might have differed if the borrower knew that its promissory note had been transferred to the participant and it had been paying the participant directly.

   If this represents the true measure of the equities, then the test fails to measure of knowledge or equities at all. If the note is endorsed and delivered to the participant and the borrower pays the participant bank directly, then regardless of the borrower’s state of mind, the loan debt is directly owned by, held by, and payable to the participant. In short, a reverse participation, with the participant becoming the lead and the lead bank becoming the participant, must occur before the district court’s balance of equities tips in favor of the participant and recognizes its ownership interests. Ironically, by misconstruing the Ninth Circuit’s analysis of the participation equities, the district court effectively eliminated equities from the analysis.


   In deciding whether to purchase a given loan participation, Northern Trust routinely conducted an independent credit evaluation of the borrower based on financial documentation made available by PSB supplemented, in many cases, by information obtained through direct contact with the loan applicant.

   Most if not all borrowers whose loans were participated to Northern Trust knew at the time of negotiating their loans or shortly thereafter that participation interests in such loans would be or were in fact sold by PSB.

   *Id.*

440. In the *Northern Trust* opinion the court responded to Northern’s arguments concerning the *Mademoiselle* equities by quoting *Chase*:
Without a hint of its earlier reliance on the controlling effect of Mademoiselle, the district court held that “[t]he borrower's knowledge of his loan’s participation is irrelevant to his continuing equitable claim [of setoff]."\(^4\) With one sentence the district court elevated its earlier factual distinction raised in Chase to a matter of law.\(^4\) Who holds the note? Who gets the check? For the district court, these variables and the constant of borrower setoff comprised the equities equation.\(^4\)

In Chase the court attempted to justify its emphasis on these equities as the focus of Mademoiselle. In Seafirst and Northern Trust the court entirely dropped this pretext. However, the district court erred in both instances. Under either analysis the Penn Square participant loses.

2. The Movement Toward Equity

By the time the district court decided Seafirst and Northern Trust, the Penn Square courts had continually misinterpreted Mademoiselle. But while the district court ignored equities specifically, its analysis abstractly moved toward equity. Once it dropped the Mademoiselle pretext, the district court attempted to balance the competing interests of the parties.\(^4\) The court explained:

From an equitable standpoint, enforcing an offset against a participated loan entails balancing benefits and hardships among at least three parties: the borrower, the lead bank, and the participant(s). These permutations are compounded when insolvency is an added factor and the court readily admits to frustration, and perhaps impossibility, in striking a balance satisfactory to all parties.\(^4\)

Three years after Chase and over two years after Hibernia, the district court admitted that a subjective cost/benefit analysis helped shape its decisions. The court confessed that this analysis yielded difficult and frustrating results. Nonetheless, the court concluded:

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\(^4\) This court is convinced that the fact that some of the borrowers from Penn Square Bank had notice that a loan participation had been sold to another bank . . . does not shift the equities from the borrowers to the participating bank. Northern Trust, 619 F. Supp. at 1343 (quoting Chase, 554 F. Supp. at 255).

\(^4\) See, e.g., Hibernia District Court Order, supra note 358, at 9 (Mademoiselle is controlling authority).

\(^4\) Seafirst, 619 F. Supp. at 1358 (emphasis added); see also Northern Trust, 619 F. Supp. at 1343 (“The borrower's alleged knowledge of the participations does not negate their equitable interests.”).

\(^4\) The earlier distinction was the fact that the borrower's knowledge of a specific transaction did not shift the equities in favor of the Penn Square participant.

\(^4\) The matter of law means that the borrower's knowledge is irrelevant in determining the right to setoff.

\(^4\) The district court's decision to ignore the Ninth Circuit opinion represents the logical extension of the district court's initial misreading of Mademoiselle. Despite the logic of this extension, the district court's pronouncement in Seafirst and Northern Trust lacks precedential support. The district court misapplied, to borrow its words, "the controlling effect of Mademoiselle."


\(^4\) 619 F. Supp. at 1358. The court used the identical language in the Northern Trust decision. 619 F. Supp. at 1343.
It is sufficient to resolve the claims in favor of the borrowers and the lead bank . . . leaving participant banks to bear the market risk of their participation ventures.\footnote{448} The court finally admitted that equitable considerations, other than those specifically described in \textit{Mademoiselle}, influenced its decision. Moreover, the court acknowledged the impossibility of making one party whole without harming another. Thus, the court reasoned that the balance tipped in favor of allowing borrower/depositor setoff\footnote{449} and letting the participant banks absorb the inevitable losses,\footnote{450} which marked a definite change in the Penn Square courts' approach.

3. \textit{The Implications of Seafirst and Northern Trust}

From one perspective, \textit{Seafirst} and \textit{Northern Trust} only compounded the district court's previous mistakes. Even worse, its new approach appears contradictory. In one instance, the court dismissed equities as irrelevant, yet in the next, equity counted for all.\footnote{451} This contradiction can be tolerated, perhaps even rationalized, because of the court's implicit admission that it looked beyond a single Penn Square participation transaction or the express terms of any participation agreement. Instead, it considered the implications of borrower/depositor setoff and participants' rights. The district court's long view suggests that disregarding the compelling \textit{Mademoiselle}-type equities in the specific furthers equity in general.\footnote{452}

\textbf{B. A Purposive Analysis of the Penn Square Problems}

The Penn Square courts most likely reached the wrong conclusions in deciding specific questions of law. Most of the Penn Square decisions were tersely worded, filled with presumptive or conclusory statements and contained little thoughtful analysis. Despite the shortcomings in their decisions,

\footnote{448} \textit{Seafirst}, 619 F. Supp. at 1358. See also \textit{Northern Trust}, 619 F. Supp. at 1343. That Northern Trust and other upstream banks were disappointed in their commercial expectations of Penn Square is not disputed, but Northern's disappointment can be termed "inequitable" only if it had an equitable claim, interest, or fund at stake. Such is not the case. \textit{Seafirst}, 619 F. Supp. at 1358. The commercial expectations and realities involved in loan participations are discussed \textit{infra} notes 474-78 and accompanying text.

\footnote{449} See \textit{Seafirst}, 619 F. Supp. at 1358. On this point the Penn Square decisions prompt emphatic the court's reasoning, but I can support the result. My reasons are discussed at length in the next sections of this Chapter. See \textit{infra} notes 462-71 and accompanying text.

\footnote{450} \textit{Id.} at 1358. \textit{Northern Trust}, 619 F. Supp. at 1343. On this point, however, the court's result is not required by permitting borrower/depositor setoff, nor is it the contractually correct result under the terms of the participation contracts. See \textit{infra} notes 472-79 and accompanying text.

\footnote{451} Compare the pronouncements in \textit{Seafirst} and \textit{Northern Trust} on the irrelevance of the borrower's knowledge of the participation with the balancing of benefits and hardships caused by the lead bank's failure in those decisions.

\footnote{452} See \textit{infra} notes 462-71 and accompanying text. In light of the insolvency and ultimate demise of the FSLIC and the problems plaguing the government in its efforts to solve the savings and loan crisis, this type of approach may be the only approach that focuses on the preservation of the integrity of the banking system, and may be the only approach that produces the politically needed result.
however, the Penn Square courts reached the equitable result on the overall issue of depositor setoff. The same is not true, however, of the result reached on the issue of the participants’ right to their respective share of the setoff deposits.

1. A Framework for Analysis

The Penn Square participation controversy narrows into two components: one strictly legal, the other equitable. The first component, the legal issues, concerns the legal significance of loan participations. Who owns the participated portions of the loans? What rights do the participation agreements create or convey? Does the law permit setoff? Does a mutuality of obligations become the “legal” subject of setoff?

The second component, the equitable issues, asks: Who do bank failures hurt the most? Who should the government protect? What is the function of National Bank Act? Who do loan participations help? Who should own the participated portions of the loans?

The two components do not exist separately or function independently of each other. In my estimation, to reach the “proper” decision, the one that seeks to achieve the greatest equitable goal at the lowest legal cost, the courts must combine the two components.

If the courts employ such a purposive analysis, then the focus comes closer to, again in my estimation, commercial reality. Reality in the particular because the inquiry specifically highlights the predetermined expectations, assumptions and intent of the parties at the time they struck specific bargains; reality in general because the inquiry starts with the understanding that legal results and equitable or political goals cannot and should not exist at polar extremes. This analytical blend ultimately recognizes that the legitimacy of legal principles and equitable purposes depend on each other and fosters better judicial decisions.

Such a purposive analysis hopes to achieve the rule or decision that best accommodates the interests, needs and relative positions of all the parties in light of the commercial realities involved in the Penn Square participation transactions. The inquiry asks questions that blend legal and equitable analyses. Who should own the participated portions of the loans? Who expected to own the participated portions? Did the borrower/depositor expect a right to set off deposit accounts against loan balances? How should proceeds of a bank liquidation be distributed?

These questions help courts focus on the specific intent, assumptions and expectations brought to the bargaining table by each party. These questions also focus on the realities of bank failures and the hardships borne by all parties. By answering these questions, courts can decide difficult cases like the Penn Square participations suits on the basis of commercial realities. Thus, a purposive approach provides a mechanism for appraising, balancing and furthering the changing needs and interest of the parties.
2. *A Purposive View of Loan Participations*

Penn Square Bank conveyed property rights in the participated loans to the upstream banks. The contractual language in the Hibernia Loan Pool Purchase Agreement and the Seafirst Participation Agreement evidence that conveyance. For inexplicable reasons, the district court recognized this conveyance in one instance, yet denied it in the next. A strong argument exists for the proposition that in law or in fact none of the Penn Square participations differ from each other.

Evaluating the Penn Square participations in light of the parties' purposes leads to the conclusion that the participants owned their respective portions of the loans. Regardless of the form or specific content of the participation contract, both Penn Square and the participant banks treated the participations as assignments of ownership. Both parties expected and intended to transfer ownership of the participated portions of the loans from Penn Square to the participant. The circumstances created by Penn Square's participation transactions reflect the expectation and assumption of participant ownership.

Penn Square originated over $2 billion in energy loans, an amount that greatly exceeded the shopping mall bank's lending limits. The law prohibited the bank from originating and continuing to own this amount of loans. Moreover, if one classified these participations as loans from the upstream banks to Penn Square then, in addition to violating its lending limits, Penn Square also violated its borrowing limits by borrowing over $2 billion from the participants. Furthermore, Continental Illinois did not intend to lend Penn Square $1 billion. Rather, it intended to purchase ownership of $1 billion in energy loans from the Oklahoma bank.

The books and records of Penn Square and the participants evidenced the expectation and assumption of participant ownership. Penn Square's records only showed the unparticipated portions of these loans as assets. The Oklahoma bank purposely failed to list the participated portions of these loans as assets. Instead, each of the participant banks classified its

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453. For that matter, the participants would have been required to show the participations as loans to Penn Square Bank.


It was the mutual intent and understanding of Northern Trust and PSB that each participation agreement conveyed property interests in the underlying loan and associated collateral and created as between Northern Trust and PSB an agency and fiduciary relationship whereby PSB would act as loan administrator on behalf of Northern Trust to the extent of the participation interest sold. Consistent with this intent and understanding, all loan participations purchased from PSB were listed as assets by Northern Trust and reflected on its books as direct loans to the individual borrowers.

*Id.*

455. *See, e.g.*, Brief of Plaintiff, The Chase Manhattan Bank, N.A., in Opposition to Defendant's Motion to Dismiss or for Summary Judgment, *Chase*, 554 F. Supp. 251 (Penn Square carried as asset on its books only portion of indebtedness which it did not sell to Chase); Reply Brief of Defendant in Support of Its Alternative Motion to Dismiss or for Summary Judgment at 21-22, *Chase*, 554 F. Supp. 251.
participations as assets and recorded them on its books as direct loans to the various borrowers. The books and records of all the banks, therefore, demonstrate the desire to sell and assign ownership of the loans and supporting collateral to the participants. Once Penn Square assigned ownership upstream, it retained at most legal title to the loans solely to service the ownership interests of the participants.

In this regard, the district court’s decision in Hibernia appears particularly perplexing. The court incongruously found that while Hibernia owned the loan pool participation, Hibernia did not own the other group of participations. Hibernia purchased millions of dollars in participations from Penn Square. Both Hibernia and the FDIC perceived no difference in intent or expectations between the two groups of participations. Yet the court believed that the parties intended to convey ownership interests in one group and not the other. Such a result, however, makes little sense.

Throughout Penn Square and Hibernia’s continuing participation relationship, Penn Square sold and Hibernia purchased millions of dollars of energy loans. The court’s assumption that Hibernia used the participations as a means to loan millions to Penn Square while it also used the same transactions to purchase millions in loans from the Oklahoma bank lacks commercial sense. Although some of the participation agreements probably failed to explicitly assign ownership of property interests to the participant, the commercial assumptions, intent and actions of Penn Square and the participant banks were very explicit. The Penn Square courts unfortunately failed to recognize the rationale behind or the circumstances surrounding the Penn Square participations. If the courts had done so, their decisions would have recognized parallel commercial expectations. The Penn Square decisions, however, frustrate commercial reality.

The purposive approach advocated in this Article recognizes commercial reality behind the participation transactions. It seeks to define legal relationships so as to further the reasons for their creation. A purposive approach to the Penn Square controversy, therefore, recognizes and protects the ownership interests belonging to the participant. Courts should also use this same purposive approach to evaluate the propriety of borrower/depositor setoff because commercial expectations support setoff.

3. A Purposive Approach to Setoff

a. The Cost/Benefit Equities of Penn Square

The insolvency of any bank creates an extreme and uncertain situation.

456. See supra note 455.

457. Even if the contracts do not explicitly convey ownership, they also are not explicit in not conveying ownership, they also cannot be read as not conveying ownership. The agreement in such a case should be “interpreted as to give effect to the mutual intention of the parties, as it existed at the time of contracting, so far as the same is ascertainable and lawful.” Okla. Stat. tit. 15, § 152 (1985). And, “[i]f the terms of a promise are in any respect ambiguous or uncertain, it must be interpreted in the sense in which the promisor believed, at the time of making it, that the promisee understood it.” Id. § 165.

458. See E. Kane, The Gathering Crisis in Federal Deposit Insurance (1985);
The courts predicated the Scott decisions on their recognition of the difficult circumstances created by bank insolvency. Depositors constitute the group hardest hit by and least able to withstand the consequences of bank failures. Therefore, they constitute the group most deserving of equitable considerations and protections. The government created the Federal Deposit Insurance Corporation precisely for this group and this reason; the right of depositor setoff was and should continue to be recognized.

b. The Expectation of Depositor Setoff

In Scott v. Armstrong, the Supreme Court believed that natural justice formed the basis for borrower/depositor setoff. Here, natural justice means "common sense and fairness." An examination of the situation presented if the borrower/depositor, rather than the bank, defaults or goes bankrupt illustrates this point.

At common law and in bankruptcy law, the bank possesses a right of setoff against the borrower/depositor. In the event the borrower defaults on its obligations owed to the bank, the bank has a right to retain the deposit.


460. FDIC v. Mademoiselle of California, 379 F.2d 660 (9th Cir. 1965).

461. See Mademoiselle, 379 F.2d at 664 (insolvency of lead bank created several inequities).

462. See Isaac, supra note 458, at 200. Isaac notes that one of the principal objectives of deposit insurance is to protect depositors of modest means from the consequences of bank failure because:

The loss by the insolvency of banks falls generally upon the farmer, the mechanic, and the laborer, who are least acquainted with the condition of banks who, of all others, are most illly able to either guard against or to sustain a loss by their banks' failure.

Id. quoting New York Assembly Journal 434 (1829).

463. See id.


465. The commercial expectation of setoff, combined with the hardships borne by the borrower/depositor, ultimately justifies setoff. See infra notes 466-78.


467. The Scott Court found that 

natural justice would seem to require that where the transaction is such as to raise the presumption of an agreement for a set-off it should be held that the equity that this should be done is superior to any subsequent equity not arising out of a purchase for value without notice.

Id. at 508.

468. The Court determined that the parties had an implied agreement of setoff that should be honored. "The set-off of debts due has been universally conceded. The equity of equality among creditors is either found inapplicable to such set-offs or yields to their superior equity."

Id. at 511.

balance as payment on the loan debt.\textsuperscript{470} Thus, a bank that requires its borrower to maintain a collateral collection account or compensating account balance at the bank in effect extracts additional security for the debt from the borrower. If the borrower defaults on its loan obligations, a fund of the borrower's cash is already in the bank and subject to the bank's setoff.

Fairness dictates that if the depository bank fails the borrower/depositor should be allowed the same setoff rights as the bank.\textsuperscript{471} Simply because the borrower/depositor exercises the right of setoff does not change the mutuality of the obligations; nor should setoff change the expectations or assumptions of the parties. Commercial reality dictates that if one party implicitly possesses the right of setoff, then the other party should as well.

It does not make sense to presume that in a commercial context, where two parties are each obligated to the other,\textsuperscript{472} that one of the parties should have the right of setoff and the other should not.\textsuperscript{473} This presumption comprises the \textit{Scott} Court's natural justice of setoff. Although neither borrower nor bank expressly granted the other the right of setoff, fundamental fairness demands that both parties should have the right to set off mutual obligations. Moreover, such natural justice comports with the expectations of the parties and the commercial realities of the relationship created by the transaction.

4. \textit{Participated Loans and the Equity of Setoff}

\textbf{a. The Undisclosed Participation}

A direct legal relationship exists between a lead bank and its borrower/depositor. This direct debtor-creditor relationship creates mutual obligations and thus supports the expectation of setoff. The relationship between that same borrower/depositor and the participant bank, however, is, at best, indirect and, at worst, nonexistent. The borrower/depositor with no notice of the participation transaction possesses no control over the subsequent dealings of its bank. The undisclosed participation, therefore, neither allows the borrower no opportunity to fully evaluate the entire lend-

\textsuperscript{470}. The banker's right to setoff is the common law, equitable right of a bank to apply the general deposits of a depositor against the matured debts of the depositor. This right grows out of the contractual debtor-creditor relationship created between the depositor and the bank at the time the account is opened, and it rests upon the principle that it would be inequitable to permit the debtor-depositor to carry an open account that induces the bank to extend credit, and then allow the debtor to apply the funds to other purposes because he had not expressly agreed to apply them to the debt.

\textsuperscript{471}. \textit{TeSelle, supra} note 469, at 40 (footnote omitted).


\textsuperscript{473}. When the borrower maintains a deposit account at its lending bank, a mutual debtor-creditor relationship is created between the borrower/depositor and the lending/depository bank.

\textit{TeSelle, supra} note 469, at 40 (footnote omitted).
ing transaction, nor informs the borrower that the bank has unilaterally altered the mutuality of their debtor-creditor relationship.

More than likely, the failure of its depository bank hurts this borrower/depositor. Requiring that person or entity, which presumably reached an implicit agreement with its depository bank that granted each party the right of setoff, to bear the economic burden of paying the full amount of its loan and waiting years to recover a fraction of the lost deposit amount seems inequitable. The borrower/depositor becomes aware of nothing that would change its expectations and assumptions about the lending transaction and its relationship with its lending/depository bank. The courts, therefore, should not deprive the uninformed borrower/depositor of its ordinary right of setoff by the unknown and unsolicited actions of its bank.

Upholding the validity of the uninformed borrower/depositor's implied agreement of setoff with its lending/depository bank possesses an undeniable appeal. Setoff comports with the commercial expectations surrounding these types of commercial relationships: the court should not permit lending/depository bank to unilaterally alter these presumptions. A palpable sense of fairness surrounds the Mademoiselle decision that the uninformed borrower/depositor retains the right of setoff against a participated loan. The same does not hold true in the disclosed participation transaction.

b. The Disclosed Participation and the Symmetry of Setoff

As with the undisclosed participation transactions, the disclosed participation reallocates the borrower/depositor's debt obligations among two or more banks. Mutuality of obligations, the recognized basis of setoff, is no longer complete. The critical difference between the disclosed and undisclosed participation transactions revolves around expectations, understandings and assumptions brought to the bargain by each party.

Quite unlike the Mademoiselle borrower, the alleged majority of Penn Square borrower/depositors were informed about the involvement of other banks in making energy loans; indeed, they not only solicited the participants' involvement with Penn Square, but in many instances knew that Penn Square's ability to make the loan depended on upstream funding. These borrowers knew that another bank often advanced the loan funds and, moreover, that the bank would own most of the loan debt.

The Penn Square participations, unlike the undisclosed Mademoiselle participation, did not constitute subsequent, unilateral attempts to alter the understanding and expectations of the parties. The Penn Square borrowers

474. See P. Zweig, supra note 1 (discussing the problems caused for depositors by the failure of Penn Square); M. Singer, supra note 2.

475. Permitting both the bank and the depositor the right of setoff, a right for which they both, according to Scott, implicitly bargained, provides symmetrical treatment of their respective obligations. If the bank has a right of setoff in the event of the borrower's insolvency, then the borrower's right of setoff should also be recognized in the event of the bank's insolvency.

476. As far as the borrower is concerned, nothing has changed the mutuality of their respective obligations or altered the symmetry of their relationship.
expected and needed the involvement of the participant banks in the lending transactions. All the parties, the borrower, Penn Square, and the participant, entered the transaction knowing that ownership of the loan debt, and thus ownership of the borrower's debt obligations, would be divided between Penn Square and the participant bank. The Penn Square participations, therefore, involved different expectations and understandings than those in undisclosed participations.

Arguably, these expectations and understandings might include an implied agreement to refrain from setoff. In short, the participants can argue that the Penn Square borrower/depositors, aware of the participants' ownership of their debt obligations, should not be allowed to cancel their debt obligations owned by one bank (the participant) with funds on deposit in another (Penn Square). This argument, however, ignores the origin of the setoff remedy and the symmetry of the debtor-creditor relationship. Although the borrower's debt is owned jointly, the borrower has one debt obligation. The mutuality of obligations changes somewhat, because the non-depository bank now owns a portion of the debt, but the symmetry of the debtor-creditor relationship remains intact.

A better method of analyzing this issue focuses on the symmetry of the debtor-creditor relationship and the ownership rights of the participant. The participant owns property rights in the loan; moreover, it certainly has a property interest in all payments made on the loan. As an owner, the participant is entitled to receive its share of all payments made on or reductions in the loan debt. Courts should use this premise as a basis to further both the borrower's expectations of setoff and the participant's expectation of payment. The logical result, therefore, permits borrower/depositor setoff against all loans, ignoring the participant's involvement, and treats each setoff as a payment on the loan debt. This approach allows the participant to receive its undiminished pro rata share of the payment.

5. The Participants' Right to a Preferred Claim

In permitting borrower/depositor setoff against all participated loans, the

477. In certain instances, the participant bank may even have a property interest in the funds in a borrower's account(s) at Penn Square. This is particularly true of a collateral collection account that holds the proceeds of production from mortgaged oil and gas properties.

478. Penn Square acted as the participants' servicing agent or, in the case of Hibernia and Seafirst, trustee. It was obligated to receive payments from the borrowers, hold the payments for the participants and then remit the funds to them in accordance with their respective agreements.

The example of the defaulting or insolvent borrower clarifies the effect of the setoff and the rights of the participants.

If a defaulting borrower has $50,000 on deposit in Penn Square and $100,000 in outstanding loan debt (90% of which is owned by an upstream bank), then Penn Square has a right to apply the funds in the deposit account against the loan debt. But Penn Square does not have a right to retain the entire $50,000. Instead, a contractual obligation requires it to treat the setoff as a payment. Therefore, the ninety percent participant has a property interest in and a right to receive $45,000 of those funds.

479. This analysis assumes that the participant and the borrower reached no express agreement that precludes setoff.
courts must protect the ownership interests of the participants and recognize the effect of the setoff on the insolvent lead's estate. The setoff represents a payment on the loan; it reduces the amount of indebtedness owing on the loan. In canceling Penn Square's deposit liabilities, the Penn Square setoffs also cancelled debt owned by the participants. As the owners of property interests in these loans and loan debt, the participants have ownership interests in the funds canceling that debt. Moreover, the contractual relationship created by the participations made Penn Square the participants' servicing agent for receiving payments on the loans. The Oklahoma bank, therefore, operated under an obligation to hold a pro rata portion of all payments on or reductions in the loan debt for the benefit of the participants. Each participant thus should receive its undiminished pro rata portion of these payments, particularly when the setoff actually increases the value of the insolvent estate. The following example demonstrates this point:

At the time Penn Square is closed, Borrower's outstanding loan balance is $100,000. Ninety percent of the loan is owned by an upstream participant. As a result, Borrower has a $100,000 liability; correspondingly, Penn Square owns a $10,000 asset and the participant owns a $90,000 asset.

Borrower also has $50,000 on deposit in Penn Square. Therefore, Borrower owns a $50,000 asset; Penn Square owns a $50,000 liability. The application of the deposit account funds ($50,000) against the total loan debt, completely extinguishes the deposit liability of Penn Square. Yet, the only asset that Penn Square's estate owns is $10,000 of Borrower's loan. Through the setoff, Penn Square's estate appropriates and cancels $40,000 of value that belongs to the participant and enhances its estate because it avoids a $50,000 liability at a $10,000 cost.

Under the Penn Square liquidation scheme, the participant receives the benefit of the setoff in the form of a receiver's certificate for a general claim in the amount of $40,000. At the time of this writing, that receiver's certificate has a value of just slightly over half of its face amount. The insolvent estate thus captured $40,000 of value belonging to the participant for which it paid that participant only $20,000 over a period of almost four years. The estate, therefore, profited by over $20,000.480

The bookkeeping nature of the setoff confused the Penn Square courts: the courts simply saw a cancellation of assets and liabilities, a mere shifting of credits and failed to recognize the participant's ownership of a $90,000 asset. The courts, therefore, misunderstood whose credits were being shifted. Then, the courts failed to see the value that Penn Square's estate derived from the setoff and compounded their error.

The participants owned their respective portions of the loans. Moreover,

480. Given the finance stress and strain on the regulatory system and the insurance fund, in the present environment it is very likely that anything — legal principle or otherwise — would be rejected if it was perceived to increase the cost of managing bank and savings and loan failures. With a very difficult and expensive job ahead of them, it can be expected that the FDIC and RTC will claim every advantage and opportunity that they may have to keep down the costs of liquidations that will be borne by the taxpayers.
Penn Square was obligated to act as the participants' servicing agent or fiduciary. Penn Square's estate, therefore, should not retain the $40,000 real dollars created by the setoff in the above example, thereby reducing the total loan indebtedness and extinguishing property rights owned by the participant, and pass along to the participant $40,000 discounted dollars in the form of a general claim. The participant and no one else, particularly Penn Square or the FDIC, owns the $40,000. $40,000 of the credits being shifted in the setoff belong to the participant, not to Penn Square. The asset that belongs exclusively to the upstream bank should not be extinguished without fully compensating the participant.

Moreover, the Penn Square courts ignored the effect of the setoffs in increasing the estate. As the above example demonstrates, the setoff increases the estate in the hands of the receiver by $40,000. That $40,000 constitutes a specific fund to which the participant, who owns that asset, can attach a preferred claim.481

The Penn Square courts correctly stated that "[n]o term in the participation certificate precluded passing on an offset to the upstream bank."482 The courts, however, pass on to the upstream bank the full benefit and effect of the setoff. As a result, the setoffs took participant property rights at a price far less than their value and thus retained the benefit for the estate. The commercial expectations and understandings of the parties do not support this result.

The Penn Square decisions deny the very reasons, expectations and understandings that represent the basis for loan participations in general and the Penn Square participations in particular. A better approach to these types of commercial controversies seeks to define the legal rights and relationships that are created in accordance with their commercial purposes. If the Penn Square courts had used this type of purposive analysis, then their analysis would make commercial sense.

VIII. FINAL OBSERVATIONS

The language chosen by the parties in their agreements and certificates may have had commercially perilous consequences, and indeed these may be perilous times for banks generally; but the solution lies in better draftsmanship of participation certificates.483

If indeed financial institutions face perilous times, then the Penn Square courts have done very little to help. In fact, their findings and their analyses

481. It should be noted that this Article was written prior to the enactment of the Financial Institutions Reform, Recovery and Enforcement Act's restructuring of the entire banking regulatory and liquidation environment. This Article expresses no opinion on the rights, powers and duties of the FDIC and RTC under FIRREA.

482. Northern, 619 F. Supp. at 1343-44.

483. Id. at 1343.
are inconsistent and often conflicting. Perhaps the cynical would say that the Penn Square decisions' real lesson about loan participations is: Don't. Often the language, intent, actions, understandings, and expectations of Penn Square Bank and the participant banks were clear. Given the "equities" at work, one wonders what kind of better draftsmanship would have changed the results of the Penn Square decisions.

484. The risk of this kind of setoff is best avoided by avoiding participations. Whenever possible, the transaction should be structured as an agented credit with each bank holding a note from the borrower in an amount equal to its pro rata share of the loan. See Essay, supra note 6, at 271. But when separate notes are not practicable, bank counsel should give careful thought to the terms of the participation agreement.