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THE FDIC AND OTHER FINANCIAL INSTITUTION INSURANCE AGENCIES AS "SUPER" HOLDERS IN DUE COURSE: A LESSON IN SELF-POLLINATED JURISPRUDENCE

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Scott A. Meacham**

Historically, the major players in the credit market have been the obligor, the obligee, and, in the case of debt arising from a sale, the assignee of the obligee. If the debt was evidenced by a promissory note, the Uniform Commercial Code (UCC) provided the rules of law that governed the interaction and relationships of these parties with respect to the debt. For example, the UCC determined the liability of the obligor on the instrument. Where the instrument was negotiated by the payee, the assignee knew that it could obtain a special status known as "holder in due course" (HDC) by meeting the requirements for that status under the UCC. The HDC status protected

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2. Under U.C.C. § 3-305 (1978), a holder in due course (HDC) takes the instrument free of all claims and defenses except defenses of a party to the instrument with whom it has dealt and a few specified defenses that are "real defenses." Conversely, a person who is not a HDC takes subject to all valid claims to the instrument on the part of any person and all defenses of any party that would be available in an action on a simple contract. U.C.C. § 3-306 (1978).


The UCC imposes five conditions that must be met to be a holder in due course:

1) The person must be a holder,
2) of an instrument,
3) for value,
4) in good faith, and
5) without notice that the instrument is overdue or has been dishonored or of any defense against or claim to it on the part of any person.


A "holder" is defined as "a person who is in possession of . . . an instrument . . . drawn, issued or indorsed to him or to his order to bearer or in blank." U.C.C. § 1-201(20) (1978). An "instrument" means a negotiable instrument. Id. § 3-102(1)(e). In context, a negotiable instrument is a writing signed by the maker which contains an unconditional promise to pay a sum certain in money and no other promise, order, or obligation except as permitted by law, and which is payable on demand or at a definite time and is payable to order or to bearer. Id. § 3-104(1).

A holder of an instrument, even if taken for value, in good faith and without notice, however, does not become a HDC of the instrument:

(a) by purchase of it at judicial sale or by taking it under legal process; or
(b) by acquiring it in taking over an estate; or
the assignee against claims of other parties to the instrument and most defenses of the obligor to the payment obligation contained in the instrument. These relationships were relatively settled, and the parties could take comfort in knowing what their relative rights and liabilities were at any given time.

This assumption has been dramatically changed in the wake of a wave of recent financial institution failures with the introduction of the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) as new players. The FDIC and the FSLIC have contended that because they are governmental entities with the duty of protecting the safety and stability of the financial services system, they should not have to play by the same commercial law rules. Both the FDIC and the FSLIC have been able to convince some federal courts that they should be accorded a unique status when seeking to enforce the obligations formerly held by a failed financial institution. The result is that a series of recent cases have

(c) by purchasing it as part of a bulk transaction not in regular course of business of the transferor.

Id. § 3-302(3).
3. Id. § 3-305.
4. These principles go back as far as Miller v. Race, 1 Burr. 452, 97 Eng. Rep. 398 (K.B. 1758).
5. The number of bank failures has risen 1,100%, from 10 in 1981 to 120 in 1985. During this same period, the number of problem banks has risen 411%, from 223 to 1,140. CENSUS BUREAU, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES, No. 810 (1987).
6. To date, no reported case involving the National Credit Union Administration insurance program has been located. However, it appears the same considerations would be involved as with the FDIC and FSLIC. Also, 12 U.S.C. § 1787(i)(2) (1982) closely follows the wording of 12 U.S.C. § 1823(e) (1982), which often is considered a root of authority for the FDIC exercise of the super powers discussed in this article.
7. The FDIC may acquire obligations owed to failed banks in the course of paying off depositors. The FDIC has two basic methods of paying off the depositors of a failed bank: direct pay-off and liquidation of the assets, or a purchase and assumption transaction. In a purchase and assumption, the FDIC as receiver arranges for a financially stable bank to "purchase" the failed bank and reopen without disruption of banking operations or loss even to uninsured depositors. For that reason, this is the preferred method. The FDIC, as corporate insurer, agrees to purchase the unacceptable or substandard assets of the failed bank either from the purchasing bank or the FDIC as receiver, depending on how the particular purchase and assumption transaction is structured. Then, the FDIC in its corporate capacity proceeds to liquidate these assets to obtain reimbursement for the funds it advanced from the insurance fund. Additional reimbursement is provided by any premium the purchasing bank may have paid for the failed bank's deposits and good assets. Hence, the FDIC can be acting in two capacities: as receiver and as corporate insurer. See generally FDIC v. Leach, 772 F.2d 1262 (6th Cir. 1985); Gunter v. Hutcheson, 674 F.2d 862 (11th Cir.), cert. denied, 459 U.S. 826 (1982); Norcross, The Bank Insolvency Game: FDIC Superpowers, the D'Oench Doctrine, and Federal Common Law, 103 BANKING L.J. 316, 318-19 (1986); Burgee, Purchase and Assumption Transactions Under the Federal Deposit Insurance Act, 14 FORUM 1146, 1151-58 (1979).

Courts have awarded the FDIC holder in due course status under federal law only in its corporate capacity for the reasons discussed later in this article. Otherwise, in this context, the FDIC as receiver stands in the same position as the bank (except, perhaps, as altered by 12 U.S.C. § 1823(e) (1982)).

In contrast, the cases involving the FSLIC have involved that agency as receiver for the insolvent savings and loan association. See, e.g., Lupin v. FSLIC, Nos. 85-5896, 86-828, 86-1126 (consolidated) (E.D. La. Mar. 30, 1987), where the court adopted the Gunter rule to bar the obligor's defenses of fraud and securities laws violations but did not seem to realize the significance
declared that when the FDIC or the FSLIC acquires an obligation in connection with a failed financial institution, they are entitled to something akin to the status of a HDC under federal law. They are given this status even though they would not be considered a HDC in these circumstances under the UCC.**

Neither the FDIC nor the FSLIC could be a HDC under the Code in these cases because they are purchasers in bulk in a transaction that is not in the regular course of business of the transferor. In addition, the obligations that the FDIC or the FSLIC acquire often are in default, and under the Code there can be no HDC on a note that is transferred with notice that it is overdue. Further, to be a HDC, one must first be a holder. Because the FDIC and the FSLIC are purchasers in bulk, the instruments acquired are not indorsed. Thus, it is unlikely that they could ever achieve HDC status. Also, the FDIC or the FSLIC often would have notice from either the institution’s records or the terms of the instrument itself that the obligor has a potential defense, and such notice is fatal to HDC status. Finally, many notes acquired today will be nonnegotiable instruments. The UCC provides HDC status only with respect to negotiable instruments.

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of the FDIC operating in its corporate capacity. The same failing is evidenced in the Hsi case cited *infra* at note 8.


9. *Compare U.C.C. § 3-302(3)(c) (1978) with, e.g., Gunter, 674 F.2d at 873. In the Gunter case, the court held that the obligor’s fraud claims against the insolvent bank were no defense where the FDIC acquired the note in execution of a purchase and assumption transaction, for value, in good faith, and without actual knowledge of the fraud at the time the FDIC entered into the purchase and assumption agreement. See also FDIC v. Leach, 772 F.2d 1262, 1267 (6th Cir. 1985) (court adopted Wood rule and held obligor and guarantor’s defense of failure of consideration was barred); FDIC v. Wood, 748 F.2d 156, 161 (6th Cir.), cert. denied, 106 S. Ct. 308 (1985) (court adopted the Gunter rule to bar usury claim of guarantor of the note).*

10. U.C.C. § 3-302(3)(c) (1978). *See comment 3 to the section: “It has particular application to the purchase by one bank of a substantial part of the paper held by another bank which is threatened with insolvency and seeking to liquidate its assets.”*


12. Id. § 3-302(1).

13. Id. While they would have the rights of the institution as a holder under U.C.C. § 3-201, that would not create a foundation for HDC rights; and the institution itself, if the defense is good, cannot assert HDC rights. Id. § 3-305(2).

14. Id. §§ 3-302(1), 1-201(25). *See also F. MILLER & A. HARRELL, supra note 2, at 104-10.*

15. A variable rate note is not a negotiable instrument. *See Northern Tr. Co. v. E.T. Clancy Export Corp., 612 F. Supp. 712 (N.D. Ill. 1985); Farmer’s Prod. Credit Ass’n v. Arena, 145 Vt. 20, 481 A.2d 1604 (1984). Some notes also will fail of negotiability because their terms subject them to another agreement, usually a mortgage or security agreement. See, e.g., Holly Hill Acres, Ltd. v. Charter Bank, 314 So. 2d 209 (Fla. App. 1975). If the note is a consumer obligation, either or both of state and federal law may operate to preclude negotiability or the HDC aspect of that concept. See, e.g., U.C.C.C. §§ 3.307, 3.404 (1974); Federal Trade Commission Trade Regulation Rule on Preservation of Consumers’ Claims and Defenses, 16 C.F.R. § 433 (1975).*

16. U.C.C. § 3-305 (1978). A status similar to that of HDC may be the result of a “waiver
Nevertheless, the FDIC and the FSLIC have been accorded HDC status as a matter of federal law and not under the UCC. The UCC has not been enacted by Congress for federal transactions; and in these cases, because of the involvement of a federal instrumentality, the liability of the obligor on the note involves federal and not state law. Since no federal statute or regulation specifies HDC status for the FDIC or the FSLIC, the issue is whether the federal common law rule should be fashioned after that of the Code or whether a different rule should apply. The courts rendering the decisions so far have concluded that the rule should vary from that of the Code.

This article analyzes the reasoning used by the federal courts in fashioning a federal common law rule different from that of the Code. Then it suggests that the rationale employed by these courts is flawed, fails to support the rule, and fails to properly account for the negative impact of such a rule on commercial transactions. This article thus argues that the FDIC and the FSLIC (and any similar financial institution insurance agency) should play by the rules provided by the UCC.

The Bases for HDC Status

The analysis of the cases affording HDC status upon the FSLIC appears to be wholly dependent on the cases according that status to the FDIC. Thus, an independent discussion regarding the FSLIC will not be undertaken. Since no reported case has been decided involving the insurance instrumentality for credit unions, likewise no independent discussion will be presented in that regard.

With respect to banks and the FDIC, the federal common law rule that protects the FDIC from most defenses of the maker of a note appears to arise for one or more of three reasons. The first reason is the case of D'Oench

of defenses clause (see, e.g., id. § 9-206), but such clauses seldom if ever appear in notes because the law itself accords HDC status law if the holder and the instrument qualifies.


18. This point of view has been defended. See, e.g., Platt & Darby, A Primer on Special Rights and Immunities of the Federal Deposit Insurance Corporation, 11 Okla. City U.L. Rev. 683 (1986).

19. For example, in Lupin v. FSLIC, Nos. 85-5896, 86-828, 86-1126 (consolidated) (E.D. La. Mar. 30, 1987), the court stated that the common law rationale and policy enunciated in the D'Oench decision is an independent basis [from 12 U.S.C. § 1823(e) (1982), which "codifies" the D'Oench doctrine, but which only applies to the FDIC] for protecting both the FDIC and the FSLIC from secret agreements and other defenses such as fraud, failure of consideration, and estoppel. However, to the extent the doctrine has only been used to protect the FDIC in its corporate capacity, a qualification should be drawn. In the Lupin case, the FSLIC brought suit as receiver. This was also true in the other FSLIC cases cited in note 8, supra. In this context the FDIC has not been awarded HDC status, and under the analysis used by the courts deciding the issue, there is no justification to extend protection beyond the concept of section 1823(e) and to the emphasized situations. See Gunter v. Hutcheson, 674 F.2d 862, 873 n.15 (11th Cir. 1982) (distinguishing FDIC v. Meo, 505 F.2d 790 (9th Cir. 1974), where fraud was held to be a defense to an action by the FDIC acting only in its capacity as a receiver).
Duhme & Co. v. Federal Deposit Insurance Corp., as codified and limited by section 1823(e) of title 12 of the United States Code. The second reason for the rule is an analysis predicated upon United States v. Kimbell Foods, Inc., which requires that several factors be balanced, including the need for a uniform rule, the policy objectives of the FDIC, and the potential harmful impact on state commercial transactions of adopting a rule of law contrary to state law. A final reason for the rule derives from the frustration that courts have experienced in trying to draw lines as to which state law defenses section 1823(e) knocks out. These courts have simplified the problem by expanding the statutory rule to knock out all defenses that would not be good against a holder in due course on the theory that this reflects the will of Congress. Each of the three bases for the rule is examined in turn.

The D'Oench Doctrine

In D'Oench the FDIC brought suit on a demand renewal note executed by D'Oench, Duhme & Co. (D'Oench) and payable to the Belleville Bank & Trust Co., which had been charged off by the bank. D'Oench had sold the bank certain bonds, which later defaulted. The predecessor notes to the renewal note were executed to enable the bank to avoid showing any past due bonds as assets. However, the receipts for the notes clearly indicated that they were not to be called for payment and that the interest payments made were to be repaid. In short, a side agreement contradicted the face value of the obligation.

The Court stated that the liability of D'Oench on the note was a federal question governed by federal law. It concluded that the statutes governing the FDIC revealed a federal policy to protect the FDIC and the public funds that it administers against misrepresentations by way of secret agreements, the effect of which is to diminish the value of the assets of banks the FDIC insures or to which the FDIC makes loans. Thus, the Court held that a person who executes an instrument that is in the form of a binding obligation is estopped to assert as a defense the fact that the parties simultaneously secretly agreed that the instrument should not be enforced.

Congress responded to D'Oench by enacting section 1823(e) of title 12 of the United States Code. Section 1823(e) invalidated contemporaneous

24. Id. at 456.
25. Id. at 457-58.
26. Id. at 459.
27. 12 U.S.C. § 1823(e) (1982) provides:
   No agreement which tends to diminish or defeat the right, title, or interest of the Corporation [i.e., the FDIC] in any asset acquired by it under this section, either as security for a loan or by purchase, shall be valid against the Corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the bank
agreements that diminished the face value of assets such as in the D'Oench case, unless they were clearly reflected on the records of the bank for all, including the FDIC, to see. Nothing in the statute, however, speaks to the invalidity of a defense not arising from a contemporaneous secret agreement, such as usury, fraud, or the like.

Nonetheless, in Federal Deposit Insurance Corp. v. Rockelman,\(^{28}\) the FDIC was accorded protection from such defenses. In Rockelman the FDIC sued the maker of a note who raised fraud as a defense. The alleged fraud consisted of assertedly false statements made to induce the purchase of stock. The note was given as the purchase price for this stock. Without analyzing whether either the D'Oench rule or section 1823(e) was applicable, and without citing any authority, the court stated:

[T]he court concludes that, although the FDIC, in its corporate capacity, is not a holder in due course within the meaning of that term under the Uniform Commercial Code, Congress intended by means of section 1823 to clothe the Corporation with the protections afforded a holder in due course and shield the Corporation against many defenses that would otherwise be available.\(^{29}\)

Such a bold assertion without supporting authority on a law school exam would receive an unsatisfactory evaluation. But courts are different. Thus, the court in Gunter v. Hutcheson\(^{30}\) also found that D'Oench provided a general basis for a federal policy to protect the FDIC and that section 1823(e) was designed to broaden this protection so as to enhance the federal policies that favor protecting the banking system. As a result, the Gunter court believed these policies supported its federal common law holding that the maker of a note under facts similar to those in the Rockelman case was precluded from asserting fraud as a defense to his liability on the note.\(^{31}\)

In fact, however, the intent of Congress appears to be quite to the contrary. As the court in Federal Deposit Insurance Corp. v. Blue Rock Shopping Center, Inc. points out,\(^{32}\) one of the purposes of section 1823(e) was to codify the D'Oench rule. Further, the court noted that, by its terms, section 1823(e) does not protect the FDIC against all defenses. The Blue Rock court quoted from the congressional comment on the purpose of the section:

\[\ldots\]

and the person or persons claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the bank, (3) shall have been approved by the board of directors of the bank or its loan committee, which approval shall be reflected in the minutes of said board or committee, and (4) shall have been, continuously, from the time of its execution, an official record of the bank.

29. 460 F. Supp. at 1003.
30. 674 F.2d 862 (11th Cir.), cert. denied, 459 U.S. 826 (1982).
31. Id. at 872 n.14.
32. 766 F.2d 744 (3d Cir. 1985).
[U]nder section 13(e) of this measure [1823(e)] as amended certain conditions for the first time are imposed upon a bank in the event agreements are entered into between customers of the bank and the bank. Prior hereto and up to the time of an unfortunate interpretation of the law it was believed that all legal agreements entered into by the bank and obligor were binding on the Corporation. 96 Cong. Rec. 10,731 (1950).\(^{33}\)

More extensive evidence of Congress’ true intent with regard to section 1823(e) is provided by the two other references to section 1823(e) in the legislative history of the provision.\(^{34}\) The first reference exists in the committee hearings on the Federal Deposit Insurance Corporation Act of 1950.\(^{35}\) This reference clearly indicates that, enacting section 1823(e), Congress was only thinking of contemporaneous, secret, and unwritten agreements between the

33. *Id.* at 753 n.26 (emphasis by the court).
34. The lack of legislative history itself suggests that Congress did not consider that it was making any extensive or controversial changes in existing law. The major debates on this bill were whether the amount of insurance should be increased from $5,000 to $10,000, whether the assessment methods should be modified, and whether the FDIC should have expanded examination authority. See Amendments to Federal Deposit Insurance Act, 1950: Hearings on S. 2822 Before the Comm. on Banking & Currency of the House, 81st Cong., 2d Sess. (1950) [hereinafter Hearings]. In fact, one congressman, after presenting the proposed changes in these areas to the House of Representatives for consideration, made the following comment regarding the other changes made by the bill: “There are numerous little changes in the law which, growing out of experience, are largely administrative changes. I have mentioned to you, however, I believe, the only major changes which the law contemplates.” S. 2822, 81st Cong., 2d Sess., reprinted in 96 Cong. Rec. 10649 (1950) (statement by Rep. Smith). Certainly, a provision intending to give the FDIC HDC status as a matter of federal law would have been a major and perhaps controversial change.
35. In committee hearings on the Federal Deposit Insurance Corporation Act of 1950, the following discussion took place between Representative Multer and H. Earl Cook, Director of the Federal Deposit Insurance Corporation:

Mr. MULTER. There has been considerable litigation through the years during the existence of the Corporation [i.e., the FDIC] in which contentions have been made that agreements between the banks and debtors have not been lived up to after the banks were closed down and that the FDIC, in collecting the assets of the bank, was put in a more favorable position than the bank itself would have been and that the FDIC could ignore the agreements with the debtors. . . . Can you tell us briefly whether or not there is any objection to putting into this proposed law an amendment to require the FDIC to comply with any such agreements that have been made in good faith and which are properly recorded between the debtors and the banks?

Mr. COOK. I think that statement of yours covered the ground entirely—where you are properly supported by such agreements and are not dependent upon oral agreements that have no binding effect.

Mr. MULTER. I think the policy of your bank [the FDIC] is to honor any such bona fide agreement.

Mr. COOK. We never back away from a bona fide agreement, and when the record is clear we inherit the obligation and stand by it. We cannot be bound when there is no record.

*Hearings, supra* note 34, at 41-42.
bank and the customer that would reduce the apparent value of the obligation. Certainly, there was no intent that section 1823(e) would act to bar other defenses arising from the transaction, such as fraud in the inducement.

Indeed, Congress' intent in adopting section 1823(e) was apparently to restrict the FDIC's powers, not to expand them. Congress believed that the FDIC generally should stand in the shoes of the failed bank with regard to defenses by obligors. As one congressman stated in offering a friendly amendment to section 1823(e):

It was never the intent of Congress to give the Corporation [i.e., the FDIC] a stronger position than that of the bank and the adoption of the amendment . . . is offered to prove that heretofore it was the intent of Congress that any agreement in the absence of fraud, was binding on the Corporation.36

The amendment passed.37 Hence, it appears that in enacting section 1823(e), Congress intended only to estop a debtor who has committed a fraud from enforcing the terms of a contemporaneous, secret, and unwritten agreement against the FDIC.

Clearly, the facts do not support the assertions in Rockelman and Gunter that Congress intended for the FDIC to be accorded HDC status as a matter of federal common law. If the FDIC and the FSLIC are to be holders in due course as a matter of federal common law in situations beyond what state law would afford, the basis for that position must come from another source.

The Kimbell Foods Basis for HDC Status

A second reason for the federal common law rule that affords the FDIC protection akin to that of a HDC is the Eleventh Circuit case of Gunter v. Hutcheson.38 The Gunter case involved a suit brought by the obligors for rescission of a $3 million note. The obligors claimed that the failed bank's officers and directors fraudulently induced them to execute the note by misrepresenting various aspects of a transaction in which the obligors had agreed to purchase the stock of another bank. Subsequent to the obligors' purchase of that bank's stock, that bank also failed. The fraudulent misrepresentations claimed by the obligors included the following: that the first bank would leave a $7 million certificate of deposit for at least one year in the bank purchased by the obligors; that the obligor's bank would have a federal funds line of $1 million through the first bank; that the first bank was in sound financial condition and would continue to offer sound financial support to obligors' bank; that obligors' bank would net $500,000 per year

37. Id.
38. 674 F.2d 862 (11th Cir.), cert. denied, 459 U.S. 826 (1982). The court cited its result as being consistent with Rockelman, 460 F. Supp. 999 (E.D. Wis. 1978), which of course it is, but that is hardly persuasive given the weakness in Rockelman's analysis. The court also cited Gilman v. FDIC, 660 F.2d 688 (6th Cir. 1981), but Gilman simply cited the district court opinion in Gunter.
and obligors' would make enough in dividends to pay the interest on their notes; and that the interest on the notes would be deferred in certain instances.  

The FDIC counterclaimed for payment of the note, relying both on section 1823(e) and on the notion that the FDIC was a HDC under federal common law. The FDIC was granted summary judgment by the district court. The court of appeals upheld the district court's decision, holding that even though some of the obligors' defenses were not based on secret agreements and, thus, were not barred by section 1823(e), they nevertheless were barred by the HDC rule of federal common law.  

In reaching its decision, and in fashioning this rule of federal common law, the court used the test outlined by the Supreme Court in United States v. Kimbell Foods, Inc. The court concluded that although state law furnished a uniform rule, the state law rule did not adequately advance the purposes of the federal program involved. First, the court reasoned that the decisions necessary for the FDIC to determine the appropriate method to handle a bank failure must be made expeditiously to preserve the going concern value of the bank. Second, the court thought that subjecting the FDIC to unlimited potential loss due to claims and defenses it did not have time to evaluate would make it nearly impossible for the FDIC to utilize the preferred purchase and assumption method. Further, the court reasoned that the FDIC could legally use the purchase and assumption method, as opposed to other available methods, only when the purchase and assumption method will reduce risk or avert a loss to the insurance fund.  

Finally, the court reasoned that imposing a different federal rule would not disrupt commercial relationships predicated upon state law because there could have been a HDC under state law. Thus, the court ruled that the FDIC is protected from fraud claims when it acquires a note in execution of a purchase and assumption transaction, in good faith, for value, and without actual knowledge of the claims at the time of entering into the purchase and assumption transaction.

39. 674 F.2d at 866 n.5.  
40. Id. at 865.  
41. Id. at 873.  
42. 440 U.S. 715 (1979). The Kimbell test for selecting an appropriate federal rule of common law involves a balancing of the following factors: the need for a uniform federal rule; whether application of the state law rule as the federal rule would frustrate specific objectives of the federal program involved; and the extent to which application of a federal rule different from the state law rule would disrupt commercial relationships predicated on state law. Id. at 728-29.  
43. For a description of a purchase and assumption transaction, see Gunter, 674 F.2d at 865-66. A problem would exist, according to the Gunter court, if HDC status were not granted to reduce potential loss. In a liquidation the maximum liability of the FDIC is fixed by the $100,000 per depositor insurance limitation; but in a purchase and assumption transaction, the FDIC agrees to purchase in its capacity as corporate insurer any unacceptable assets. Thus, in a purchase and assumption transaction the FDIC could incur obligations beyond $100,000 per depositor. Id. at 870 n.10.  
44. Id. at 873. The court also believed any other result would gut section 1823(e) as the obligor could merely assert as fraud the failure to perform the same unwritten agreement, the breach of which may not be asserted against the FDIC under section 1823(e). Id. at 871-72.
The Sixth Circuit was the next court to adopt the federal common law HDC rule to protect the FDIC. In Federal Deposit Insurance Corp. v. Wood,\textsuperscript{43} the FDIC brought suit in its corporate capacity against a guarantor on a note that the FDIC had acquired as part of a purchase and assumption agreement.\textsuperscript{46} The guarantor raised the defense that the note was usurious under state law, a defense clearly beyond the purview of section 1823(e). Applying a Kimbell Foods analysis,\textsuperscript{47} the court concluded that the FDIC takes free of all defenses that are not good against a HDC where the FDIC, in its corporate capacity, acquires a note as part of a purchase and assumption transaction, for value, in good faith, and without actual knowledge of any defenses.\textsuperscript{48} Moreover, this opinion explicitly goes beyond HDC status under state law to "super" HDC status. The FDIC was held to have no duty to examine the assets of the failed bank before it agrees to execute a purchase and assumption transaction. The fact that the note had a stated rate higher than the legal rate and that the note was in the bank's files was not sufficient to put the FDIC on notice as to the possible defense.\textsuperscript{49}

Finally, in another recent case, Federal Deposit Insurance Corp. v. Leach,\textsuperscript{50} the court used similar reasoning and held that the obligor's and guarantor's defenses of failure of consideration could not be asserted against the FDIC. The claimed defense arose out of a real estate transaction where the note was given to the vendor to secure the release of the real estate. The vendor assigned the note to the failed bank but never conveyed the real estate. Once again, the court held that since the FDIC in its corporate capacity did not have actual knowledge of this defense, the defense could not be asserted against the FDIC.

**Line-drawing Difficulties Under Section 1823(e) as a Basis for HDC Status**

The last reason for the decisions awarding HDC status to the FDIC is the judicial expansion of the scope of section 1823(e) because of the difficulty

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With all deference, fraud and breach of contract are not the same and, in any event, the result outstrips this rationale when it extends to defenses the court itself admitted were not based on an agreement and thus not barred under section 1823(e).

45. 758 F.2d 156 (6th Cir. 1985).

46. The FDIC can bring suit in its capacity as a receiver of the failed bank or in its capacity as a corporate insurer. The Gunter decision limited the HDC rule to the latter context where the note was acquired in a purchase and assumption transaction. 674 F.2d at 872. The Lupin decision, discussed supra note 19, which affords the FSLIC similar rights, overlooks or ignores this fundamental point and is flawed for that reason.

47. 758 F.2d at 159-61.

48. Id. at 161. The cases relied on as authority are, essentially, Gunter and Gilman. Thus, the self-pollination process proceeds apace.

49. Id. at 162. The court's approach eliminates the no-notice (as opposed to no actual knowledge) requirement for a HDC for all practical purposes. Under this standard, it is hard to conceive when the FDIC would ever have notice of a claim or defense in the ordinary purchase and assumption transaction. In addition, since being bound by notice from the records of the bank is implicit in section 1823(e), this ruling deviates even farther from the apparent intent of Congress as to the status of the FDIC.

50. 772 F.2d 1262 (6th Cir. 1985).
in deciding which defenses section 1823(e) was intended to knock out. Expansion eliminates the need to draw lines to prevent circumvention of the section. This analysis was readily apparent in the Gunter case. The Gunter court believed the Gunter's' fraud claims were not barred by the express language of section 1823(e) because the Gunter's' defenses were not based on an oral agreement. Instead, the Gunter's claimed that no valid obligation existed because of the fraud in failing to perform certain oral agreements. The court nevertheless barred the Gunter's defenses, reasoning that if the Gunter's were allowed to assert their fraud defenses in this instance, "the obligor would successfully thwart the 'no agreement' protection of § 1823(e) by asserting as fraudulent the same unwritten agreement of which a breach ... may not under § 1823(e) be asserted against the FDIC." Thus, it is apparent that the court was mistakenly concerned with not allowing the Gunter's to circumvent section 1823(e), even though by its terms section 1823(e) clearly did not apply.

A recent case that clearly shows the courts' difficulty in determining the scope of section 1823(e) and which opted for expansion of the section to avoid difficult line drawing is Federal Deposit Insurance Corp. v. Langley. Langley involved a real estate transaction where the failed bank misrepresented loan terms and the amount of acres and corresponding mineral rights in the underlying property. The obligors contended that the misrepresentations concerning the amount of acres in the property and its mineral rights were outside section 1823(e).

The court, however, said that the defenses were part of an overall undisclosed arrangement with the failed bank concerning both loan terms and the property to be purchased. The court believed that "to allow the Langleys to shift the focus of their defense in the instant case would create an unacceptable 'end run around § 1823(e)'." By expanding the concept of "agreement," the court held that the obligor's defenses emanated from an agreement that had the effect of misinforming the FDIC and, thus, was barred by section 1823(e). In essence, the court expanded the scope of section 1823(e) because it could not draw an effective line between those defenses that are a part

51. 674 F.2d at 867.
52. Id. at 871-72 (quoting FDIC v. Lattimore Land Corp., 656 F.2d 139, 146 n.13 (5th Cir. 1981)).
54. Id. at 546.
55. Id. In reaching its decision, the court cited itself as being "strong authority" for the proposition that the language of section 1823(e) is "all encompassing." Id. at 545. Interestingly, the court believed it was effectively blocked from resting its decision on the HDC concept because the bank failed after it had brought suit against the obligors and the defenses had already been raised. Thus, the FDIC arguably had actual knowledge of these defenses. The court indicated that knowledge of an agreement raising defenses is irrelevant in relation to section 1823(e), which appears literally to be true.

In affirming the Fifth Circuit, the Supreme Court stated that as a matter of contractual analysis the bank made certain warranties regarding the land, the truthfulness of the warranties was a condition to performance of the debtors' obligation to repay the loan, the warranties were a part of the accepted meaning of the word "agreement" in a commercial context, and it could be "safely assumed" that Congress did not mean to use the word "agreement" in a narrower sense in section 1823(e). 56 U.S.L.W. 4026, 4027-28 (U.S. Dec. 1, 1987).
of the agreement itself and those defenses that are collateral to the agreement, but which arise out of the same transaction.

*A Criticism of the Kimbell Foods Analysis as a Basis for HDC Status*

The decisions awarding HDC status to the FDIC depend on a rule of federal common law that differs from the UCC rule. In *Kimbell Foods*, the Supreme Court held that, once it is determined that federal law governs, the question of whether to adopt state law as the federal rule or to fashion a different federal rule depends on a balancing of several factors. The factors that a court must balance are: the need for a national uniform body of law; whether application of the state law rule would frustrate specific objectives of the federal program; and the extent to which application of a different federal rule would disrupt commercial relationships predicated on state law.

It is well established that federal law applies in actions involving the FDIC. The only real issue is whether the governing rule of law should be provided by state law or whether a distinct federal common law rule should be fashioned. In each of the above cases awarding the FDIC HDC status based on the *Kimbell Foods* doctrine, the courts used the balancing process and determined that the FDIC should be protected by a federal common law rule that gives the FDIC a status akin to or better than that of a state law HDC. The FDIC was accorded such a status even though it did not meet all of the requirements for a HDC under the UCC. For the reasons discussed below, it is submitted that the balancing of the *Kimbell Foods* factors by these courts is erroneous.

*The Need for a Nationally Uniform Rule of Law*

The need for a uniform federal rule can hardly be disputed. As the court

As the discussion of the legislative history of section 1823(e) indicates, assumptions by the courts as to what Congress intended have not been particularly accurate. See *supra* text at notes 33, 35, and 36. However, the root problem with the decision of the Court appears to be its starting point that a misrepresentation, such as made by the bank about the property, is a warranty and thus a part of the agreement of the parties. Perhaps the statement of the Court on this point can be limited to the facts of this case. Unfortunately, it is not so qualified. Where the proper line between a misrepresentation and a warranty lies must depend upon the facts of each case. Equating a misrepresentation with a contractual undertaking, without more, creates a cause of action in strict liability where otherwise only a defense or no liability might exist. See J. FLEMINC, *TORTS* 607, 612 (6th ed. 1983); C. MORRIS, *TORTS* 298-306 (2d ed. 1980).

On balance, the Court’s possible expansion of section 1823(e), while more limited than the expansion effected through the “super holder in due course” doctrine, appears equally unsupported. Unfortunately, it also raises issues as to the status of the FDIC as receiver (see *supra* notes 7 and 19) and as to the status of the FSLIC and the NCUA, which do not have section 1823(e) in their arsenal of weapons. But see *infra* notes 100 and 101. Accordingly, it is even more important now for Congress to clearly express its will.

57. Id. at 727-28.
58. Id. at 728-29.
60. 766 F.2d 744, 748 (3d Cir. 1985) (quoting FDIC v. Rodenberg, 571 F. Supp. 455, 460 (D. Md. 1983)).
in *FDIC v. Blue Rock Shopping Center, Inc.*, stated: """"Holding the FDIC to different standards of care in different states would frustrate its attempts to promote the stability of, and confidence in, the nation's banking system."""" Clearly, a uniform federal rule would assist the FDIC in carrying out its duties as insurer of the nation's banking system, if for no other reason than it would promote simplicity and economy. However, the need for a uniform federal rule hardly necessitates the rejection of a rule of state law. Each state, including Louisiana, has adopted article 3 of the UCC, which governs commercial transactions and provides for HDC status. These statutes have been adopted with very few changes from the uniform text of the Code, at least with respect to the status of a HDC in nonconsumer transactions. Thus, state law is uniform in this respect and would serve to meet the FDIC's need for uniformity.

This proposition has been recognized in cases where the issue was not HDC status but the rights of an accommodation party. The Third Circuit in *FDIC v. Blue Rock Shopping Center, Inc.*, stated: """"[W]e will 'follow the model UCC and those cases which best supplement the UCC and further its purposes and design'."""" The *Blue Rock Shopping Center* case involved a suit brought by the FDIC in its corporate capacity against a party to a negotiable instrument executed in favor of the failed bank. The party claimed that it was an accommodation maker and that the FDIC had unjustifiably impaired the collateral securing the instrument. The court held that the rule of section 3-606(1)(b) of the UCC should govern the dispute.

**Frustration of Specific Objectives of the Federal Program**

The second factor involved in the Kimbell Foods analysis is whether application of a state law rule would frustrate specific federal objectives. In analyzing this factor, it is helpful to keep in mind that the central purpose of the FDIC is to bring to depositors sound, effective, and uninterrupted operation of the banking system with resulting safety and liquidity of bank deposits.

In *FDIC v. Wood*, the court started with the above premise and then stated that the use of a purchase and assumption agreement is a """"dramatically"""" effective way for the FDIC to fulfill its purpose. Then, the court

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62. 766 F.2d 744 (3d Cir. 1985).
63. Id. at 749 (quoting United States v. Uenum, 658 F.2d 300, 304 (9th Cir. 1981)).
66. Id.
67. Id. at 161. This is because the operation of the bank is not interrupted and the acquiring bank takes over all deposits, so no loss of uninsured deposits occurs.
concluded, as have other courts, 68 that subjecting the FDIC to potential state law claims would "in many cases prevent the transaction." 69 The court's rationale for this last proposition is that Congress allows purchase and assumption transactions only when the FDIC first determines that the cost of a purchase and assumption transaction would be less than the cost of a liquidation, and that the FDIC would be unable to make such a determination, or, at the least, could not make it quickly, if it first had to evaluate assets because of its potential exposure to unknown claims and defenses. 70

There are several questionable aspects about this line of reasoning. The court does not consider the second part of the statute, which dispenses with the need for cost evaluation where "the continued operation of such insured bank is essential to provide adequate banking services in its community." 71 This is an exception that, arguably, must be read generously to justify the HDC role for the FDIC. The federal HDC rule itself emphasizes the importance of a purchase and assumption transaction because banking service to depositors will not be disrupted. Of course, in most cases depositors can, with some inconvenience, transfer their business to another bank. Congress presumably removed the cost evaluation restriction primarily for cases where no other bank existed to service the depositors of the failed bank. However, the purchase and assumption method also is touting because (1) it does not freeze funds and thus impact on other components of the intricate financial system; and (2) because it does not cause a loss of confidence in the banking system. 72 Viewed in this light, very few banks would be able to cease operations without impact because they are nonessential in providing adequate banking services to their communities. In short, a strict cost evaluation perhaps should not be the only consideration in applying the statute.

Even if a strict cost evaluation remains the test, the statute only states that the FDIC shall not provide assistance in an amount in excess of what the FDIC determines to be "reasonably necessary" to save the cost of liquidation. 73 This appears to mean that the FDIC only needs to make a rough estimation of the failed bank's assets and not a precise calculation. The FDIC does

68. See, e.g., FDIC v. Leach, 772 F.2d 1262 (6th Cir. 1985); Gunter v. Hutcheson, 674 F.2d 862, 870 (11th Cir.), cert. denied, 459 U.S. 826 (1982).
69. 758 F.2d at 161.
70. Id. at 161. 12 U.S.C. § 1823(e)(4)(A) (1982) states:

No assistance shall be provided under this subsection in an amount in excess of that amount which the Corporation [FDIC] determines to be reasonably necessary to save the cost of liquidating, including paying the accounts insured of such bank, except that such restriction shall not apply in any case in which the Corporation determines that continued operation of such insured bank is essential to provide adequate banking services in the community.

The court also noted in passing that subjecting the FDIC to defenses when it acquires a note would unjustifiably give the maker of that note preferential treatment over depositors and other creditors of the bank. 758 F.2d at 160. Suffice it to state that a good defense to payment is quite different from a claim to recover payment, and it is hard to discern a preference in not having to pay what is not owed.

71. On this point, see Judge Merritt's dissent in Leach, 772 F.2d at 1269-70.
72. See, e.g., Gunter, 674 F.2d at 865.
not need to "know its ultimate losses to the last cent before selecting a purchase and assumption." As the court in Gunter recognized, the statute only requires "a reasoned judgment that the risk of a purchase and assumption is not greater than a liquidation."75

For this reason, the court in Wood seemingly overstated the case.76 Moreover, Judge Merritt emphasized other deficiencies in his dissenting opinion in the Leach case:

The court in Wood misinterpreted a statute instructing the FDIC to choose purchase and assumption only when it thinks this will be cheaper than liquidation as mandating the minimization of the actual cost of purchase and assumption by immunizing the FDIC from state law defenses. The Wood rule is clearly not justified by the policy underlying this statute, and its only certain effect is to redistribute the cost of bank failure from taxpayers, each of whom bears only a small fraction of the total cost, to a small number of note makers whose individual liability may be significant.77

Finally, there are other deficiencies with the reasoning of the Wood court and that of other courts that have followed this view. For example, even if the state law rule applied subjecting the FDIC to possible defenses, the FDIC could make a reasoned judgment as to the relative costs of a purchase and assumption transaction versus a straight liquidation. The applicability of state law defenses should only be relevant with regard to the amount of uninsured deposits the FDIC must induce an assuming bank to take since a set cost in a straight liquidation is the payment of the insured depositors. Thus, the allowance of the assertion of state law defenses would make a difference in a purchase and assumption transaction only to the extent that there are uninsured deposits or to the lesser extent of the amount of bad assets, if bad assets are less than the amount of uninsured deposits.78 That is to say, if

74. The Wood court surmised that subjecting the FDIC to state law claims could force it to make a detailed examination of the bank's records and, thus, both increase the cost of, and lose the timeliness that is necessary to effectuate, a purchase and assumption transaction. 758 F.2d at 161. Besides overstating the requirements of the statute, it seems unlikely that such an examination would be fruitful. Many defenses like fraud or failure of consideration are not apparent on the face of the note or from bank records, albeit a few, such as usury, might be. See F. Miller & A. Harrell, supra note 2, at 164.
75. Gunter, 674 F.2d at 871.
76. Id.
77. 772 F.2d 1262, 1270 (6th Cir. 1985) (emphasis added).
78. This point can probably be made more clearly through the use of several simple examples in the following table. It is assumed that the FDIC will recover 100 percent of the value of the good assets and none of the value of the bad assets.

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a failed bank has one depositor of $100,000 and one of $150,000, in a liquidation the FDIC would have to pay $200,000. In a purchase and assumption, both depositors will be covered and the FDIC at most would be out an addition $50,000. Therefore, the FDIC should only need to make a cost evaluation for potential state law defenses for a portion of the bank's assets sufficient to cover the extra cost, if at all. 79 Certainly, this should be feasible since the purchasing bank itself makes a rough pre-purchase estimate of good assets based on regulatory examination categories, and the statute does not require the FDIC to go into a more extensive in-depth analysis. 80

Another imprecision in the reasoning used by courts adopting the federal HDC rule is that the FDIC in a purchase and assumption transaction is subjected to a certain amount of credit risk, which may make the method more costly than a liquidation. Yet this consideration is not mentioned in applying the statutory test. 81 It is difficult to ascertain a difference between the risk that a debt is uncollectible due to economic factors and that a debt is uncollectible due to legal defenses, if there indeed is a difference. Just like the risk of assertion of state law defenses, credit risks are latent and have the potential of diminishing the value of the assets acquired by the FDIC.

Ironically, it actually appears that the FDIC's underlying objectives might be better served by allowing the assertion of valid state law defenses. As stated before, the FDIC's primary purpose is bringing to depositors sound, effective, and uninterrupted operation of the banking system with resulting safety and liquidity of bank deposits. 82 By allowing the makers of notes to assert valid state law defenses against the FDIC, the entire banking system would be forced to bear the risk of improper conduct by the failed bank.

The individual debtor obviously could not control the conduct of the bank and should not be forced to bear the risk. Forcing the system to bear the risk should promote self-regulation and, thus, better practices within the system. Under the opposite view, which bars most defenses, there is less motivation on a system-wide scale to eliminate improper banking practices of the sort that give rise to state law defenses. Hence, placing the risk on the banking system as a whole would promote market discipline in the system. This is an objective the FDIC itself has embraced. 83

79. As of 1985, only 23.9% of total bank deposits were uninsured. The amount of uninsured bank deposits has been falling steadily since the FDIC was formed in 1934. FDIC ANN. REP. 70 (1985). Therefore, the first two numerical examples in the table in note 78 represent a close approximation of the actual composition of deposits the FDIC encounters. The "extra cost," then, of a purchase and assumption will be a maximum of 25 percent of the bank's deposits, the amount of uninsured deposits. As the trend toward a greater percentage of insured deposits continues, the existence of potential state law defenses will become increasingly less important in the FDIC's cost balancing. Thus, the impact of potential state law defenses appears to be much less than supposed.


81. For example, in Gunter the court used the risk of the unknown defense in holding for the FDIC, but did not consider the risk of lack of creditworthiness of the note maker or the diminished value of any underlying collateral.


83. Norcross, supra note 7, at 316, 344.
Subjecting the FDIC to state law defenses legitimately only bears upon the net amount that the FDIC must ultimately pay out of the insurance fund. Deficiencies in this fund, if any, should be made up by increasing premiums to member banks. As one commentator stated:

[No] statute vaguely implies that debtors ought to be forced to subsidize the insurance fund. The FDIC’s application of its superpowers as bars to the defenses of debtors has expanded well beyond the bounds originally intended by Congress when it codified the result reached in D’Oench. Forcing individual, bank, and business debtors to subsidize a fund created expressly for deposit protection serves no purpose remotely related to market efficiency or safety. It simply forces a group of debtors to pay for the financial “sins” of their former bankers.84

Disruption of Commercial Relationships Predicated on State Law

The final factor requiring analysis under the Kimbell Foods balancing test is whether application of a federal rule different from the state law rule would disrupt commercial relationships generally predicated on state law.85 The courts that have awarded the FDIC “super” HDC status have given this factor short shift on the basis that commercial relationships would not be unduly disrupted. These courts reasoned that the notes could have been transferred to a state law HDC, in which case the makers’ defenses would have been barred.86

One significant shortcoming of this premise is that the status given the FDIC exceeds that of a HDC because the FDIC is only bound by actual knowledge and will prevail absent bad faith. The UCC does not allow HDC status when the holder has notice of a defense even if there is good faith.87 Another shortcoming is that a maker of a note certainly has no expectation at the time the note is executed that as a result of an assignment, any defense to payment will be barred against someone who takes the note in a bulk transfer, perhaps after it is due, and who may have a clear warning that something may be wrong. However, under the federal rule, the FDIC is entitled to ignore any such notice including any implications from a failure in payment. Many HDC cases that are litigated under the UCC turn on precisely the notice consideration.88

If the federal rule of HDC status for the FDIC persists, it may be well to advise makers who deal with financial institutions to follow the advice once given by legal services lawyers to consumers: delete the “or order” language.

84. Id. at 345.
87. U.C.C. §§ 3-302, 1-201(19), (25) (1978). U.C.C. § 3-302(1)(c) will not allow HDC status where the holder has notice that the note is overdue or has notice of any defense or claim to it on the part of any person. U.C.C. § 1-201(25) provides that a person has “notice” of a fact when “he has actual knowledge of it, or has received notice or notification of it, or from all of the facts and circumstances known to him at the time in question he has reason to know that it exists.” (Emphasis added.)
The reason is there can be no HDC of such an instrument.\textsuperscript{89} If this will invoke the final \textit{Kimball Foods} factor, it raises a more significant potential problem related to the form of negotiable instruments.\textsuperscript{90} Many notes today are not negotiable and, thus, no HDC can exist. Nonetheless, at least one court has held that the immunity from state law defenses extends to nonnegotiable instruments.\textsuperscript{91} If the FDIC is allowed HDC status on \textit{nonnegotiable} instruments, then the departure from and possible impact on commercial relationships clearly is significant.\textsuperscript{92} Moreover, in this environment a knowledgeable commercial debtor may attempt to obligate the FDIC to recognize defenses as part of the note, as is the case in consumer transactions with respect to assignees under the Federal Trade Commission "HDC rule."\textsuperscript{93} In that event, it would indeed be startling if the FDIC were allowed to ignore a provision of the very contract it is enforcing.\textsuperscript{94}

Another disruption of relationships should be perceived to exist if the "super" HDC status of the FDIC is applied to consumer transactions. Outside of this context, there basically is no HDC status in consumer transactions.\textsuperscript{95} A decision that the FDIC is a HDC with respect to consumer paper would be contrary to the policy of most states and the policy of another agency of the federal government itself, the Federal Trade Commission. Thus, substantial disruption of expectations under other law might occur if HDC status were imposed with respect to notes given by consumers.\textsuperscript{96} And if an exclusion

\begin{itemize}
\item \textsuperscript{89} See U.C.C. §§ 3-104, 3-805 (1978).
\item \textsuperscript{90} See supra note 15.
\item \textsuperscript{91} FDIC v. Gulf Life Ins. Co., 737 F.2d 1513 (11th Cir. 1984) (FDIC given HDC status as to unearned premiums on credit life policies). \textit{But see} FDIC v. Galloway, 613 F. Supp. 1392 (D. Kan. 1985) (no HDC status for FDIC on guaranty agreements acquired as part of purchase and assumption transaction).
\item \textsuperscript{92} See \textit{Galloway}, 613 F. Supp. at 1402.
\item \textsuperscript{93} Federal Trade Commission Trade Regulation Rule on Preservation of Consumers’ Claims and Defenses, 16 C.F.R. § 433 (1987), discussed \textit{infra} at note 95.
\item \textsuperscript{94} The court in FDIC v. Blue Rock Shopping Center, Inc., 766 F.2d 744 (3d Cir. 1985), arguably denied the FDIC that ability.
\item \textsuperscript{95} See, e.g., U.C.C.C. §§ 3.404, 3.405 (1974), preserving consumer defenses in assigned paper and in direct loan situations. Many states have similar laws. See also Federal Trade Commission Trade Regulation Rule on Preservation of Consumers’ Claims and Defenses, 16 C.F.R. § 433 (1975), as amended, to the same effect requiring a contractual provision giving the consent of the holder to the assertion of claims or defenses by the consumer. Of course, if the defense arose out of the conduct of the bank that lent the money to the consumer, the bank would not be able to take free of the defense under U.C.C. § 3-305(2).
\item Note that in its present form, the FTC rule would not allow a consumer’s defenses against a seller who was merely paid by the bank to be asserted against the bank or its assignee, or a consumer’s defense against a bank that defrauded the consumer to be asserted against the assignee of the bank when the note was later assigned. However, if the FDIC took assigned seller paper or a note evidencing a purchase money loan, the FTC rule notice would preclude HDC status for the FDIC.
\item \textsuperscript{96} Admittedly, the FTC rule and many state laws do not clearly deprive an assignee of a bank that defrauded a consumer or otherwise engaged in conduct that created a defense of HDC status. However, such assignments were considered to be rare occurrences. See U.C.C.C. § 2.403 comment (1969). To permit assignments to the FDIC (which are not rare occurrences)
\end{itemize}
for this situation is made, the question arises whether it makes sense to allow enforcement of some commercial debts notwithstanding valid state law defenses. Indeed, the policy basis underlying enforcement by the FDIC of obligations owing to a failed bank despite the existence of valid state law defenses disappears if the FDIC cannot enforce the portfolio of the failed bank across the board and, instead, must review the files to sort out non-negotiable notes and consumer notes.

Proper Analysis Summarized

As the above discussion indicates, under a proper Kimbell Foods analysis, the FDIC should have to play by the same rules as everyone else. It already must do so in situations other than a purchase and assumption transaction. While the desirability of a uniform rule is clear, this does not mean that the rule need be one of immunity from valid state law defenses. To apply the UCC rule would be to apply a uniform rule; it would not detract from FDIC policy; it would not disrupt existing relationships under state law; and it would bring the law in this area into line with the overwhelming weight of authority concerning the rights of the United States on commercial paper in other contexts where, almost without exception, the UCC rule is followed.

Indeed, the better economic policy also would be served; subjecting the FDIC to such defenses would promote market discipline within the banking system as a whole. Thus, application of the state law rule will not frustrate any specific objectives of the FDIC but, instead, may promote them. Moreover, as purchase and assumption transactions decrease in favor of modified purchase and assumption transactions, the suggested position may become reality as even the arguably flawed present justification for HDC status may not exist in the latter type of transaction.

\[\text{footnote: to cut off defenses would seem an unjustified intrusion on the policy of these consumer protection laws even if it is not a violation of them as they are now formulated.}\]

97. See, e.g., In re Jeter, 48 Bankr. 404 (Bankr. N.D. Tex. 1985) (holding that FDIC, when acting as receiver, is subject to same defenses to which its predecessor bank would be subject). See also infra note 99 as to a further holding by the court.

98. F. Miller & A. Harrell, supra note 2, at 24-26.

99. In a modified purchase and assumption, the FDIC generally only transfers the insured deposits of the failed bank to the purchasing bank. Then, the purchasing bank is allowed to buy any of the good assets it wants. The FDIC usually finances this transaction by the FDIC, as receiver, borrowing from the FDIC in its corporate capacity and pledging the assets of the failed bank as collateral. Thus, there generally is no good faith purchase by the FDIC in its corporate capacity, and there is certainly no need to allow the FDIC to avoid state law defenses in the interest of an expedient transfer of assets and liabilities under a purchase and assumption.

In In re Jeter, 48 Bankr. 404, 410-12 (Bankr. N.D. Tex. 1985), the court refused to apply the HDC doctrine where the FDIC as insurer only had a security interest in the asset to secure a loan in a modified purchase and assumption transaction. The court stated that where the FDIC as receiver borrows money from the FDIC as a corporation under 12 U.S.C. § 1823(d), the FDIC as a corporation only has a security interest in the assets retained by the FDIC. The court held that the federal common law rule giving the FDIC HDC status would only apply where the FDIC in its corporate capacity actually owns the assets.

This type of transaction has become increasingly popular in recent years. Under the Jeter analysis, HDC status will not be available to the FDIC under this type of transaction.
Section 1823(e) and the D’Oench Doctrine

Bringing the rule for financial institution insurance agencies into line with the rule for other instrument holders would not expose financial institution insurance agencies to undue risk. Congress has expressly provided the FDIC with a weapon to protect itself from borderline “fraudulent” agreements entered into between the failed bank and the obligor,¹⁰⁰ which seems to be the only justifiable circumstance where protection is needed.¹⁰¹ This weapon is contained in section 1823(e),¹⁰² which provides:

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

Note that under section 1823(e) it is not relevant whether the asset is evidenced by a negotiable note, a nonnegotiable note, or a guaranty.

Section 1823(e) represents a codification of D’Oench Duhme & Co. v. FDIC.¹⁰³ In D’Oench the Supreme Court held that a brokerage house was estopped from asserting against the FDIC its agreements with a failed bank that notes given to enable the bank to carry defaulted bonds on its books would not be enforced.¹⁰⁴ The Court held that federal policy was to protect the FDIC from misrepresentations of assets arising in the form of contemporaneous “secret agreements” between the bank and the obligor.¹⁰⁵ Congress responded by enacting section 1823(e) to codify and clarify the D’Oench holding.¹⁰⁶

¹⁰⁰ Congress likewise provided protection to the National Credit Union Administration at 12 U.S.C. § 1782(i)(2) (1982).
¹⁰¹ This concept is also the principle in D’Oench and thus would be available to the FSLIC even though the statutes cited do not apply to it. While there are some differences between the doctrine and the statute, they do not appear material; but to the extent they are, Congress can act for the FSLIC as it has done for the FDIC and NCUA. Indeed, probably the same result under the D’Oench facts would be reached today under U.C.C. § 3-119. Thus, even in the seminal situation which gave rise to this whole matter, the state law rule is appropriate for federal transactions.
¹⁰³ 315 U.S. 447 (1942).
¹⁰⁴ Id. at 461.
¹⁰⁵ Id. at 459.
¹⁰⁶ See, e.g., FDIC v. Blue Rock Shopping Center, Inc., 766 F.2d 744, 753 (3d Cir. 1985);
The courts applying section 1823(e) or its policy have struggled with one common problem which, as discussed previously, was one reason for the development of the HDC doctrine for the FDIC.107 That common problem is how to determine the fact situations to which section 1823(e) applies and those to which it should not. As noted, the courts often have responded by expanding the scope of section 1823(e).108

These line-drawing difficulties ought not to expand the scope of section 1823(e) beyond the original scope intended by Congress; rather, courts should apply the section only as Congress originally intended. Congress clearly intended that the FDIC should stand in the shoes of the failed bank except with regard to the limited exception carved out by section 1823(e).109 Thus, the key is to define clearly the exception and its application. In determining where to draw the line with regard to which defenses are knocked out by section 1823(e), the analysis must begin by looking to the D'Oench fact situation and Congress' response to that holding.

D'Oench, of course, involved a 'secret' agreement between a debtor and its bank that the notes executed by the debtor were not valid even though they appeared valid on their face. Congress probably had the same concerns with the broad language used by the majority in D'Oench as Justice Jackson did in his concurring opinion.110 Therefore, Congress enacted section 1823(e) to minimize that concern.

Section 1823(e) provides, in essence, only that no contemporaneous agreement that diminishes the FDIC's interest in any asset it acquires is valid against the FDIC unless it meets certain conditions that render the agreement non-secret. Committee discussions on the provision make it clear that Congress was imposing these conditions as a means of establishing that such an agree-

FDIC v. Wood, 758 F.2d 156, 159 (6th Cir.), cert. denied, 106 S. Ct. 308 (1985); Norcross, supra note 7, at 316, 328. See also discussion supra at notes 33-37.

Some courts believe that D'Oench still exists as an independent basis for barring certain defenses of the obligor. See In re Longhorn Securities Litigation, 573 F. Supp. 278 (W.D. Okla. 1983). This view probably is irrelevant where section 1823(e) applies and so long as D'Oench is not read for more than the legislative history suggests. See Platt & Darby, supra note 18, at 701-04.


108. See discussions supra at notes 51-55.


110. Justice Jackson obviously believed that the majority's holding could be read too broadly and added:

No doubt many questions as to the liability of the parties to commercial paper which comes into the hands of the Corporation [FDIC] will best be solved by applying local law with reference to which the makers and the insured back presumably contracted. The Corporation would succeed only to the rights which the bank itself acquired where ordinary and good faith commercial transactions are involved. 315 U.S. 447, 474 (1942) (Jackson, J., concurring).
ment existed and was binding so it could be taken into account from the inception in evaluating the asset.111 A main concern was that customers might assert agreements against the FDIC of which the FDIC had no proof of their existence.

Thus, Congress' clear intent was that section 1823(e) should apply only to those few cases where an obligor is attempting to assert the terms of a contemporaneous agreement entered into with the bank of which no record appears against the FDIC. Section 1823(e) was intended to apply whether the agreement itself is asserted or a theory of fraud or estoppel or the like based upon its nonperformance is claimed. On the other hand, the section does not apply where the obligor wants to assert a defense based on an agreement contained in the instrument itself that is sought to be enforced. Examples include usury or injury to the contractual status of a party to the instrument. Nor does the section apply to a defense not based on a promise by the bank to perform a duty, such as fraud in the inducement. A brief discussion of the application of this definition of the rule of section 1823(e) to some of the common fact situations which have arisen may be helpful.

The D'Oench and Similar Fact Situations

Applying the above test to the D'Oench fact situation would yield the same result—the obligor's claimed defense would be barred. The defense would be barred because the obligor is attempting to enforce a secret, contemporaneous agreement with the bank that the note is not fully enforceable.112 The only difference is that section 1823(e) seems to assume, not to impose, the requirement of a "guilty party" that the D'Oench decision could be read to impose.

Another common fact situation is where the obligor leaves a term of the instrument blank, such as the amount, and reaches an agreement with the bank that a certain amount will be entered by the bank. Later, he discovers that a higher amount was entered contrary to the obligor's agreement with the bank.113 A variation of this fact situation exists where the maker signs a note that is later claimed to mistakenly not reflect the agreement.114 Once again, section 1823(e) should act to bar the obligor's defense in this situation because the obligor is attempting to enforce a contemporaneous, unrecorded agreement with the failed bank against the FDIC.

Moreover, even if the bank's conduct constitutes fraud in these cases, the obligor should not be able to assert against the FDIC a defense based on fraud, estoppel, or waiver. The argument that the bank's fraud nullified the

111. See Hearings, supra note 34, at 41-42.
112. See also FDIC v. Hoover-Morris Enterp., 642 F.2d 239 (4th Cir. 1980). Cf. Gunter v. Hutcheson, 674 F.2d 862 (11th Cir.), cert. denied, 459 U.S. 826 (1982), which should have held that an agreement to defer interest was barred under section 1823(e) even though it was alleged the defense was fraud based on the failure to perform that agreement.
transaction and, therefore, no valid agreement resulted simply end-runs section 1823(e). It should not be relevant whether the bank never intended to perform the asserted agreement or whether its determination to breach was a lessor sort; it is the derogation of the value of the asset due to the asserted agreement that concerned Congress.

Failure of Consideration and Misrepresentation

Another common fact situation that arises is where the bank promises to do something, such as set up an escrow as partial consideration for the obligor's execution of the obligation, and then fails to perform. The obligor's defense of failure of consideration should be barred if it depends on the assertion of the terms of an agreement not meeting the requirements of section 1823(e). Again, even if the defense rises to fraud in the inducement, this defense should be barred because ultimately it depends on the terms of an agreement not qualifying under section 1823(e) being asserted against the FDIC.

In some situations, however, failure of consideration and fraud should be assertable against the FDIC. For example, if the instrument was executed totally without consideration, lack of consideration should be assertable against the FDIC because it does not depend upon the terms of a collateral agreement against the FDIC but arises from the agreement contained in the very instrument the FDIC seeks to enforce. The same result should prevail if the defense is fraud in concealing the nature of the instrument itself or duress that precludes the instrument from being a valid contract. Also, the defense should be assertable whenever the bank makes a material misrepresentation to the obligor to induce execution of the instrument, but not whenever the bank makes a warranty or a promise as to performance.

Defenses Arising from the Agreement Sought to be Enforced

Several recent cases have involved an obligor raising the defense of usury or impairment of collateral, which releases the obligor as an accommodation


116. See, e.g., FDIC v. Galloway, 613 F. Supp. 1392 (D. Kan. 1985). This may also have been an appropriate view of the facts in FDIC v. Meo, 505 F.2d 790 (9th Cir. 1974), but the court did not consider section 1823(e).


118. See, e.g., FDIC v. Langley, 792 F.2d 541 (5th Cir. 1986), aff'd 56 U.S.L.W. 4026 (U.S. Dec. 1, 1987) (statements as to the property purchased as well as promises as to bank performance). See also FDIC v. Hatmaker, 756 F.2d 34 (6th Cir. 1985); Gunter v. Hutcheson, 674 F.2d 862 (11th Cir.), cert. denied, 459 U.S. 826 (1982) (same). If both types of misrepresentation exist in a case, the obligor may prevail even though the other defense is barred. This does not suggest a need to "broaden" the protection of section 1823(e).

119. See, e.g., FDIC v. Wood, 758 F.2d 156 (6th Cir. 1985).
Clearly, these defenses should not be barred because they do not arise from a secret contemporaneous agreement; instead, they arise from the terms of the executed note itself and are not the type of risk against which section 1823(e) guards. An obligor should be allowed to assert this type of defense against the FDIC.

**Conclusion**

The recent financial institution failures have introduced new players into the commercial transactions arena. These new players have long been accorded substantial protections against “secret contemporaneous agreements” between the failed institution and the obligor. However, some courts have extended the protection for one or more of three reasons, allowing the FDIC and the FSLIC (and potentially the NCUA) to take free of most of an obligor’s state law defenses on the instrument.

However, none of these reasons holds up under scrutiny. The legislative history clearly indicates section 1823(e) was not intended to accord HDC status to any of these players, and there is no basis in the opinion or policy of *D’Oench*, given the congressional response to it, to extend it to create HDC status. Also, the *Kimbell Foods* balancing by some courts that see it as the basis for HDC status appears flawed. Indeed, when the underlying policy factors and arguments are closely examined, it is clear that the objectives of Congress in establishing the federal insurance agencies would be best served by forcing those agencies to live within the state law rule. Difficulty in line-drawing furnishes no excuse to go beyond the express protection given to the agencies by Congress, particularly when clear guidelines to determine cases can be formulated. Thus, these agencies should be subject to the same state law rule that governs all other commercial transactions of this type in the United States.

120. See, e.g., FDIC v. Blue Rock Shopping Center, Inc., 766 F.2d 744 (3d Cir. 1985).