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The FDIC as Holder in Due Course: Some Law and Economics

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I. INTRODUCTION

When a federally insured bank fails, the Federal Deposit Insurance Corporation (the "FDIC") typically intervenes to protect depositors. As part of the bailout, the FDIC undertakes the role of liquidator of the bank's assets, both physical and intangible. A bank's intangible assets consist primarily of its loan...
portfolio, that is, its rights to receive repayment from borrowers. A failed bank's loan portfolio is packed with "troubled" loans, which are of doubtful collectibility for a variety of reasons. In most cases, the borrower is insolvent and simply cannot repay the loan. In other cases, the bank's right to repayment is subject to offset or reduction because the borrower has a valid defense against the bank. For example, a borrower may contend that he is relieved from his obligation to repay his loan on grounds that he lacked mental capacity to contract, or that the bank defrauded him. When the FDIC acquires a loan following a bank's failure, a borrower will assert this defense against the FDIC. This Article analyzes the governing rules under which the FDIC can acquire the power to collect the loan free of the borrower's defenses.

The FDIC acquires loans by transfer in the course of carrying out its statutory function as liquidator. Ordinarily, a transferee of an intangible property right, such as the right to receive repayment of loaned money (an "obligation"), acquires the right subject to defenses available under the loan agreement between the party who promised to pay (the "obligor") and the party who bargained for such payment (the "obligee"). The transferee's interest is also subject to any defense or claim the obligor had against the obligee that accrued before the obligor received notification of the transfer. Thus, the transferee of an obligation generally does not obtain rights against the obligor greater than those of the original obligee. A transferee who is a holder in due course, however, takes free from virtually all the obligor's claims or defenses.


2 The purchaser of an intangible property right receives less protection than a purchaser of goods. A good-faith purchaser of goods takes free of the true owner's claims if the purchaser obtained voidable, as opposed to void, title from his seller. See U.C.C. § 2-403(1) (1990). See generally, Grant Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 YALE L.J. 1057 (1954) (describing the historical genesis of special rights of the good faith purchaser).

3 Under U.C.C. § 3-302, a transferee must: (1) be a holder; (2) of a negotiable instrument; (3) acquired for value; (4) in good faith; and (5) without notice of claims or defenses. U.C.C. § 3-302 (1990).

The FDIC, as transferee of assets in the form of obligations owed to a failed bank, normally does not satisfy all of the requirements to receive immunity as a holder in due course conventionally defined. It would, therefore, acquire no greater rights than those the failed bank had against the borrower. Under the emerging federal law, however, the FDIC is immune from certain claims and defenses raised by an obligor even though they would be valid against an ordinary transferee.

Federal law governing the FDIC’s immunity derives from common law and statute. The Supreme Court first awarded immunity to the FDIC in D’Oench, Duhume & Co. v. FDIC. In that case, the Court estopped an obligor from asserting as a defense against the FDIC that the failed bank orally agreed never to enforce the obligor’s promissory note. The court reasoned that, as a matter of federal common law, invalidating the use of such a defense against the FDIC would “protect [the FDIC], and the public funds which it administers against misrepresentations as to the securities or other assets in the portfolios of the banks which [the FDIC] insures or to which it makes loans.” This principle of estoppel applied in favor of the FDIC has come to be known as the “D’Oench doctrine.”

Eight years after this decision, Congress created statutory immunity for the FDIC as part of a revision to the Federal Deposit Insurance Act. Section 1823(e) of the Act immunizes substantial revisions to Article 3, which governs negotiable instruments. See generally Fred H. Miller, The Benefits of New UCC Articles 3 and 4, 24 UCC L.J. 99 (1991). See infra Part V.

See discussion infra Part V concerning technical requirements for classification as a holder in due course. The FDIC typically does not qualify for holder in due course immunity because the FDIC acquires obligations “as part of bulk transactions not in regular course of business of the transferor,” U.C.C. § 3-302(c) (1990). See, e.g., Firstsouth, F.A. v. Aqua Construction, Inc., 858 F.2d 441, 442 (8th Cir. 1988) (describing application of U.C.C. § 3-302(c) as enacted in Arkansas, ARK. STAT. ANN. § 85-3-302(3c), to Federal Savings and Loan Insurance Corporation acting as receiver for bank in suit on promissory note).

315 U.S. 447 (1942).

the FDIC from certain claims and defenses an obligor may assert against it. Where an obligor's claim or defense is based on an agreement to which the FDIC is not a party, it is invalid against the FDIC unless the obligor can establish that the agreement was, since its creation, a part of the bank's official records.

Even after D'Oench and passage of § 1823(e), courts have developed federal common law to provide the FDIC with immunity akin to that afforded a holder in due course under state law. To be eligible for such immunity, the FDIC must: (1) acquire the obligation in connection with the resolution of a failed bank; (2) for value; (3) in good faith; and (4) without actual knowledge of the claim or defense. This expanded common law doctrine has come to be known as the "federal holder in due course rule."

To what extent should the FDIC be immune from defenses asserted against it in its capacity as transferee of a failed bank's assets? One might establish a rule under which the FDIC is never immune; under such a rule, the FDIC would be subject to all defenses a borrower might have against the failed bank, whether or not the FDIC qualifies as a holder in due course.

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mon Law, 103 BANKING L.J. 316, 328 (1986).

8 12 U.S.C. § 1823(e) provides:
No agreement which tends to diminish or defeat the interest of the Corporation in any asset acquired by it under this section or section 1821 of this title, either as security for a loan or by purchase or as receiver of any insured depository institution, shall be valid against the Corporation unless such agreement —
(1) is in writing,
(2) was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution,
(3) was approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and
(4) has been, continuously, from the time of its execution, an official record of the depository institution.

10 See id.

course, however defined. Moving toward greater immunity, one could apply the state law holder in due course rule to the FDIC. Under this arrangement the FDIC would be vulnerable to the obligor's defenses unless it could establish its status as a holder in due course, in which case it would be immune to those defenses that are invalid against a holder in due course. At the opposite end of the spectrum, the FDIC could be absolutely immune from all defenses raised by an obligor. Somewhere between the state law rule and a rule of maximum immunity stands current federal law. The question of what level of immunity to grant the FDIC is particularly relevant in light of disagreement among federal courts and the large number of cases which raise it.\(^\text{12}\)

Courts have justified the FDIC's immunity as furthering a distributional goal. Immunizing the FDIC enables it to resolve bank failures at lower cost to the federal deposit insurance fund. But the cost of bank failure does not evaporate when the FDIC is immune — it simply shifts to the borrowers whose defenses are invalidated. The impact of a rule of immunity on the federal fisc is obviously important. Apart from redistributing the cost of bank failure, however, a rule of immunity can reduce the loss associated with bank failure to the extent it is efficient.\(^\text{13}\)

\(^{12}\) See, e.g., supra note 11 and accompanying text. As reported by the FDIC, bank failures increased at an alarming rate throughout the 1980s. Ten failures were reported in 1980, 120 in 1985, and 206 in 1989. Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the Comm. on Banking, Finance and Urban Affairs of the House, 101st Cong. 2d Sess., Banking Industry in Turmoil: A Report on the Condition of the U.S. Banking Industry and the Bank Insurance Fund 24 (Comm. Print 1990) (hereinafter “Subcomm. Report”). In addition, the number of so called “problem banks” has increased substantially since 1980. Id. The reserves of the insurance fund available to resolve bank failures declined from approximately $18.3 billion in 1987 to $11.4 billion in June 1990, reflecting the increased number of resolutions requiring cash assistance. Id. at 21. The Subcommittee estimated that the cost of resolving bank failures from 1990 to 1993 would range between $17 and $36 billion. Id. at 45-46. Id. at 55. Observers have estimated that within the first four months of 1993, failures will mount to more than one a day. Jerry Knight and Susan Schmidt, Bush, Clinton Reluctant to Discuss Coming Wave of Bank, Thrift Failures, THE WASH. POST (Oct. 4, 1992).

\(^{13}\) Cf., e.g., Robert D. Cooter & Edward L. Rubin, A Theory of Loss Allocation for Consumer Payments, 66 TEX. L. REV. 63 (1987) (using economic analysis to develop an analytic framework for the efficient allocation of losses due to
Part II of this Article describes the FDIC's role in bank failure resolution. Part III examines the law governing the FDIC's immunity from obligors' claims and defenses. Part IV then proposes an economic framework for evaluating an immunity rule's efficiency as a loss allocation device. Part V evaluates the holder in due course rule, a familiar and analogous loss allocation rule, concluding that it is efficient. Part VI of this Article proposes a rule of immunity for the FDIC that efficiently allocates loss between borrowers and the FDIC.

II. THE FDIC'S ROLE IN BANK FAILURE RESOLUTION

Congress established the FDIC in 1933 in the aftermath of financial crisis to restore public confidence in banks. In 1989, in response to an unprecedented number of failures in the savings and loan industry, Congress enacted the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"). FIRREA overhauled the federal deposit insurance system, consolidating in the FDIC authority over deposit insurance. In addition to its role as deposit insurer, the

fraud, forgery, and error between consumers and financial institutions).


The Senate Committee on Banking, Housing, and Urban Affairs described the purposes of FIRREA as follows: "First, the legislation seeks to recapitalize the Federal deposit insurance system and to provide for the resolution of outstanding and anticipated failures of insured institutions. Second, the legislation seeks to preserve a safe and stable system of residential housing finance." S. Rep. No. 19, 101st Cong., 1st Sess. 1 (1989). See also H.R. Rep. No. 54, 101st Cong., 1st Sess. 307-08 (1989).

Prior to FIRREA, the FDIC administered the Permanent Insurance Fund ("PIF") which protected federally insured depositors of federal or state chartered banks. With FIRREA, Congress abolished the Federal Savings and Loan Insurance Corporation ("FSLIC"), which had previously served as administrator of federal deposit insurance for savings associations. FIRREA also renamed the insurance fund previously administered by the FSLIC, calling it the Savings
authority typically closes it and appoints the FDIC as receiver. In the context of a bank resolution, the FDIC acts in two distinct capacities: as the insurer ("FDIC-Corporate"), and as the receiver of the failed bank. The FDIC typically knows of the precarious condition of a failing bank long before the bank closes. As soon as bank failure becomes a real possibility, the

of law. See, e.g., K.S.A. § 9-1902 (defining conditions under which bank or trust company becomes insolvent under Kansas law).

22 Cf. 12 U.S.C. § 1821(b). The FDIC has no authority to close a bank under its jurisdiction. Only a bank's chartering authority may do so. For national banks, the relevant authority is the Comptroller of the Currency, see 12 U.S.C. § 191; for state chartered banks, it is the state chartering authority. Michael B. Burgee, Purchase and Assumption Transactions Under the Federal Deposit Insurance Act, 14 FORUM 1146, 1149-50 (1979).


24 See supra note 18.


26 "As the principal federal regulator of state nonmember banks, FDIC is likely to be as conscious of the failing bank's problems as the state banking authority." Burgee, supra note 22, at 1151; See IRVINE H. SPRAGUE, BAILOUT: AN INSIDER'S ACCOUNT OF BANK FAILURES AND RESCUES 29-30 (1986) (The FDIC maintains and updates weekly a "probable fail" list of banks that have a high probability of failure over the next 90 days). The FDIC's pre-failure involvement can be a matter of a few days to several months. Brainsilver, supra note 21, at 327. Brainsilver observed: "On an informal basis, the FDIC is usually informed on the general condition of the sick institution well before [a declaration of insolvency], and in the case of insured non-member banks, we are (wearing our regulatory hat) of course as intimately involved in the problem from the start as is the state supervisor." Id. at 329 n.6.

Prior to its involvement as a liquidator, the FDIC will ordinarily have had access to reports prepared by bank examiners which "reflect asset values adjust-
FDIC typically will begin to consider its options in connection with the discharge of its dual roles. The FDIC-Corporate can discharge its obligations as deposit insurer by paying depositors' insured claims in cash or "by making available to each depositor a transferred deposit in another insured bank in an amount equal to the insured deposit." As receiver, the FDIC may liquidate the failed bank, merge it with another insured bank, transfer any or all of its assets to another bank, create a new bank, or structure a transaction that combines one or more of the foregoing.

The FDIC's governing statute limits the agency's discretion to select among resolution methods. The statute requires the FDIC to adopt a resolution which minimizes the cost to the deposit insurance fund and maximizes the return to creditors of the failed bank. To achieve its goal, the FDIC-Corporate may use deposit insurance fund money in ways other than direct payment of insured claims. The FDIC-Corporate may expend no more than the amount that it would have expended if it liquidated the bank and paid all insured depositors in full.

ed for estimated losses in all assets, particularly loans . . . ." Id. at 328.


28 12 U.S.C. § 1821(d) (Supp. II 1990). The FDIC can also provide 'open bank assistance' by making loans, purchasing assets or making deposits in a failing bank before it closes. 12 U.S.C. § 1823(c) (Supp. II 1990). The FDIC can only provide this type of assistance if either: (1) the assistance is undertaken to prevent the default of the institution; or (2) the assistance is taken in order to lessen the risk to the FDIC posed by an institution's operation under severe financial conditions. 12 U.S.C. § 1823(c)(1) (Supp. II 1990). See FDIC Statement of Policy on Assistance to Operating Insured Banks and Savings Associations, 55 Fed. Reg. 12, 559 (1990).


30 Pursuant to 12 U.S.C. § 1823(c)(2)(A) (Supp. II 1990), the FDIC can: (1) make a direct cash payment to a failing bank to permit its continued operation; (2) await closing of the bank and pay out on insured deposit claims; or (3) finance the assumption of the failed bank's deposit liabilities by way of a purchase and assumption transaction, discussed infra notes 32-43 and accompanying text. Burgee, supra note 22, at 1151-52.

31 12 U.S.C. § 1823(c)(4)(A) (Supp. II 1990). For example, if it appeared that the assets of a financial institution were sufficient to pay its insured deposit liabilities, then no assistance would be permitted, unless the continued operation of the insured depository is essential to provide adequate depository services to the community. 12 U.S.C. § 1823(c)(4)(A) (Supp. II 1990). If the cost test is satisfied, the FDIC must consider the immediate and long term obliga-
The FDIC prefers a resolution known as a purchase and assumption transaction. In one common type of purchase and assumption transaction, the FDIC arranges for a sale of the failed bank's assets and liabilities to a healthy bank who submits the highest bid (the "assuming bank"). The assuming bank purchases all assets of the failed bank that are of market quality ("acceptable assets") and assumes all of its deposit liabilities, including uninsured deposits. The assuming bank is usually willing to pay a premium over book value of the acceptable assets reflecting the bank's going concern value (the "premium"). In the typical case, the value of the failed bank's
acceptable assets plus the premium is less than its deposit liabilities. To induce the assuming bank to undertake the transaction, the FDIC as receiver must pay the assuming bank an amount equal to the difference between the deposit liabilities on the one hand, and the acceptable assets plus the premium on the other (the "FDIC payment"). Thus a purchase and assumption transaction gives depositors of the failed bank uninterrupted access to deposited funds, avoiding returned checks, lost time value of money, and loss of confidence associated with the alternative of closing the failed bank and paying the claims of insured depositors. It also involves a lower immediate cash outlay by the FDIC-Corporate than that required to pay insured claims in full.

The FDIC as receiver obtains cash for the FDIC payment from the FDIC-Corporate by either selling or pledging the unacceptable assets of the failed bank to FDIC-Corporate. The

note 22, at 1155.

33 Id.

34 Id. Assume total deposit liabilities (D) equal $100,000, acceptable assets (A) equal $20,000, and the premium bid by the assuming bank (P) is $5000. The FDIC payment will be D - (A + P), or $75,000.

35 The FDIC allows a bank to close and pays the claims of insured depositors only as a "last resort." Burgee, supra note 22, at 1152. Burgee observed that bank failure and subsequent payoff of insured deposits:

results in an interruption of vital banking services to the community which the failed bank served. The failed bank's main office and any branches which it operated are permanently closed. As a consequence, virtually all of the failed bank's employees are without jobs. All time, demand and savings deposit accounts of the failed bank are frozen and any checks in transit at the time the bank closed are returned unpaid to the drawer.

. . . [A]ny going concern value that the failed bank may have had as a viable banking enterprise is lost irrevocably with the permanent closing of its business.

Id. at 1153.

36 See supra note 31. Limitations on available cash have had an impact on the method by which regulators have resolved failed thrifts. The need for a massive bailout of the savings and loan industry through FIRREA has been attributed to underfunding of the FSLIC's insurance fund: "[B]ecause the thrift insurance fund (the FSLIC) had insufficient reserves to close or reorganize insolvent thrifts, policymakers permitted institutions with massive incentives to gamble with federally insured funds to run up losses in excess of $150 billion (excluding interest payments on funds borrowed to clean up the mess)." Subcomm. Report, supra note 12, at 5-6. The Subcommittee concluded that the FDIC faced the same crisis as the FSLIC faced — insufficient cash to pay for its expected caseload of bank failures. Id. at 6-10, 19.

40 12 U.S.C. § 1823(d)(1) (Supp. II 1990). The FDIC-Corporate has the
owner of the unacceptable assets (FDIC-Corporate or receiver as the case may be) then undertakes to liquidate them. The FDIC applies the proceeds of such liquidation first to reimburse itself for the FDIC payment. The FDIC then distributes any remaining proceeds through the receivership to the failed institution's non-depositor creditors.

Notwithstanding the particulars of the transaction the FDIC may arrange to resolve a bank failure, the FDIC typically finds itself responsible for the liquidation of at least some of the failed bank's unacceptable assets. The FDIC acquires the assets in bulk, under distress conditions, and knowing that the assets are non-performing or otherwise objectionable to a healthy bank. This is the context in which the rule of immunity comes into play. Borrowers, not surprisingly, raise defenses to the FDIC's collection efforts. The federal rule of immunity determines which claims and defenses are valid against the FDIC and which are not.

III. THE FDIC'S IMMUNITY

A. The D'Oench Doctrine

The tension between the rights of a bank receiver and obligors on obligations comprising a failed bank's portfolio is almost as old as the regulation of banking in the United States. From the dawn of regulation, financially troubled banks scrambled to disguise inadequate capitalization and uncollectible loan portfolios from the scrutiny of the bank examiner. In a typical

authority to purchase any assets from the FDIC as receiver in connection with a purchase and assumption transaction, including assets which are non-transferable under state law. FDIC v. Bank of Boulder, 911 F.2d 1466, 1471 (10th Cir. 1990).


44 FDIC v. Blue Rock Shopping Center, Inc., 766 F.2d 744, 752 (3d Cir. 1985).
case, a bank in trouble would arrange for a friendly dupé to execute a promissory note subject to an oral agreement that the note was "for the accommodation of the bank" and would never be called. The bank examiner would consider the promissory note for what it appeared to be — the unconditional obligation of the party who signed it, and would value the loan as an asset of the bank accordingly. When the bank failed and a receiver sued to collect, the dupe would assert as a defense the oral agreement negating his liability.

Courts considering such "fictitious asset" cases applied classical contract principles and decided them based on the presence or absence of consideration for the obligation. A few courts recognized that application of these principles could reward dishonest bankers and their cronies. In The German American State Bank v. Watson, the defendant gave his note to the bank as an accommodation to his friend who had already borrowed the statutory limit from the bank. In dicta, the court observed that the defendant could not avoid liability by proof that he and the bank intended that his unconditional obligation would have no effect other than to deceive the bank examiner. Alternatively to its holding that the defendant’s obligation was supported by consideration, the court held: "To allow the relations of the parties to be controlled by such an agreement would be to countenance and give effect to a secret arrangement entered into for the purpose of evading the law which limits the amount which a bank may lend to one person."

45 See, e.g., Higgins v. Ridgeway, 47 N.E. 32 (N.Y. 1897); Note, Liability on a Note Given to a Bank as a Fictitious Asset, 38 HARV. L. REV. 239, 239-40 (1925) (criticizing decisions finding sufficient consideration for defendant's note in his improved position as a stockholder of the bank as "overstep[ping] the commonly accepted bounds of consideration.")
46 99 Kan. 686 (1917).
47 Id. at 693.
48 Id. at 690. In First National Bank of New Rockford v. Davidson, 188 N.W. 194 (N.D. 1922), the court opined in dicta that the defendants' note, given to the bank to deceive the bank examiner as to the extent of their overdraft, was enforceable against them. The court reasoned that defendants knew that banking was "fraught with public concern" and that "public faith and credit and honesty in business transactions" are critical assets of a bank. Id. at 199. Even assuming that the note was supported by legal consideration, "it was wrong for the defendants to so sign such note upon any understanding of nonliability . . . ." Id. See also Vallely v. Devaney, 194 N.W. 903, 906 (N.D. 1923) ("To
By the 1930s, state courts had recognized a rule which estopped a defendant from asserting non-liability on an obligation pursuant to an agreement with the bank designed to fool the bank examiners. The common law rule was based on the doctrine of equitable estoppel and operated when a party to an obligation permitted it to be used in a way that overstated the bank's assets. The rule thus estopped the obligor from asserting a defense based on a side agreement with the bank that his obligation was not what it appeared to be.

The Supreme Court in *D'Oench, Duhme & Co. v. FDIC,* incorporated the state law rule into federal common law to immunize the FDIC from defenses of borrowers. The facts in *D'Oench* reveal a familiar attempt by the failed bank to prop up its financial statement by "cooking" its books. The petitioner was a securities broker who sold bonds to a bank. After default on the bonds, the petitioner purchased them by exchanging the bonds for promissory notes. The bank could then show the bank examiner "live" notes on its books in place of the defaulted bonds, with the effect of concealing the bank's losses on the bonds. The obligor asserted as a defense to the FDIC's collection action that its note was given without consideration and that the FDIC was not a holder in due course.

The Court held as a matter of federal common law that the obligor's defense based on a "secret agreement" was invalid against the FDIC. To allow such a defense would derogate

sanction any arrangement, therefore, whereby the real assets and securities of a bank are to be regarded as less than or different from the apparent assets and securities, would tend to defeat the entire purpose of the regulatory measures.

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50 315 U.S. 447 (1942).

51 Id. at 454.

52 A few years before *D'Oench,* in *Deitrick v. Greaney,* 309 U.S. 190 (1940), the Court held that as a matter of federal law, a borrower was estopped from asserting against a receiver of a failed bank a defense based on an oral understanding that the bank would never call his note. The borrower and the bank had used the note to conceal from the bank examiner the bank's criminal purchase of its own stock. The Court held that the purpose of the criminal sanctions under the National Bank Act would be defeated "if a director or officer or any other by his connivance could place in the bank's portfolio his obligation good on its face, as a substitute for its stock illegally acquired." Id. at 195. In *Deitrick,* the obligor's action was itself a violation of the National Bank
from the federal policies underlying the FDIC Act which "pro-protect [the FDIC] . . . from misrepresentations made to induce or influence the action of [the FDIC]." Justice Jackson, in a concurring opinion, observed: "The [FDIC] did not simply step into the private shoes of local banks. The purposes sought to be accomplished by it can be accomplished only if it may rely on the integrity of banking statements and banking assets." The FDIC thus became immune from any defense raised by an obligor whenever an obligation "was designed to deceive the creditors or the public authority or would tend to have that effect."

The Court held that proof of the obligor's intention to deceive the bank examiners was not required. Even though the obligor did not know the bank would use his note to deceive the FDIC, he presumptively knew that the note concealed the true value of the bank's assets from the bank examiners. The obligor need only have been aware of the appearance made by his note in the records of the bank. The Court noted, "It would be sufficient in this type of case that the [obligor] lent himself to a scheme or arrangement whereby the banking authority on which [the FDIC] relied in insuring the bank was or was likely to be misled."

Act. 309 U.S. at 198. In D'Oench, however, the obligor had committed no statutory offense. Even though the FDIC Act imposed criminal sanctions on persons who lied to influence the FDIC, 315 U.S. at 461, the obligor had executed the promissory notes before the FDIC came into existence. Id. at 464 (Frankfurter, J. concurring).

53 315 U.S. at 459 (citation omitted).

54 Id. at 472.

55 Id. at 460. Whether the bank or the FDIC is actually deceived is irrelevant. Id. at 459, 461. The D'Oench doctrine bars affirmative claims as well as defenses. E.g., Timberland Design, Inc. v. First Service Bank for Savings, 932 F.2d 46 (1st Cir. 1991). The FDIC is entitled to immunity under the D'Oench doctrine in its corporate and receivership capacities. E.g., FDIC v. McClanahan, 795 F.2d 512, 514 (5th Cir. 1986). The D'Oench doctrine protects the FSLIC. E.g., McLemore v. Landry, 898 F.2d 996, 1000 (5th Cir.), cert. denied sub nom., River Villa Partnership v. Sun Belt Fed'l Bank F.S.B., ___ U.S. ___, 111 S.Ct. 428 (1990). Assignees of the federal insurers are entitled to immunity under the D'Oench doctrine as well. E.g., Porras v. Petroplex Sav. Ass'n, 903 F.2d 379 (5th Cir. 1990); Bell & Murphy and Assocs., Inc. v. Intenfirst Bank Gateway, 894 F.2d 750 (5th Cir. 1990); FDIC v. Newhart, 892 F.2d 47 (8th Cir. 1989).

56 315 U.S. at 459-60.

57 Id. at 460.

58 Id. at 460. The obligor's ignorance of the bank's scheme to conceal its
Whether an obligor has "lent himself to a scheme or arrangement" sufficient to invoke the *D'Oench* doctrine against him has been the subject of litigation. For example, in *FDIC v. Meo*, an obligor executed a note in favor of a bank as payment for his purchase of voting stock in the bank. Unbeknownst to the obligor, the bank sold him non-voting stock. After the bank failed, the FDIC sued to collect the obligation, and the obligor raised fraud and failure of consideration as defenses. The Ninth Circuit held for the obligor. The *D'Oench* doctrine did not bar the obligor's defense of failure of consideration because the obligor "was neither a party to any deceptive scheme involving, nor negligent with respect to, circumstances giving rise to the claimed defense to his note ...."

Only a few litigants have been as successful as Meo in establishing innocence as a defense to the *D'Oench* doctrine. In *FDIC v. McClanahan*, the obligor signed a promissory note but left the amount due blank on the oral understanding that if the bank approved his loan application, the bank would fill in the appropriate amount. An unscrupulous bank officer told the obligor that his loan application had been denied. The obligor failed to retrieve his incomplete note. The officer completed the note and pocketed the proceeds. The Fifth Circuit concluded that by signing and delivering a blank promissory note, the true net worth was no defense to the application of the doctrine. *Id.* In his concurring opinion, Justice Jackson observed: "[T]he obligor's conduct was intended to and did have a direct and independent effect on unknown third parties, among whom [the FDIC] now appears." *Id.* at 474 (citation omitted).

Appellant was a bona fide purchaser-borrower; he did not enter into any scheme or secret agreement whereby the assets of the bank would be overstated; he was wholly innocent of the wrongful action of [the bank] in issuing voting trust certificates instead of common stock shares; he was not negligent in failing to discover the manner in which the stock order was actually executed; and, most importantly, appellant had no knowledge whatsoever of the failure of consideration until after the bank was closed and appellee instituted this suit. *Id.* at 792.

The court distinguished the facts from those in *D'Oench*:


2. 795 F.2d 512 (5th Cir. 1986).
obligor "lent himself" to a scheme sufficiently to invoke the
D'Oench doctrine against him. The court left open the possi-
bility that an obligor's innocence may preclude estoppel under
the D'Oench doctrine: "It may be possible to imagine circum-
stances in which — whether because of prevailing business
practices or the maker's extreme lack of sophistication — the
signing of a blank note could be so wholly innocent as to pre-
clude the FDIC from requiring on that basis alone that the
maker be estopped from defending himself on grounds of failure
of consideration and fraud in the inducement."

B. 12 U.S.C. § 1823(e)

In 1950, Congress enacted statutory immunity for the FDIC
in 12 U.S.C. § 1823(e). Under § 1823(e), an obligor may as-
sert a claim or defense against the FDIC only if she has ex-
pressly conditioned her obligation to pay on the events giving
rise to the claim or defense. Courts have generally taken the
view that § 1823(e) codifies the D'Oench doctrine. Nonetheless, the D'Oench doctrine has survived as an independent basis
of immunity.

Both the D'Oench doctrine and § 1823(e) focus on the nature
of the obligation and whether it appeared unconditional, thus
"tending to deceive" bank examiners. Unlike the D'Oench doc-

63 Id. at 517.
64 Id. at 516, (citing Meo, 505 F.2d at 792). But see, FSLIC v. Gordy, 928 F.2d 1558, 1566 (11th Cir. 1991) (D'Oench doctrine applies even in the absence of bad faith, recklessness or negligence of the obligor).
65 See supra, note 9. FIRREA subsequently amended § 1823(e) to provide explicitly for its application to the FDIC in its capacity as receiver, and made some grammatical changes. Pub. L. 101-73 § 217(4). FDIC v. State Bank of
Virden, 893 F.2d 139, 143 (7th Cir. 1990).
66 See, e.g., Twin Constr., Inc. v. Boca Raton, Inc., 925 F.2d 378, 382 (11th Cir. 1991); Firstsouth F.A. v. Aqua Constr., Inc., 858 F.2d 441, 442, n.2 (8th Cir. 1988); FDIC v. Blue Rock Shopping Center, Inc., 766 F.2d 744, 753 (3d Cir. 1985); Hartigan v. Commonwealth Mortgage Corp. of America, 723 F. Supp. 1258, 1261 (N.D. Ill. 1989) ("[T]he D'Oench doctrine sweeps more broadly than [section 1823(e)]."); Miller & Meacham, supra note 8, at 627-28 (arguing that Congress intended to restrict the FDIC's powers pursuant to § 1823(e) rather than expand them).
trine, however, § 1823(e) expressly defines when an “agree-
ment” has the tendency to deceive bank examiners — when it
fails to satisfy each of the section’s four recordation require-
ments. An agreement, to be effective against the FDIC, must be
written, executed contemporaneously with the acquisition of the
obligation by the bank, approved by the bank’s board of direc-
tors or its loan committee as noted in the bank’s minutes, and,
continuously an official record of the bank. Under § 1823(e),
the FDIC is immune unless the statute’s four recordation re-
quirements are satisfied even if the FDIC had actual knowledge
of an unrecorded claim or defense. The FDIC thus acquires
obligations free from any claim or defense based on an agree-
ment that purports to negate or impose conditions on the obli-
gor’s obligation to pay and which is not a part of the bank’s
records.

Section 1823(e) also appears to render the culpability of the
obligor irrelevant. Nonetheless, culpability remained an issue in

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68 The Supreme Court in Langley v. FDIC, 484 U.S. 86 (1987), recognized
two related policy goals underlying § 1823(e). First, by barring all claims or
defenses based on agreements which are not part of a bank’s official records,
the statute protects the reliability of bank records, and ostensibly enables bank
examiners to rely on them in evaluating the worth of a bank’s assets and the
extent of its liabilities. Id. at 91-92. Second, by requiring contemporaneous and
continuous recordation of all aspects of an agreement, § 1823(e) ostensibly
“ensures mature consideration of unusual loan transactions by senior bank
officials and prevents fraudulent insertion of new terms with the collusion of
bank employees when a bank appears headed for failure.” Id. at 92. The contemproaneity requirement has resulted in uncertainty as to whether a post-
closing loan modification or workout is enforceable against the FDIC. See FDIC
v. Laguarta, 939 F.2d 1231, 1234, 1239 (6th Cir. 1991); FDIC v. Manatt, 922
F.2d 486, 489 (8th Cir.), cert. denied, ___ U.S. ___, 111 S.Ct. 2889 (1991) (dicta);
RTC v. Crow, 763 F. Supp. 887, 892-95 (N.D. Tex. 1991); Elizabeth C. Yen,
Loan Modification and Workout Agreements: Are They Inherently Unenforceable

69 The Supreme Court held that the FDIC’s actual knowledge of an unre-
corded claim or defense was irrelevant. Langley v. FDIC 484 U.S. 86, 94-95
(1987); FDIC v. Rosenthal, 477 F. Supp. 1223, 1227 (E.D. Wis. 1979), aff’d, 631
F.2d 733 (7th Cir. 1980) (FDIC’s notice of substantial discount off face value of
note at time of acquisition would not affect its immune status under § 1823(e)).
The Court’s holding in Langley has been extended to the D’Oench doctrine.
FDIC v. Laguarta, 939 F.2d 1231, 1238 (5th Cir. 1991) (“Although Langley was
decided under section 1823(e), we find no reason why we should reach a
different result in this respect under D’Oench Duhme than we would reach
under section 1823(e).”); Sunbelt Savings FSB v. Amrecorp Realty, 736 F. Supp.
litigation by way of a narrow interpretation of the term "agreement." Section 1823(e) only invalidates claims or defenses based on an "agreement." Instead of asserting their innocence, obligors could escape § 1823(e) by characterizing their claim or defense as one in equity, tort, or any way other than based on an agreement. Regardless of whether the FDIC asserted the D'Oench doctrine or § 1823(e) or both, the obligor could overcome the FDIC's immunity by arguing that he was a blameless victim of the failed bank's wrongdoing. For example, an obligor might assert that the failed bank made misrepresentations that induced her to enter into a loan. The obligor would argue that her defense of fraud in the inducement was not based on an agreement. Because the defense was not based on an agreement, but rather the bank's fraud, § 1823(e) would not protect the FDIC. Moreover, because the obligor did not "lend herself" to a scheme, the D'Oench doctrine would also be unavailable to the FDIC.

In Langley v. FDIC, the Supreme Court held that the term "agreement" in § 1823(e) includes any conditions on the obligor's obligation to pay, including the truthfulness of representations made to induce the obligor to undertake the obligation. The decision eliminated the relevance of the culpability of the obligor and undercut the viability of fraud defenses against the FDIC. The FDIC acquired Langley's promissory note as

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70 See infra note 75.
71 For example, in Gunter v. Hutcheson, 674 F.2d 862 (11th Cir.), cert. denied, 469 U.S. 826 (1982), obligors on a $3 million note held by the FDIC pursuant to a purchase and assumption transaction attempted to rescind it on the grounds of the failed bank's fraud. The Eleventh Circuit held that § 1823(e) did not bar the obligors' defense because the defense was not based on an agreement. The court characterized their defense as based on the premise that because of the fraud of the bank, no agreement existed at all. Id. at 867. The court ultimately held the FDIC was immune from the defense based on federal common law. See infra, notes 73-81 and accompanying text.
74 See FDIC v. Gordy, 928 F.2d 1558, 1566-67 (11th Cir. 1991); Timberland Design, Inc. v. First Service Bank for Savings, 932 F.2d 46, 50 (1st Cir. 1991); Hartigan v. Commonwealth Mortgage Corp. of America, 723 F. Supp. 1258, 1262 n.5 (N.D. Ill. 1989) ("pre-Langley decisions . . . call for a greater degree of
part of a purchase and assumption transaction and brought suit to collect. Langley defended on grounds that the failed bank had procured his note by fraudulent misrepresentations regarding the land Langley was to obtain in exchange for it. The FDIC claimed immunity under § 1823(e). Langley argued that his fraudulent inducement defense was not based on an agreement and was not barred by § 1823(e).

The Court rejected Langley’s contention that the term “agreement” encompassed only promises to perform an act in the future. It noted that § 1823(e) allows federal and state bank examiners to rely on a bank’s records in evaluating the worth of the bank’s assets. The specific recordation requirements in § 1823(e) “ensure mature consideration of unusual loan transactions by senior bank officials, and prevent fraudulent insertion of new terms, with the collusion of bank employees, when a bank appears headed for failure.” To further these purposes, the term “agreement” must encompass every understanding between the parties regarding the obligation, including both promises and conditions to liability. Section 1823(e) barred Langley’s defense of fraudulent inducement because it was

borrower involvement than the Supreme Court has now made clear is required).  

Prior to Langley, many courts interpreted the term “agreement” to encompass only promises. E.g., FDIC v. Leach, 772 F.2d 1262 (6th Cir. 1985) (failure of consideration defense not based on agreement); Gunter v. Hutcheson, 674 F.2d 862 (11th Cir.), cert. denied, 469 U.S. 826 (1982) (fraud in the inducement defense not based on agreement); FDIC v. Ohlson, 659 F. Supp. 490, 491 (N.D. Iowa 1987) (mental incapacity defense not based on agreement).

“Such evaluations are necessary when a bank is examined for fiscal soundness by state or federal authorities . . . and when the FDIC is deciding whether to liquidate a failed bank . . . or to provide financing for purchase of its assets . . . by another bank . . . The last kind of evaluation, in particular, must be made ‘with great speed, usually overnight, in order to preserve the going concern value of the failed bank and avoid an interruption in banking services.’” 484 U.S. at 91 (quoting Gunter v. Hutcheson, 674 F.2d 862, 865 (11th Cir.), cert. denied, 469 U.S. 826 (1982)). In reality, the FDIC does not evaluate a failed bank’s assets overnight. It typically has a fairly accurate picture of the fair market value of a bank’s loan portfolio well before it determines to enter into a purchase and assumption transaction. The consummation of a purchase and assumption transaction itself may occur overnight. See supra notes 26-28 and accompanying text.

Langley, 484 U.S. at 92.

Id. at 87.
really based on a defense of failure of an unrecorded condition precedent — the truthfulness of the oral representations. 79

The Court interpreted the meaning of the term “agreement” by reference to the black letter law of contracts. 80 But it clarified another question regarding the scope of § 1823(e) by analogy to state law governing negotiable instruments. Langley argued that because of the failed bank’s fraud, the FDIC had no “interest” in his obligation which the agreement in question could “tend to diminish.” Therefore, the FDIC did not acquire an “asset” to which its statutory immunity attached. The Court resolved the issue by citing to U.C.C. § 3-305, which excepts from a holder in due course’s immunity those defenses which would render an obligation void as opposed to merely voidable. 81 Langley’s fraud in the inducement defense could render his obligation merely voidable, and so the FDIC’s voidable title to it was protected under § 1823(e). 82

To illustrate, suppose the FDIC acquires an instrument that purports to be the unconditional promissory note of A as part of a purchase and assumption transaction. In defense, A claims that she only signed the note because a bank officer held a gun to her head. Using the rubric of the holder in due course rule, A raises a “real” defense, that of duress, which would be valid against a holder in due course. 83 Consequently, the obligor may raise this defense notwithstanding § 1823(e). If, however, the obligor’s defense was “personal” (rendering the obligation voidable as opposed to void), it would be subject to the recordation requirements of § 1823(e). 84

79 Id. at 91. The Court held: “Quite obviously, the parties’ bargain cannot be reflected without including the conditions upon their performance, one of the two principal elements of which contracts are constructed.” Cf. FARNSWORTH, CONTRACTS § 8.2, at 537 (1982) (“[P]romises, which impose duties, and conditions, which make duties conditional, are the main components of agreements”). Id.

80 Id. at 90-91.

81 Id. at 93 (citing U.C.C. § 3-305(2)(c) (1978)). See U.C.C. § 3-305(a)(1) (1990).

82 Langley, 484 U.S. at 93-94.


Although it cited the holder in due course rule to support part of its opinion, the Court did not address whether the rule of immunity embodied in § 1823(e) applies only when the obligation at issue is negotiable.86 The Court described Langley’s obligation as a “facially unqualified note,”96 and an “instrument.”97 But it did not expressly find that Langley’s obligation was negotiable, nor did it expressly limit its holding to negotiable instruments or even unconditional obligations to pay.88 The ordinary meaning of “asset,” as it appears in § 1823(e), includes not only property rights in the form of unconditional obligations but also property rights under bilateral contracts. After Langley, the issue remains whether and to what extent a rule of immunity applies to the FDIC where the obligation in issue is part of a bilateral agreement.89

C. The Federal Holder in Due Course Rule

The federal holder in due course rule by which the FDIC acquires the immunity of a state law holder in due course appeared prior to Langley probably as a means of closing the escape hatch from the D’Oench doctrine and § 1823(e) for unwitting victims of bank misconduct. The first whisper of the rule appeared in a 1978 district court opinion. In FDIC v. Rockelman,90 the obligor alleged fraud in the inducement against the FDIC, in particular that the failed bank tricked him into exchanging his promissory note for shares of the failed bank’s holding company. The bank officer allegedly induced Rockelman to execute the note by representing that dividends on the shares would pay the interest on it and that the shares would

86 Some circuit courts have not limited applicability of § 1823(e) to negotiable instruments. See FDIC v. Aetna Casualty & Surety Co., 947 F.2d 196, 206 n.9 (6th Cir. 1992) (dicta); FDIC v. Galloway, 856 F.2d 112 (10th Cir. 1988); FDIC v. P.L.M. Int’l, Inc., 834 F.2d 248, 254 (1st Cir. 1987); FDIC v. Gulf Life Ins. Co., 737 F.2d 1513 (11th Cir. 1984).
87 Langley, 484 U.S. at 93.
88 Id.
89 Id. at 86. In Gunter, in which the Eleventh Circuit applied the federal holder in due course rule, the obligation was a “note” containing no “transfer restrictions.” Gunter, 674 F.2d at 872.
90 See infra notes 124-134 and accompanying text.
appreciate sufficiently to repay the principal.  Although the court quoted § 1823(e), it did not discuss whether the obligor's defense was based on an agreement, and if so, whether the agreement satisfied the recordation requirements. Instead, the court asserted without citation to authority that Congress intended § 1823(e) to "clothe [the FDIC] with the protections afforded a holder in due course and shield [the FDIC] against any defenses that would otherwise be available." Such immunity would "promote soundness in banking and . . . aid and protect the FDIC in the conduct of its duties."

Nine years after Rockelman but five years before Langley, the Eleventh Circuit adopted the holder in due course concept to protect the FDIC from an obligor's defense of fraud in the inducement. In Gunter v. Hutcheson, Gunter alleged fraud in the inducement as a defense to the FDIC's suit against him on his promissory note. The court held that § 1823(e) did not bar Gunter's defense because it was not based on an agreement. Rather, no agreement existed at all because of the failed bank's fraud. Nonetheless, the court held that federal common law immunized the FDIC from Gunter's defense. The court observed that any other result would undercut the FDIC's immunity under § 1823(e). If fraud in the inducement was a valid defense under § 1823(e), an obligor would merely plead as fraud what was in substance but not form the bank's failure to perform an unrecorded agreement.

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91 Id. at 1000.
92 The Court in Langley did not expressly adopt the Rockelman court's expansive interpretation of § 1823(e). Langley interpreted the term "agreement" in § 1823(e) to include any promise or condition which limits the obligor's liability. It did not hold that § 1823(e) gave the FDIC the rights of a holder in due course.
93 Rockelman, 460 F.Supp. at 1003. The court's assertion regarding Congressional intent appears inconsistent with the scant history on the original enactment of § 1823(e). See, Miller & Meacham, supra note 8, at 626-28.
94 460 F. Supp. at 1003. The court acknowledged that some defenses would remain valid against the FDIC but expressly declined to identify them. Id. at 1003.
95 674 F.2d 862 (11th Cir.), cert. denied, 459 U.S. 826 (1982).
96 Id. at 867.
97 Id. at 871-72. The court did not consider whether Gunter's defense constituted fraud in fact, a "real" defense which would be valid against a holder in due course. It held: [The FDIC has a complete defense to state and common law fraud
The court in Gunter applied the test enunciated by the Supreme Court in United States v. Kimbell Foods, Inc.,\(^9\) to justify both the creation of federal common law and the adoption of a federal rule that differed from the applicable state law rule.\(^9\) Citing D'Oench, the court held that federal law controls the rights and obligations of the FDIC.\(^10\) It further held that, given the special circumstances facing the FDIC, the substance of the federal law should not follow state law. Rather, the federal rule should comprehensively immunize the FDIC from those claims and defenses that would be invalid against a holder in due course.

According to the court, the first two factors in the Kimbell Foods test — the need for national uniformity and the impact of state law on the furtherance of federal goals — dictated a uniform federal rule of immunity for the FDIC. The court reasoned that the FDIC needed immunity to fulfill its statutory function. First, purchase and assumption transactions preserved "stability of and confidence in the banking system" and thus were preferable to liquidation as a method of bank failure reso-

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\(^9\) Gunter, 674 F.2d at 869-72. In Kimbell Foods, the Court adopted a two part test for determining whether state or federal law governed the priority of the Small Business Administration (SBA) and the Farmers Home Administration (FHA) as creditors. The first part of the test involved a determination of whether state or federal law should govern the question. Federal law provided the rule of decision because the SBA and the FHA "derived their authority to effectuate loan transactions from specific Acts of Congress passed in the exercise of a 'constitutional function or power.'" 440 U.S. at 726-27. The second part of the test involved determining the content of the federal law, particularly whether state law should provide the federal rule of decision. This depended on consideration of three factors: (1) whether the federal program required nationwide uniformity; (2) whether adopting state law would frustrate national policy; and (3) whether a federal rule would disrupt commercial relations based on state law. \textit{Id.} at 728. The Court concluded that a uniform national rule was not necessary and that the state law embodied in the U.C.C. should provide the rule of decision. \textit{Id.} at 729.

\(^10\) 674 F.2d at 869. The court also cited D'Oench as providing a "general basis for a federal policy to protect the FDIC." \textit{Id.} at 872 n.14.
lution.\textsuperscript{101} Under federal statute, the FDIC could enter into a purchase and assumption transaction only where the cost of such a transaction was less than the cost of a pay-out of insured depositors’ claims. Because of the severe time constraints the FDIC faced when determining how to resolve a bank failure, “the only method of evaluating potential loss open to the FDIC [is] relying on the books and records of the failed bank to estimate what assets would be returned by a purchasing bank and to estimate which of those assets ultimately would be collectible.”\textsuperscript{102} Without a uniform rule of immunity, the FDIC would be faced with the “impossible” task of determining which assets would be collectible and which would be subject to an undisclosed claim or defense.\textsuperscript{103} If put to this task, the FDIC might not choose a purchase and assumption transaction, a result contrary to the federal goals underlying the creation of the FDIC.\textsuperscript{104}

In weighing the third \textit{Kimbell Foods} factor — impact on settled commercial expectations — the court emphasized the unconditional nature of Gunter’s obligation. It observed that

\begin{itemize}
  \item \textsuperscript{101} Id. at 870.
  \item \textsuperscript{102} Id.
  \item \textsuperscript{103} The court held that a uniform federal rule of immunity was necessary to protect the FDIC’s statutory function given the practical constraints on the FDIC’s decisions in a bank failure.
  \item Unlike the loan programs of the SBA and FHA, which provided ample opportunity for federal officials to ascertain the impact of state law on loan decisions, decisions concerning the appropriate method of dealing with a bank failure must be made with extraordinary speed if the going concern value of the failed institution is to be preserved. Subjecting the FDIC to the additional burden of considering the impact of possibly variable state law on the rights involved could significantly impair the FDIC’s ability to choose between the liquidation and purchase-and-assumption alternatives in handling a bank failure.
  \item 674 F.2d at 869. The factual premise on which the court based its conclusion does not reflect reality. The FDIC does not evaluate the market value of a failed bank’s assets overnight. See supra note 26.
  \item \textsuperscript{104} The First Circuit has held that the federal holder in due course rule is designed expressly to facilitate the FDIC’s use of purchase and assumption transactions. In re 604 Columbus Avenue Realty Trust, 968 F.2d 1332 (1st Cir. 1992). Consequently, the FDIC cannot invoke the federal holder in due course rule unless it has acquired the obligation by way of a purchase and assumption transaction. \textit{Id. Accord}, FDIC v. Laguarta, 939 F.2d 1231, 1239 n.19 (5th Cir. 1991). The \textit{D’Oench} doctrine is not subject to this limitation and can apply even when the FDIC acquired the obligation by operation of law as receiver.
\end{itemize}
Gunter’s note contained no “transfer restrictions,” though the court did not state whether the obligation was in negotiable form. The court found that the FDIC was not a holder in due course of the note simply because the FDIC acquired it outside the ordinary course of the failed bank’s business. The court held that Gunter’s obligation could have fallen into the hands of a holder in due course who would have been immune from his defense. Thus, a rule immunizing the FDIC could have only an insignificant impact on Gunter’s commercial expectations. Because Gunter should have anticipated the possibility that his obligation could fall into the hands of an immune party, the first two Kimbell Foods factors outweighed the third.

These decisions articulate a federal holder in due course rule that creates immunity for the FDIC similar to that enjoyed by a holder in due course, even though the FDIC does not qualify for such immunity under state law. If the FDIC acquires an obligation in a purchase and assumption transaction, for value, in good faith, and without actual knowledge of the defense at the time it entered into the purchase and assumption agreement, it takes the obligation free of any defense that would be invalid against a holder in due course. With federal holder in due course immunity, the FDIC trumps the obligor’s personal defenses regardless of whether the obligor “lent himself” to a scheme to defraud, or whether the defense asserted was based on an agreement. Thus the federal holder in due course rule plugged a hole in both the D’Oench doctrine and

105 674 F.2d at 872.
106 Id.
107 Id. The court’s conclusion would be correct only if Gunter’s obligation was in negotiable form.
108 See, e.g., FSLIC v. Murrey, 853 F.2d 1251, 1256 (5th Cir. 1988) (expressly relying on U.C.C. § 3-302 (1978) for the substance of federal holder in due course immunity).
pre-Langley § 1823(e) through which an "innocent" obligor could pass. In essence, the federal holder in due course rule immunizes the FDIC from certain claims and defenses against which it would not be immune under the D'Oench doctrine or § 1823(e).

The requirements for federal holder in due course status are custom tailored to fit the FDIC. In FDIC v. Wood, the court held that, absent actual knowledge about a defense to an obligation acquired in a purchase and assumption transaction, the FDIC is sufficiently "innocent" to qualify for the immunities of a holder in due course even when it does not satisfy the requirements of holder in due course status. It held: "If it is true that the state's bright-line requirements prevent the FDIC from being a holder in due course, then it is inappropriate to apply those requirements to a government agency crucial to the existence of the modern banking system when they are without purpose." The court did not explore what the purpose of the rejected bright-line requirements might be.

110 Under the federal holder in due course rule, whether the obligor's claim or defense sounded in tort, equity or statutory violation, or whether the obligor "lent himself" to a scheme to deceive became irrelevant. For example, in FDIC v. Wilson, 722 F. Supp. 306 (N.D. Tex. 1989), the court held that even if an obligor could establish his "complete innocence" as an escape from the D'Oench doctrine, he must still establish that "the basis of his innocence is a defense available against a holder in due course." 722 F.Supp at 317. The obligor alleged mental incapacity as a defense to his obligation. Because under Texas law, the defense of mental incapacity was invalid against a holder in due course, the FDIC was immune from it under the federal holder in due course rule. Id. at 317-18.

111 Gunter, 674 F.2d at 872 n.14; In re 604 Columbus Avenue Realty Trust, 968 F.2d 1332 (1st Cir. 1992). In FDIC v. Ohlson, 659 F. Supp. 490, 491 (N.D. Iowa 1987), the court held that § 1823(e) did not bar the defense of mental incapacity because it was not based on an agreement. Nonetheless, the federal holder in due course rule immunized the FDIC against it. Id. at 491.

112 758 F.2d 156 (6th Cir.), cert. denied, 474 U.S. 944 (1985). The Sixth Circuit applied the federal holder in due course rule to invalidate an obligor's usury defense. Under state usury law, the note in question bore an interest rate which exceeded the lawful limit for a non-business loan. Because the defense asserted was usury and was not based on an agreement (pre-Langley), neither the D'Oench doctrine nor § 1823(e) squarely applied to bar it. The court adopted the Gunter court's formulation of the federal holder in due course rule, and held that the obligor's usury defense was invalid against the FDIC because it would be invalid against a holder in due course under state law. Id. at 159-61.

113 Id. at 160.
The federal holder in due course rule protects the FDIC when it acquires an asset in a purchase and assumption transaction, even though acquisition of an obligation in an out of the ordinary course transaction would normally preclude holder in due course status. Furthermore, the FDIC's acquisition of the obligation in a purchase and assumption transaction automatically satisfies the requirements that the FDIC acquire the obligation in good faith and for value.

Under the federal holder in due course rule, the FDIC is immune unless it has "actual knowledge" of the defense. The obligor in Wood argued that the FDIC did not qualify for immunity because it had constructive knowledge of the defense of usury. The obligor asserted that his note bore an interest rate in excess of the non-business limit, and the failed bank's files did not contain an affidavit of business purpose, which the state usury statute required. The court rejected this argument and held that for purposes of the federal holder in due course rule the FDIC is immune unless it has actual as opposed to constructive knowledge of a defense as of the date of the purchase and assumption transaction, and that the FDIC is entitled to a presumption that it has no knowledge of a defense. Thus, unlike under the D'Oench doctrine or § 1823(e), for federal holder in due course status, the FDIC is not charged with knowledge of defenses that review of the bank's records would have revealed. In the context of a

114 See infra note 163 and accompanying text. E.g., Sunbelt Savings, FSB v. Montross, 923 F.2d 353, 355 (5th Cir. 1991) ("the FDIC receives notes by bulk transfer involuntarily and as a matter of course, thus, such a technical state-law requirement cannot be allowed to defeat the policy behind federal holder in due course doctrine."); Campbell Leasing, Inc. v. FDIC, 901 F.2d 1244, 1249 (5th Cir. 1990).

115 Gunter, 674 F.2d at 872-73. The court held that when the FDIC acquires an obligation as part of a purchase and assumption transaction, it gives "value" for it. It further held that acquisition of the obligation in a transaction between FDIC as receiver and FDIC-Corporate, notwithstanding that the parties did not deal at arms' length, was in good faith. Id. at 873-74. FDIC v. Ashley, 585 F.2d 157 (6th Cir. 1978).

116 758 F.2d at 161-62. As to the distinction between actual and constructive notice, see Brian A. Blum, Notice to Holders in Due Course and Other Bona Fide Purchasers Under the Uniform Commercial Code, 22 B.C. L. REV. 203, 209-12 (1981).

117 758 F.2d at 161-62.

118 FDIC v. Wood, 758 F.2d at 156, 162. The FDIC is charged with knowl-
purchase and assumption transaction, the court reasoned that the FDIC simply does not have time to examine the assets of the troubled bank to determine their value. Strangely, this conclusion contradicts one of the expressed purposes of the FDIC’s immunity — to enable it to rely on the recorded value of obligations in determining whether to engage in a purchase and assumption transaction.

The *Wood* court’s holding with respect to the meaning of “actual knowledge” is confusing in light of the uncertainty as to whether the federal holder in due course rule applies to non-negotiable instruments. Under the holder in due course rule, a transferee is charged with knowledge of certain egregious irregularities that appear on the face of the negotiable instrument; a transferee is not charged with knowledge of irregularities that appear in documents other than the instrument itself. In *Wood*, the court reached the result that would have obtained under the state law holder in due course rule governing negotiable instruments without determining whether the obligation at issue was negotiable, and without expressly limiting its holding to negotiable instruments. Suppose an obligation is expressly conditional in the sense that the obligor’s obligation to pay is expressly subject to performance by the obligee according to terms of the agreement. If the federal holder in due course rule applies (notwithstanding that the obligation is not in negotiable form), the FDIC may acquire the obligation free of defenses which appear in the writing but of which the FDIC had no actual knowledge because it did not actually read the contract.
D. Incongruence Among the Sources of Immunity

The D'Oench doctrine, § 1823(e), and the federal holder in due course rule overlap with unexplained differences at the margin. It is puzzling why all three sources of immunity continue to exist notwithstanding that each purports to further the same goal: to enable the FDIC to carry out its statutory duties. Perhaps three distinct sources of immunity exist because it is to the FDIC's advantage that they do. If the FDIC is not immune under one source of immunity, it may be immune under another. The FDIC, by shifting the three sources of immunity like shells in the infamous con, can stretch its immunity beyond the scope of any one source.

The existence of three sources of immunity creates a number of problems. For example, each of the three sources limits the FDIC's immunity depending on the nature of the obligation in question, in particular, the extent to which the defense asserted is expressed in the written form of the obligation. The combined rule arising from the three sources, if it is possible to articulate one at all, is unsettled regarding the scope of the FDIC's immunity when the asset on which it sues is not an unconditional obligation to pay.

Under the D'Oench doctrine, the FDIC is immune from an obligor's defense only if the defense relied on by the obligor was not "memorialized in writing or otherwise made explicit such that . . . the FDIC would have knowledge of the bank's obligations during an evaluation of the bank's records." Thus, under the D'Oench doctrine, the bank documents embodying the obligation must "clearly manifest the bilateral nature of the rights and obligations." If the defense alleged is not "manifest" from the bank's records, then the obligor "lent himself to a scheme or an arrangement likely to mislead the banking authorities."

121 FDIC v. McCullough, 911 F.2d 593, 600, en banc reh'g denied, 920 F.2d 13 (11th Cir. 1990).
122 Id. at 601 (quoting FSLIC v. Two Rivers Associates, 880 F.2d 1267, 1275 (11th Cir. 1989)).
123 FDIC v. Gordy, 928 F.2d 1558, 1567 (11th Cir. 1991); FDIC v. Laguarta, 939 F.2d 1231, 1238-39 (6th Cir. 1991) (defenses based on bank's breach of funding obligation as set forth in loan agreement not barred by D'Oench doctrine even though promissory note was silent as to funding obligations.)
Whether a particular defense is sufficiently expressed under § 1823(e) depends on whether the defense satisfies specific recording requirements. If it does not, the obligation is effectively unconditional with respect to that defense in the hands of the FDIC. Some courts have, however, been unwilling to enforce the statute literally when the obligation at issue is not a traditional promissory note but rather a contract with performance obligations on both sides. For example, in *Howell v. Continental Credit Corp.*, the FDIC sought to recover from Howell the amount due on an equipment lease. The obligor/lessee defended on the grounds that the lessor breached its obligation to obtain title to the leased equipment. The court held that although the details of how the lessor was to obtain title were not contained in the lease, the lease "clearly manifested the bilateral nature of the lessee's and lessor's rights and obligations." The court held that "the fact that the court must go outside the leases to test the strength and validity of the defenses is not fatal where the foundation and basis of that defense is in a document arguably meeting the nonsecrecy requirements of § 1823(e)." In *FDIC v. Aetna Casualty & Surety Company*, the Sixth Circuit followed *Howell* and expanded it. The obligation at issue was Aetna's blanket banker's bond covering the failed bank. The FDIC tried to cut off Aetna's defenses of misrepresentation and adverse agency. Although Aetna's defenses were not expressly preserved in the bond, the court held that they were not based on a "secret or unwritten contractual condition" as was the case under both

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124 655 F.2d 743 (7th Cir. 1981).
125 The original lessor discounted the lease with a bank. The bank failed and FDIC acquired the lease in a purchase and assumption transaction.
126 655 F.2d at 747.
127 655 F.2d at 748.
129 The district court held that the bond was an asset and Aetna's defenses were based on an agreement. It held that Aetna's defenses did not satisfy § 1823(e)'s recordation requirements because Aetna did not prove the failed bank's board knew that the bond application contained fraudulent misrepresentations and expressly endorsed those misrepresentations in its minutes. *Id.* at 201-202.
130 The court recognized that *Howell* was distinguishable for this reason. *Id.* at 206.
The court held: "[A] blanket bond, unlike a promissory note, involves bilateral obligations. To strip Aetna of the defense of material misrepresentation... would effectively deny Aetna the benefit of its bargain... [W]e would be 'giving the FDIC the ability to transmute lead into gold.'" The Sixth Circuit in Aetna expressly disagreed with the Eleventh Circuit's holding in FDIC v. Gulf Life Insurance Co. that § 1823(e) barred unrecorded defenses to coverage under an insurance contract.

Under the federal holder in due course rule, any condition to liability appearing in the written form of the obligation defeats the FDIC's immunity. Thus if any defense appears in the writing, the federal holder in due course rule does not immunize the FDIC. The Fifth Circuit in Sunbelt Savings, FSB v. Montross, held that the federal holder in due course rule only protects the FDIC when the obligation is in the form of a negotiable instrument satisfying all the technical requirements for negotiability of Article 3 of the U.C.C. The FDIC sued on a promissory note bearing a variable interest rate which was not technically negotiable under Texas's codification of the U.C.C. The court held that the federal holder in due course rule, as well as the D'Oench doctrine and § 1823(e) operate to protect the FDIC from "disadvantage" when "it is forced to assume control of a troubled financial institution." Extending the federal holder in due course rule to protect the FDIC from defenses against non-negotiable instruments "would bestow a benefit on the FDIC by changing the assets' nature — actually enhancing their value." The Eleventh and Sixth

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131 Id. at 201.
132 947 F.2d at 207, (quoting Sunbelt Sav. FSB Dallas v. Montross, 923 F.2d 363 (5th Cir. 1991)).
133 737 F.2d 1513 (11th Cir. 1984).
134 947 F.2d at 207, 208 n.15.
135 923 F.2d 353, 356, aff'd en banc, 944 F.2d 227 (5th Cir. 1991).
136 Since Montross, the Supreme Court of Texas has held that a variable interest rate note meets the sum certain requirement of U.C.C. § 3-104(1)(b) -(1978). Amberboy v. Societe de Banque Privee, 831 S.W.2d 793 (Tex. 1992). The 1990 revisions to Article 3 achieve the same result by recognizing that an instrument bearing a variable rate of interest can be a negotiable instrument. U.C.C. §§ 3-104(a), 3-112(b) (1990).
137 923 F.2d at 356.
138 Id. The court observed that makers of non-negotiable notes "sign only a
Circuits have not so limited the application of the federal holder in due course rule, but rather have applied it regardless of the non-negotiability of the obligation.\textsuperscript{139}

These cases illustrate the current muddle created by the three sources of immunity. When an obligation is expressed as an unconditional obligation to pay, for example by way of a standard promissory note, all three sources of immunity are relatively easy to apply and all reach the same result. When the obligation is not in such form, but is part of a bilateral agreement, the three sources of immunity can yield inconsistent results.

IV. EVALUATING THE EFFICIENCY OF AN IMMUNITY RULE

When an obligor considers undertaking an obligation, she considers the possibility that she will acquire a claim against the obligee or a defense to her liability caused by the obligee's failure to perform according to the terms of the contract. By private agreement and pursuant to ordinary rules of contract and tort law, the obligor and the obligee allocate between themselves the risk of loss arising from an obligee's potential failure to perform ("nonperformance loss"). From an efficiency standpoint, the parties' private agreement and rules of law operate to allocate loss to whichever of them could have avoided it at lower cost.\textsuperscript{140} The obligor will also consider the possibility that she will incur a fairly rare subset of nonperformance loss. This particular type of loss will occur where the obligor has a contractual obligation to repay their debt; they had no expectation that holder in due course doctrine would strip them of their defenses." Id. In its en banc opinion, the Fifth Circuit held that any personal defenses asserted by the obligor must be "based on documents of the savings institution at the time of its insolvency and not upon secret agreements unenforceable under D'Oench." 944 F.2d at 228-29 (citations omitted).


\textsuperscript{140} RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 95 (4th ed. 1992).
valid claim or defense but cannot effectively assert it to offset or reduce her liability on the obligation.

To illustrate, suppose B agrees to loan A $50 a week for the next year in exchange for A's promise to repay B at the end of two years. Now suppose that, at the same time she enters into the contract with A, B sells to C her right to collect payment from A. Call the transaction between A and B Contract 1, and the transaction between B and C Contract 2.

The value of Contract 1 to A is the value of B's performance — the amount of the loan. Most of the risk A assumes under Contract 1 arises from the possibility that B will not lend the money as promised. But B's nonperformance would not result in a loss to A, for A and B allocated the risk of loss from B's nonperformance to B. In such circumstances, B's nonperformance creates in favor of A a cause of action for breach or a defense to B's claim for payment in an amount equal to the value of B's performance. In other words, A looks primarily to B to compensate her for B's nonperformance. But A would be just as happy to recover for B's nonperformance from C.

Immunity rules reallocate loss between A and C which A and B originally allocated to B. A will ultimately bear loss due to B's nonperformance if two conditions are satisfied: (1) B is insolvent or otherwise unresponsive to the claim or defense; and (2) C is immune. The subset of nonperformance loss that A cannot shift to B or C shall be referred to as "immunity loss."

In this hypothetical, A is the obligor, B is the obligee and C is the transferee.

For example, if B has promised to extend to A a revolving line of credit on which A can draw provided certain conditions are satisfied, B could fail to perform by refusing to advance funds to A even though A had satisfied the conditions.

If B is insolvent but has not transferred A's obligation to an immune party, A will assert her defense against B as a reduction to her liability on the obligation. If A has an affirmative claim against B she can set it off against her liability, to the extent that her obligation is sufficiently executory. Loss to A because of B's insolvency where B has not transferred A's obligation is not considered immunity loss for purposes of this analysis.
Although by definition A cannot shift immunity loss to B, A can insure herself at B's expense against the risk of immunity loss. She can negotiate with B for a reduction in the price of the loan to compensate her for assuming the risk of immunity loss. The reduction in the price of credit is equal to the cost of insurance (the premium) A incurs to insure herself against the risk of immunity loss. The amount of the premium equals A's expected immunity loss (probability of loss multiplied by the magnitude of loss).\footnote{144}

Suppose that A can only acquire one type of defense, and that if it occurs, it would reduce the value of her bargain by $1000. A will demand a reduction in the price she pays for credit equal to $1000 (the value of the defense) times the probability that she will acquire the defense, times the probability that she will not be able to shift the loss arising from the defense to B or C.\footnote{145} A calculates the probability that she will not be able to shift nonperformance loss to either B or C based on two factors: the probability of B's insolvency and the probability that C will be immune to A's claims and defenses.\footnote{146}

Recall that C purchases A's obligation from B. As part of this transaction, C considers the possibility that A will be able to escape liability on her obligation due to a defense she may

\footnote{144} If it is cheaper than paying A to assume the risk of immunity loss (by way of a reduction in the price of credit), B will obtain third party insurance for A against the risk of immunity loss. For example, B could arrange for another party to guarantee his performance. If the probability that the third party would become insolvent is lower than the probability that B would become insolvent, A's expected immunity loss and the price reduction she will demand declines. If the decline in the price A pays for credit (if she assumes the risk) is greater than the cost to B of obtaining the guarantee, B will have an incentive to purchase third party insurance.

\footnote{145} Expressed as a formula, A's expected immunity loss equals $L(PC \times PU)$, where $L$ = the value of the defense; $PC$ = the probability that A will acquire the defense; and $PU$ = the probability that A will not be able to shift the loss to B or somebody else.

\footnote{146} Expressed as a formula: $PU = PF \times PI$ where $PF$ = the probability that B will be insolvent, and $PI$ = the probability that the transferee (C) will be immune. If B is solvent, then A will not bear immunity loss. A will not care whether C is immune because A can shift nonperformance loss to B. Even if B is insolvent, A will not bear immunity loss if B transfers his obligation to a non-immune party because A can shift nonperformance loss to the non-immune party. The probability that a non-immune party would be insolvent would only be relevant as to A's ability to recover for affirmative claims.
acquire against B, thus reducing the value of the obligation to C.¹⁴⁷ Loss due to B's nonperformance that A can shift to C is the inverse of A’s immunity loss (“nonimmunity loss”). In the hypothetical case, A and C divide the total expected loss due to A’s acquisition of a claim or defense and B’s inability to answer for it (“total expected immunity loss”)¹⁴⁸ according to the respective probabilities that each will bear it. C can insure against nonimmunity loss but will demand that B reduce the price of A’s obligation by an amount equal to C’s cost of insurance (expected nonimmunity loss).¹⁴⁹

By demanding compensation from B during the course of negotiating the respective underlying transactions, A and C each in essence insure at B’s expense against the risk of immunity/non-immunity loss. In A’s case, she will demand a reduction in the price of credit. In C’s case, he will demand a discount off the purchase price of A’s obligation. The amount of compensation each party demands will be equal to the cost each party incurs to insure against the risk of loss incurred, that is the expected immunity or nonimmunity loss, as the case may be. The greater the probability that A will bear immunity loss, the higher the premium to insure against it, and the more compensation A will require from B to assume the risk. Conversely, C will demand more compensation from B as the probability that he will bear nonimmunity loss increases.¹⁵⁰

¹⁴⁷ Perhaps the most important factor in the value of Contract 2 to C is A’s creditworthiness. When C purchases A’s obligation from B without recourse to B, C assumes the risk that A will not be able to perform her obligation to repay B (“credit loss”). C assumes the risk of credit loss even if A never acquires a claim or defense, and regardless of B’s solvency. In other words, the risk that C will bear credit loss is unaffected by immunity rules.

¹⁴⁸ Expected immunity loss plus expected non-immunity loss equals total expected immunity loss. Expressed as a formula, total expected immunity loss equals L(PCS x PF).

¹⁴⁹ Expressed as a formula, C’s expected nonimmunity loss equals L(PCS x PF x (1 - PI)). Assuming that L = $1000, PCS = 70%, PF = 40% and PI = 90%, then E(LC) = $252. This is the amount that C will demand from B as a discount off the face value of A’s obligation to compensate C for assuming the risk of L.

¹⁵⁰ Suppose that at the time B enters into Contract 1, he has not transferred A’s obligation to C or anyone else. When A is uncertain as to whether B will transfer A’s obligation at all, A takes into consideration, in addition to the factors outlined above, the possibility that B will be insolvent and not have transferred the obligation. This additional consideration changes the earlier
The foregoing analysis reveals the factors that A and C consider regarding their respective risks of bearing immunity or non-immunity loss. The applicable rule of immunity is but one factor in the calculation. In a given situation, other factors may (and in reality probably do) dwarf the importance of a rule of immunity. For example, if A believes that B will not become insolvent, A will conclude that she will always be able to recover the value of her defense from B. Thus, a rule of immunity would have no impact.\textsuperscript{151} Similarly, if A believes that B will likely become insolvent but not have transferred A’s obligation, an immunity rule would have no impact. In this scenario, C is out of the picture. Thus A’s hypothetical ability to recover the value of her defense from a third party (as expressed in an immunity rule) would be irrelevant. Conversely, if A believes the probability that B will become insolvent and have transferred the obligation to a third party is high, then the applicable immunity rule becomes relatively more significant. With the current instability among financial institutions, obligors, obligees and the FDIC may become increasingly more sensitive to the possibility of bank failure and FDIC involvement, there-

\textit{formula slightly: A’s expected immunity loss now equals } L(PC x PF(1 - PT) + PF(PT x PI)), where PT = the probability that B will transfer A’s obligation. Suppose \( L = \$1000, PC = 70\%, PF = 40\%, PT = 60\%, PI = 10\%. E(L) = \$128.80.\) Under these assumptions, the probability that B will be insolvent but \textit{not} have transferred A’s obligation is 11.2\%. The probability that B will both be insolvent and have transferred the obligation to an immune party is only 2.4\%. Of the total premium A will demand ($128.80), $112 is attributable to the probability that B will be insolvent but not have transferred A’s obligation. The balance of $16.80 is attributable to the probability that B will transfer A’s obligation to an immune party.

Where A is not certain that B will transfer A’s obligation at the time Contract 1 is formed, A may overestimate or underestimate the likelihood that B will transfer his obligation. If A does so, he may demand a premium which either overcompensates or undercompensates him for assuming the risk. B absorbs the cost of overcompensating A and enjoys the benefit of undercompensating A. A’s uncertainty as to whether B will transfer A’s obligation does not inure to the benefit or detriment of C. If and when B does transfer A’s obligation, C calculates his expected loss the same way as he did in the simple example. C is certain that B will transfer A’s obligation, and certain that B will transfer it to him. Continuing the assumptions made in the previous paragraph, at the time of B’s transfer of A’s obligation to him, C would nonetheless demand a discount of $252 off the face value of A’s obligation.

\textsuperscript{151} A’s expected immunity loss will approach zero as the probability that B will become insolvent approaches zero.
by increasing the relative importance of an immunity rule in their transactions. Thus, the task at hand is to select the optimal rule of immunity for efficiently allocating loss between A and C.

The cornerstone of economic analysis is the premise that private agreements between parties will generally produce efficient results. A and C are unlikely to be able to allocate efficiently immunity loss by a private agreement because the cost of negotiation is likely to overshadow the benefits. A is primarily concerned with B's performance and C is primarily concerned with A's performance. As to these aspects of the transaction, the benefits of negotiation are much higher and probably are worth the cost. Intervention in the form of a rule of law is economically justified only when the parties fail to achieve an efficient result on their own. In such situations, an efficient rule of law brings about an allocation of resources like that the parties would have reached on their own in the absence of market failure.

As a threshold matter, any clear rule of immunity, regardless of its content, would increase efficiency over the state of affairs where the immunity of a transferee is random. An immunity rule provides certainty, which reduces transaction costs. To the extent that an immunity rule yields a predictable outcome, it enables the parties more accurately to quantify their expected immunity (or nonimmunity) loss. Certainty of outcome, regardless of what the outcome is, makes the transaction more valuable to the parties to it.

An efficient rule of immunity is one that places liability on the party better able either to avoid the loss or to insure against it. Richard Posner gives the following example to illustrate the distinction between prevention and insurance as methods of minimizing loss:

152 POSNER, supra note 140, at 9-10.
153 See id.
154 See Cooter & Rubin, supra note 13, at 68.
155 “Transaction costs” are the costs associated with reaching a market transaction, including without limitation, the costs of finding and learning about the party one wishes to deal with, conducting negotiations, monitoring performance and enforcing the bargain in the event of nonperformance. See Ronald Coase, The Problem of Social Cost, 3 J.L. & ECON. 1, 16 (1960).
Suppose I agree to supply someone with 1000 widgets by July 1; my factory burns to the ground; and I cannot procure widgets from anyone else in time to fulfill the contract. Suppose further that there was no way in which I could have anticipated or prevented the fire . . . . A loss that can be averted by an expenditure smaller than the expected loss is preventable, but not all losses are preventable in this sense; the fire that destroyed the factory . . . was assumed not to be. It may be possible through insurance, however, to reduce the costs created by the risk of loss. The insured exchanges the possibility of loss for a smaller, but certain cost (the insurance premium). 156

Using this example, an efficient rule would allocate the loss caused by the fire to the seller if the seller could have insured against the risk of loss from the fire more cheaply than the buyer. The costs of insurance can be divided into two categories: (1) measurement costs; and (2) transaction costs. Measurement costs are costs associated with determining the expected loss, i.e., the probability that the risk will occur and the magnitude of the loss if it does occur. The primary transaction cost is that of pooling the risk with other risks. 157 The seller is likely the cheaper insurer against loss due to a fire in her own factory because, generally speaking, she can acquire information about both the likelihood and magnitude of loss more cheaply than the buyer.

If an immunity rule imposes liability on only A or C, the other will have no incentive to avoid or insure against the risk of loss. This problem has been dubbed the "paradox of compensation" which afflicts no-fault or strict liability rules. 158 Where more than one party can take precautions or acquire insurance, an efficient liability rule will provide an incentive for any party who can to do so to the extent that such party can do so more cheaply than non-liable parties. Fault-based liability rules, for example, encourage one party to take precaution to avoid liabil-

156 POSNER, supra note 140, at 103.
157 POSNER, supra note 140, at 104-05.
ity to the extent of the legal standard of fault, and the other party to take precaution to avoid residual liability.\textsuperscript{169}

Whether a liability rule yields an aggregate reduction of loss sufficient to justify it turns on an analysis of empirical data measuring the elasticity of precaution with respect to liability.\textsuperscript{160} A rule that imposes liability will reduce loss only to the extent that parties actually modify their behavior in response to it. A rule that has no effect on loss-reducing behavior has no economic justification. The parties' responsiveness to rules of liability depends on the parties' knowledge of the rule and their respective abilities to take the rule into consideration when fashioning their behavior.

V. THE HOLDER IN DUE COURSE RULE EFFICIENTLY ALLOCATES LOSS

The essence of the holder in due course rule is that a transferee of an obligation who is a holder in due course is immune from all competing claims of ownership of and virtually all defenses to the obligation. Immunity depends on whether the transferee can pass two tests. First, the transferee must qualify for holder in due course status. Second, the particular defense asserted against the transferee must be among those against which a holder in due course is immune.

To pass the first test and attain the exalted status of holder in due course is no easy task. Under U.C.C. § 3-302, a transferee must: (1) be a holder;\textsuperscript{161} (2) of a negotiable instrument;\textsuperscript{162}

\textsuperscript{169} See Cooter & Rubin, supra note 13, at 74.

\textsuperscript{160} Id. at 75; Daniel J. Givelber et al., Tarasoff, Myth and Reality: An Empirical Study of Private Law in Action, 1984 Wis. L. Rev. 443, 487-90 (analyzing empirical evidence of the impact of a liability rule on the conduct of psychotherapists).

\textsuperscript{161} "Holder' with respect to a negotiable instrument, means the person in possession if the instrument is payable to bearer or, in the case of an instrument payable to an identified person, if the identified person is in possession." U.C.C. § 1-201(20) (1990). As to the distinction between "order paper" and "bearer paper," see ROBERT S. WHITE & JAMES J. SUMMERS, UNIFORM COMMERCIAL CODE 561-643 (3d ed. 1988).

\textsuperscript{162} The term "negotiable instrument" includes only signed writings that order or promise the payment of money. U.C.C. § 3-104, cmt. 1 (1990). U.C.C. § 3-104 contains a more liberal definition of "sum certain" than that contained in the 1978 Official Text. The definition of a negotiable instrument in the 1990 Official Text to encompasses a variable interest rate instrument. U.C.C. §§ 3-
(3) acquired for "value," and (4) "in good faith," and (5) without notice of claims or defenses. If any one of these attributes is lacking, the transferee cannot be a holder in due course. Even if a transferee can satisfy the foregoing requirements, he cannot be a holder in due course if he acquired the obligation under circumstances generally described as outside the ordinary course of the obligee's business. Each prerequisite is a significant limitation on the ability of a transferee to become a holder in due course, and thus, on the transferee's immunity from the obligor's claims and defenses.

The efficiency justification underlying these technical requirements for holder in due course status is not apparent at first blush. Indeed, commercial law treatises present the requirements as a matter of rote. But the requirements can be justified as serving the efficiency goal of allocating loss to the party who had a better opportunity to either avoid the loss or insure against it. The component parts of the holder in due course rule further several efficiency goals. Some requirements reduce uncertainty regarding the probability of immunity loss for both parties, thus reducing both parties' costs of insuring against it. Other requirements place liability for loss on the

104(a), 3-112(b), § 3-112 cmt. 1 (1990). U.C.C. § 3-104(d) makes it clear that if the document in question contains a conspicuous statement that it is not negotiable when it comes into the possession of a holder, then no holder can attain the status of a holder in due course.


164 Under U.C.C. § 3-302 (a)(2) (1990), the holder must acquire the instrument "without notice that the instrument contains an unauthorized signature or has been altered . . . without notice of any claim to the instrument described in Section 3-306" and "without notice that any part has a defense or claim in recoupment described in Section 3-305(a)." Furthermore, the instrument may not "bear such apparent evidence of forgery or alteration or [be] otherwise so irregular or incomplete as to call into question its authenticity." U.C.C. § 3-302(a)(1) (1990).

165 "A holder does not become a holder in due course of an instrument: (i) by legal process or by purchase in an execution, bankruptcy, or creditor's sale of similar proceeding; or (ii) by purchase as part of a bulk transaction not in the ordinary course of the transferor; or (iii) as the successor in interest to an estate or other organization." U.C.C. § 3-302(c) (1990). This is the provision which, among others, prevents the FDIC from attaining holder in due course status under state law when it acquires the assets of a failed bank as part of a purchase and assumption transaction.

166 See WHITE & SUMMERS, supra note 161, at 551-52.
party who could have prevented or insured against it more cheaply.

The requirement that A's obligation be in negotiable form before anyone can be a holder in due course of it reduces uncertainty about the probability that A's obligation will fall into the hands of an immune party. The requirement provides a bright line test for determining the probability of immunity loss and reduces both parties' costs of insurance. Return to the imaginary transaction among A, B, and C. Suppose A executes her obligation to B in the form of a non-negotiable instrument. Under the holder in due course rule, A's use of a non-negotiable instrument eliminates any probability that A's obligation will fall into the hands of an immune party. Because A knows he will never bear immunity loss, he will not expend resources negotiating with B for compensation to insure against it. Conversely, C knows that he can never be a holder in due course of A's obligation and will demand compensation from B equal to his expected nonimmunity loss. Any rule that A, B, and C can easily apply to determine the likelihood that an obligation will fall into the hands of an immune party enhances efficiency by reducing costs. "Negotiability" is not essential; a rule that requires an obligation to be printed on red paper in order to cut off claims or defenses would do the trick. Notwithstanding the arbitrary and arcane aspects of negotiability, it provides an effective, bright line test. Whether an obligation is negotiable or not is a relatively simple determination, which yields a remarkably certain outcome.\footnote{166}

The holder in due course rule's requirement that the transferee have no notice of a claim or defense\footnote{169} allocates loss to the party as between A and C who could have insured against it more cheaply. At the time A negotiated with B regarding A's obligation, A could only estimate the probability that he would have a claim or defense and the magnitude of such claim or defense. If when C negotiates with B to acquire A's obligation, C has no notice that A has a claim or defense against B, C is in virtually the same position as A was in. C must estimate the

\footnote{166}{The key to maximizing the efficiency of a particular legal rule is to make it inexpensive to apply and interpret. The rules governing negotiability epitomize the efficiency associated with certainty.}

\footnote{169}{See supra note 165.}
likelihood that A will acquire a claim or defense and the magnitude of such claim or defense. If C has no notice of a claim or defense, then, arguably A remains the cheaper insurer because A probably is better able to acquire information about the likelihood and magnitude of his own loss. But, when C has notice that A has a claim or defense when C acquires A's obligation from B, C's access to information regarding the likelihood and magnitude of A's loss is better than A's was, that is, C knows with certainty the likelihood of A's loss. Because when C negotiates with B, he has more information about the probability of performance loss occurring (it has or is certain to occur), he is the cheaper insurer against it.

Under the holder in due course rule, C cannot be immune if he acquires A's obligation at a judicial sale or by legal process, in taking over an estate, or as part of a bulk transaction outside the ordinary course of B's business. Again the requirement imposes the loss on the party who could have insured against it more cheaply. A calculates his expected immunity loss by taking into account, among other things, the probability that B will transfer A's obligation to a third party. A will bear immunity loss if either B becomes insolvent and has not transferred A's obligation, or B becomes insolvent and B transferred A's obligation to an immune party. Suppose that at the time A enters into Contract 1 with B, A is uncertain whether B will transfer the obligation at all. Presumably, A can determine relatively easily the likelihood that B will transfer A's obligation in the ordinary course of B's business. But A is less able to

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170 Notice of a claim or defense deprives a transferee of immune status only if the transferee receives it “at a time and in a manner that gives a reasonable opportunity to act on it.” U.C.C. § 3-302(f) (1990). Thus, if a transferee acquires notice of a claim or defense after concluding negotiations with B, the notice comes too late. In such a circumstance, C's ability to insure against the loss was no better than A's.

171 C's additional information about the probability that performance loss will occur (it is certain to occur), reduces his measurement costs relative to A. See supra notes 156-157 and accompanying text.

172 U.C.C. § 3-302(c) (1990). C could acquire the rights of a holder in due course by virtue of the shelter principle if B was a holder in due course. U.C.C. § 3-302(c) cmt. 4 (1990).

173 A's expected immunity loss equals L(PC x PF(1-PT) + PF(PT x PI)) where PT = the probability that B will transfer A's obligation. See supra note 146.
determine the likelihood that B will transfer it outside the ordinary course of B's business, such as at a judicial sale or in a bulk transfer. For C, on the other hand, the fact of such transfer is certain. The additional information C has at the time he negotiates with B makes him the cheaper insurer.\textsuperscript{174}

The requirement that a transferee be a "holder" can be justified in the same way. A "holder" with respect to a negotiable instrument "means the person in possession of the instrument is payable to bearer or, in the case of an instrument payable to an identified person, if the identified person is in possession."\textsuperscript{175} For example, if an instrument in the form of order paper has not been indorsed to the transferee, he cannot be a holder of it.\textsuperscript{176} Returning to the hypothetical parties, transfer to C of order paper without B's indorsement is the type of extraordinary transaction which A cannot accurately anticipate. But C, by examining the instrument embodying the obligation, can detect the absence of an appropriate endorsement. Again, the availability of this information to C makes him the cheaper insurer.

C's superior ability to avoid loss underlies the requirement that C must give "value" before he can qualify as a holder in due course.\textsuperscript{177} The meaning of the term "value" as it is used in Articles 3 and 4 of the U.C.C. is different from the meaning of the same term used elsewhere in the Code.\textsuperscript{178} The definition of "value" for holder in due course purposes is narrower than the concept of consideration. Stated generally, a transferee gives "value" only to the extent that he performs the agreed upon consideration or otherwise makes an irrevocable commitment to a party other than his transferor. A transferee who has given only an executory promise in consideration for the obligation has not given "value" and, therefore, cannot be a holder in

\textsuperscript{174} This transactional requirement can also be explained based on an anecdotal observation that obligations transferred under extraordinary circumstances are more likely to be subject to claims and defenses. To the extent this assumption is valid, then the requirement can also be justified under the same logic as the requirement that the transferee acquire the instrument without notice of a claim or defense. See supra notes 169-171 and accompanying text.
\textsuperscript{175} U.C.C. § 1-201(20) (1990), supra note 161.
\textsuperscript{176} See U.C.C. § 3-201(b) (1990).
\textsuperscript{177} U.C.C. §§ 3-302(a)(2)(i), 3-303 (1990).
\textsuperscript{178} See U.C.C. § 1-201(44) (1990) (definition of "value" for all purposes other than with respect to negotiable instruments and bank collections).
due course. If C has only promised to pay B for A's obligation, he can offset any nonimmunity loss he sustains as a result of A's claim or defense against B by refusing to perform part or all of his executory promise. If C is immune, however, A would be left with a loss in value which she could not recover from B.

The status of the transferee as a holder in due course does not provide him with immunity to all defenses. Like the technical prerequisites to holder in due course status, the distinction between those defenses against which a holder in due course is or is not immune has traditionally been presented as a matter of rote. But the distinction can be understood at least in part on efficiency grounds.

U.C.C. § 3-305 does not list the defenses against which a holder in due course is not immune. Rather, they are defined by exclusion. A holder in due course is vulnerable to the so-called "real defenses," which are: (i) infancy of the obligor to the extent it is a defense to a simple contract; (ii) duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor; (iii) fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms; (iv) discharge of the obligor in insolvency proceedings.

Whether a defense is "real" and therefore valid against a holder in due course is only significant if the transferee otherwise qualifies for holder in due course status. If the transferee

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181 See WHITE & SUMMERS, supra note 161, at 573.
182 In U.C.C. § 3-305 cmt. 2 (1990), the drafters list defenses which are cut off by holder in due course status:

[N]onissuance of the instrument, conditional issuance, and issuance for a special purpose (Section 3-105(b)); failure to countersign a traveler's check (Section 3-106(c)); modification of the obligation by a separate agreement (Section 3-117); payment that violates a restrictive indorsement (Section 3-206(f)); instruments issued without consideration or for which promised performance has not been given (Section 3-303(b)), and breach of warranty when a draft is accepted (Section 3-417(b)). The most prevalent common law defenses are fraud, misrepresentation or mistake in the issuance of the instrument.
qualifies, it would appear that, based on the type of obligation and the transaction in which he acquired it, the transferee had no better opportunity than the obligor had to avoid or insure against the loss. So why should a holder in due course be vulnerable to real defenses?

The distinction between real and personal defenses, with some exceptions,\(^1\) turns on whether the defense renders the obligation void or merely voidable. In general, a defense that would render the obligation merely voidable is invalid against a holder in due course; a defense that would render the obligation void, on the other hand is valid against a holder in due course. The meaning of the terms "void" and "voidable" and the legal distinction between them are among the great mysteries of commercial law,\(^2\) and the Code does not attempt to define them.\(^3\) The distinction appears to be a matter of degrees. In general, a defense renders an obligation void if it does not appear that a contract between the parties was ever actually formed due to an impairment of the will or judgment of the obligor or to external illegality.\(^4\) An obligation is merely

1. The defenses of infancy and discharge in bankruptcy, are valid against a holder in due course regardless of whether the defense would render the obligation void. Infancy is a valid defense against a holder in due course even though it would only render the obligation voidable at the option of the infant under state law. U.C.C. § 3-305(a)(1)(i) cmt. 1 (1990). The defense of discharge in insolvency proceedings is valid against a holder in due course regardless of whether the obligation is rendered technically void because of the discharge. U.C.C. § 3-305(a)(1)(iv) (1990). "Insolvency proceedings" is defined in U.C.C. § 1-201(22) (1990).

2. Grant Gilmore described the concept of "voidable title" as it relates to the interest of a good faith purchaser of goods as: "a vague idea, never defined and perhaps incapable of definition, whose greatest virtue, as a principle of growth, may well have been its shapeless imprecision of outline." See Gilmore, supra note 2, at 1059.

3. The words "void" or "voidable" do not appear in U.C.C. § 3-305(a)(1) (1990). U.C.C. § 3-305 cmt. 1 states that as to the defenses of mental incompetence, guardianship, ultra vires acts or lack of corporate capacity or any incapacity other than infancy: "If under the local law the effect is to render the instrument entirely null and void, the defense maybe asserted against a holder in due course. If the effect is merely to render the obligation voidable at the election of the obligor, the defense is cut off."

voidable when the defect is less severe. A voidable transaction is one where the circumstances of contracting were suspect enough to provide the injured party with some relief, but not sufficiently suspect to treat the contract as though it had never been formed.\textsuperscript{188}

Whether a particular defense renders an obligation void or merely voidable is normally not an important distinction. It becomes important only when the perpetrator of the conduct giving rise to the defense is insolvent or otherwise cannot answer for her conduct.\textsuperscript{189} Regardless of how courts have articulated and applied the concepts, the distinction between defenses which render obligations void as opposed to voidable is actually a means of allocating loss between two parties who are able to take steps to prevent it.

A rule that imposes liability on a transferee for defenses that render the obligation void creates an incentive for him to monitor the practices of transferors. He will monitor transferors' practices to detect conduct which could give rise to such a defense. Once detected, a transferee can deter such conduct by refusing to deal with offending transferors. Clearly, a transferee would have a much stronger incentive if he were vulnerable to all defenses, not just the "real" ones. But such a rule of strict liability would eliminate the incentive on the part of the obligor to police the practices of the obligee/transferor.\textsuperscript{190} An efficient rule imposes liability on the transferee only when he is the lower cost avoider.

\textsuperscript{188} Personal defenses are those which do not deny the existence of a contract between prior parties, but which assert that the contract, by reason of some act or circumstances occurring contemporaneously or subsequently, has become voidable or defeasible, in whole or in part, between the original parties — as, for example, failure or absence of consideration, breach of warranty, fraud in the inducement, duress, mistake, and the like.

\textit{Id.} at 78.

\textsuperscript{189} In the law governing sales of goods, the distinction between void and voidable title is relevant only when the goods fall into the hands of a bona fide purchaser for value. A bona fide purchaser for value who acquires voidable title is immune from the claims of ownership of the true owner. A bona fide purchaser who acquires only void title (for example, from a thief) holds the goods subject to the claims of the true owner. U.C.C. § 2-403 (1990).

\textsuperscript{190} See supra notes 158-159 and accompanying text.
The exception from holder in due course immunity for the real defenses is efficient if it allocates liability between the holder in due course and the obligor according to their relative costs of precaution. Both A and C can take precautions against nonperformance loss. For example, if B has a reputation for defrauding customers, A and C can refuse to deal with her. For both A and C, the cost of taking such precaution involves the cost of obtaining information regarding B's reputation, and searching out a substitute for B if B is unacceptable.

For conduct giving rise to personal defenses, A's costs of precaution are generally lower than C's. But, as to real defenses, due to A's extremely high cost of precaution, C is probably able to prevent B's misconduct at a lower cost than A can. Return to the hypothetical parties, A, B and C. Suppose B tricks A into signing a negotiable instrument by telling A that it is a letter to the governor, exploiting the fact that A cannot read. B then sells A's note to C, who qualifies as a holder in due course. Unless A's defense of fraud is a real defense, C will be immune. For A to prevail against C, A must establish that:

(1) B's misrepresentation induced his signature; (2) that A did not know the "essential terms" of the instrument; and (3) that A had no "reasonable opportunity" to gain such knowledge. In essence, A must establish that his cost of precaution was extremely high. To avoid the loss, he would have had to employ "unreasonable" means to gain knowledge about the terms of the document he signed.

In this situation, C's cost of precaution is probably lower

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191 U.C.C. § 3-305(a)(1)(iii) (1990); WHITE & SUMMERS, supra note 161 at 573. U.C.C. § 3-305 cmt. 1 (1990) states:
The test of the defense here stated is that of excusable ignorance of the contents of the writing signed. The party must not only have been in ignorance, but must also have had no reasonable opportunity to obtain knowledge. In determining what is a reasonable opportunity all relevant factors are to be taken into account, including the age and sex of the party, his intelligence, education and business experience; his ability to read or to understand English, the representations made to him and his reason to rely on them or to have confidence in the person making them; the presence or absence of any third person who might read or explain the instrument to him, or any other possibility of obtaining independent information; and the apparent necessity, or lack of it, for acting without delay.

192 See, e.g., FDIC v. Turner, 869 F.2d 270 (6th Cir. 1989).
than A's. Even though as to this transaction C might not be able to prevent A's loss any cheaper than A could, C may be the cheaper developer over time of a means of detecting and deterring B's dishonest conduct. A is likely to deal with B only once, not as part of an ongoing commercial relationship. C, as a purchaser of obligations due to B, is more likely to deal with B on a repeat basis. Because the volume of C's business with B is likely to far exceed that of A's, C is likely to be more responsive to a rule of immunity that imposes liability on C for losses due to real defenses. C is likely to respond to such a rule by developing a means of policing B's business to detect conduct giving rise to a real defense. In any event, C is likely to be able to pool and spread the risk of loss due to real defenses at a lower cost than A.

VI. TOWARD AN EFFICIENT RULE OF IMMUNITY FOR THE FDIC

The three sources of the FDIC's immunity overlap with differences at the margin. The scope of each source of immunity is different from the others, and the differences themselves vary among the federal circuits. It is impossible to articulate in a workable form a single immunity rule that harmonizes all three sources as the courts have interpreted them. This section proposes an efficient rule of immunity for the FDIC, which shall be referred to as the FDIC immunity rule.

Under the FDIC immunity rule, the FDIC would be immune from a defense if two requirements are satisfied: (1) the asset on which the FDIC sues contains a written promise to pay money that is unconditional with respect to the claim or defense alleged; and (2) the FDIC acquired the asset in one of its statutory capacities (as receiver or FDIC-Corporate). Once eligible, the FDIC would be immune from all claims and defenses except those which would render the obligation void as opposed to voidable.

The first requirement to qualify for immune status — that the obligation be a written promise to pay money and at least unconditional with respect to the defense alleged — blends the 1

A party's responsiveness to liability and ability to develop a method of precaution are factors which bear on efficient allocation of loss. See Cooter & Rubin, supra note 13, at 76.
disparate requirements of the three sources of immunity into a single requirement with respect to the form of the obligation (the "form requirement"). Under the FDIC immunity rule, the obligation at issue need not be in negotiable form or be completely unconditional. The bank's records regarding the obligation must, however, reflect that the obligation is unconditional with respect to the particular claim or defense alleged.

Conditionality of obligations is measurable on a continuum. Obligations that meet the technical requirements for negotiability under U.C.C. § 3-104 are at the extremely unconditional end, and bilateral contracts with interdependent obligations are at the extremely conditional end. The three sources of immunity tolerate different levels of conditionality with respect to the obligation at issue. At one extreme, in the case of the federal holder in due course rule, the asset must be a negotiable instrument, and the FDIC may not have "actual knowledge" of a claim or defense at the time it acquires it. Toward the other extreme, under U.C.C. § 1823(e), the asset may be completely conditional, provided that the defense asserted does not meet the recordation requirements of U.C.C. § 1823(e). Perhaps at the most conditional extreme, the D'Oench doctrine merely requires that the agreement underlying the alleged defense be "secret" and that the form of the obligation "tend to mislead" bank examiners. The FDIC immunity rule sets the required unconditionality of the obligation somewhere in the middle of the conditionality continuum. Although the obligation need not be in negotiable form, it must be in the form of a

194 The U.C.C. recognizes this continuum by adopting different definitions of "instrument" for purposes of Article 3 (governing negotiable instruments) and Article 9 (governing secured transactions). As used in Article 3, "instrument" means a negotiable instrument meeting the requirements of U.C.C § 3-104 (1990). As used in Article 9, "instrument" means a negotiable instrument or "a certificated security (defined in U.C.C.§ 8-102) or any other writing which evidences a right to the payment of money and is not itself a security agreement or lease and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment." U.C.C. § 9-105(i) (1990). Article 3 negotiable instruments are a subset of Article 9 instruments, and only Article 3 instruments can fall into the hands of an immune party.

195 E.g., Montross, 923 F.2d 353 (5th Cir. 1991).
196 E.g., Gulf Life, 737 F.2d 1513 (11th Cir. 1984).
197 See supra notes 50-58 and accompanying text.
written promise to pay money. Furthermore, either the obligation must be unconditional or the alleged condition giving rise to the defense must not appear among the express conditions to liability. For example, if an obligation is in the form of a promissory note (that is, an unconditional promise to pay money) but is not technically negotiable because it does not contain the words "to order" or "to bearer," it would meet the FDIC immunity rule form requirement. If the obligation were to pay rent under a lease, it would meet the FDIC immunity rule form requirement if the particular defense was that the bank agreed to accept rent of $1000 even though an express term in the lease set the rent at $5000.

The requirement that the FDIC acquire the obligation either as receiver or in its corporate capacity is comparatively straightforward. This requirement circumscribes the scope of the rule by describing the particular factual circumstance in which it applies. In all other circumstances, under ordinary state law, that is, the holder in due course rule, would apply.

As to the second part of the FDIC immunity rule, once the FDIC qualifies for immune status, it takes free of all claims and defenses except those which would render the obligation void as opposed to voidable.

In part V, this Article explored the efficiency justifications underlying the allocation of loss embodied in the holder in due course rule. Stated simply, in certain circumstances, a transferee of an obligation is in a better position to reduce loss than the obligor, and in those situations, the transferee is not immune from the obligor's claims and defenses. Starting with the reasonable assumption that the holder in due course rule efficiently allocates loss, the next step is to determine whether the FDIC immunity rule changes the allocation of loss which the holder in due course rule would accomplish. To the extent the FDIC immunity rule changes the allocation of loss, it is necessary to determine whether the new allocation is efficient.

Consider how an obligor's behavior changes if he must consider the impact of the holder in due course rule plus the FDIC immunity rule in determining his expected immunity loss. The FDIC immunity rule increases an obligor's expected immunity loss in two ways. First, it grants the FDIC immunity when the

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obligation at issue would not satisfy the form requirements of the holder in due course rule. Second, the FDIC immunity rule grants the FDIC immunity when the transaction in which the FDIC acquires the obligation would not satisfy the transaction requirement of the holder in due course rule.

To illustrate the effect of the FDIC immunity rule's less restrictive form requirement, consider the following hypothetical. Suppose X borrows money from Y. In determining his expected immunity loss, X will take into consideration the probabilities that: (1) he will acquire a claim or defense against Y; (2) that Y will become insolvent; and (3) that Y will transfer X's obligation to an immune party. The probabilities that X will acquire a claim or defense and that Y will become insolvent are no different under the FDIC immunity rule than under the holder in due course rule, but the third probability is affected.

Suppose Y is a finance company and X's obligation is not in negotiable form. Because his obligation is not in negotiable form, under the holder in due course rule X knows that no one can become a holder in due course of it. The probability that Y will transfer his obligation to an immune party is zero, and X's expected immunity loss is zero. Now suppose, all other things remaining the same, that Y is a federally insured bank. Under the FDIC immunity rule, the FDIC could become a transferee who would be immune from unrecorded claims and defenses to an obligation, even a non-negotiable one. Thus, when X borrows from a federally insured bank using a non-negotiable instrument, he faces expected immunity loss attributable solely to the FDIC immunity rule. Under the FDIC immunity rule, the FDIC can achieve immunity by acquiring an obligation outside the ordinary course of the bank's business, i.e., in a purchase and assumption transaction, even though under the holder in due course rule, such an extraordinary course buyer would not be immune. This expanded immuni-

199 See discussion supra note 146 and accompanying text.
200 See discussion supra note 146 and accompanying text.
201 See discussion supra Part VI.
202 An obligor faces such loss when she uses a negotiable instrument because the FDIC can achieve immune status even though it does not acquire the obligation in an ordinary course transaction. See supra Part VI.
203 See supra note 166 and accompanying text.
ty for the FDIC creates an additional increment of loss beyond the expected loss associated with the holder in due course rule.

The efficiency considerations that justify the allocation of loss under the holder in due course rule justify the allocation of loss between the FDIC and an obligor under the FDIC immunity rule. The FDIC immunity rule imposes liability for defenses on the FDIC only when it is able to avoid or insure against the loss more cheaply than the obligor. Return to the hypothetical loan between X and Y where Y is a federally insured bank. Suppose X executes a note under which he agrees to repay Y provided Y continues funding the loan at agreed intervals. Y fails and the FDIC acquires X's note. X wants to assert against the FDIC a defense based on Y's fraudulent misrepresentation of certain facts. X's defense is not based on Y's failure to fund according to the agreement, but rather on breach of an "unrecorded" agreement regarding the truthfulness of certain facts. X's note would not be negotiable because his promise to pay is expressly conditional. Under the holder in due course rule, a transferee of it would be subject to X's defense. Under the FDIC immunity rule, however, the FDIC would not be subject to X's defense if it acquired the obligation in a purchase and assumption transaction because the bank's records do not contain a condition on the obligation supporting the particular defense X alleges. Is there an efficiency justification for immunizing the FDIC in this case when an ordinary transferee would not be immune? Again, the answer to this question depends on the parties' relative costs of measuring and pooling their risk.

The FDIC immunity rule form requirement combines the allocative functions of the holder in due course rule's negotiability and notice requirements. The FDIC immunity rule contains a more liberal unconditionality requirement than that of negotiability. But it imposes a more restrictive lack of notice requirement than that under the holder in due course rule. At the heart of the concept of negotiability is the requirement that the obligation be in writing, and contain an unconditional promise or order to pay money. If an obligation contains conditions on the promise to pay, for example, it is not negotiable

204 U.C.C. § 3-302 (1990).
205 U.C.C. § 3-104(a) (1990).
and will always be subject to all of the obligor's defenses. Even if the obligation is negotiable, a transferee cannot be a holder in due course of it if, generally speaking, she has actual knowledge of a claim or defense or constructive knowledge of an irregularity that could have been gained by examining the instrument.206

Under the FDIC immunity rule, the FDIC will be immune only if the obligation is a written promise to pay money and the bank's records of the loan transaction contain no condition with respect to the defense alleged.207 In other words, the FDIC can be immune to a defense to a conditional (non-negotiable) obligation provided that the bank's records do not provide it with notice of the possibility of the type of defense alleged. If the bank's records reflect that the obligation is conditional with respect to the defense alleged, even the FDIC is not immune.

Recall that the holder in due course requirement of negotiability provides both the obligor and the transferee with a bright line test for determining in advance the likelihood that a transferee will be immune to a claim or defense.208 The FDIC immunity rule requirement regarding the conditionality of the obligation provides less certainty than that provided by the requirement of negotiability. On the other hand, the notice component of the FDIC immunity rule is arguably more certain than the notice requirement under the holder in due course rule. Under the FDIC immunity rule, the transferee's subjective knowledge and good faith are irrelevant, whereas these facts are germane to a determination of "notice" under the holder in due course rule.209 These subjective factors make the holder in due course rule less certain in outcome than the FDIC immunity rule.210 On balance, the FDIC immunity rule may not be any less certain in outcome than the holder in due course rule. The current state of the law governing the FDIC's immunity, however, permits substantially more uncertainty than the proposed FDIC immunity rule.211 Reformation of the current

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206 See supra note 120 and accompanying text. U.C.C. § 3-302(a)(2) (1990); Blum, supra note 116, at 234-40.
207 See supra Part VI, at 269.
208 See supra note 168 and accompanying text.
210 See Cooter & Rubin supra note 18, at 78.
211 See supra, Part III(D).
law to reduce uncertainty in the application of the FDIC's immunity would increase efficiency by reducing transaction costs.

Now consider whether the FDIC immunity rule allocates loss efficiently. To the extent that he can acquire information about the types of probable performance loss in his transaction more cheaply than the FDIC can, the obligor should, and under the FDIC immunity rule does, bear immunity loss. An obligor bears immunity loss if he does not identify in the bank's records possible sources of nonperformance loss as express conditions to his obligation to pay. The FDIC immunity rule induces an obligor to reduce the risk of immunity loss by fully documenting every possible claim or defense. But, the obligor and bank will only document possible claims and defenses to the extent that the marginal cost of doing so is less than the marginal benefit.\footnote{The marginal benefit of documentation is equal to the marginal reduction in expected federal immunity loss.} The marginal benefit of documentation is equal to the marginal reduction in expected federal immunity loss.\footnote{To the extent that the marginal cost of further documentation exceeds the marginal benefit, the obligor will execute an obligation without completely recording all defenses and insure against the residual risk of immunity loss at the bank's expense.} When the insured bank's records reflect an express condition on an obligation giving rise to a defense, both the obligor and the FDIC have identical access to information about the types of performance loss for which a transferee will not be immune — it appears in the bank's records. So why should the FDIC bear the loss? The FDIC's mechanism for insuring against the

\footnote{For a discussion of some of the costs of writing detailed contracts see Clifford W. Smith, Jr. & Jerold B. Warner, \textit{On Financial Contracting: An Analysis of Bond Covenants}, 7 \textit{J. Fin. Econ.} 117 (1979).}

\footnote{Because an obligor's expected federal immunity loss depends on the product of a number of factors, the magnitude of other factors will affect the marginal impact of increased documentation. For example, as the probability that the bank will fail increases, the marginal impact of additional documentation on reduction of expected immunity loss will increase accordingly. This suggests that the more precarious the financial condition of a bank, the more documented the conditions on the obligation will be.}

\footnote{Marginal cost of documentation is likely to exceed marginal benefit where the probability that the obligor will acquire a claim or defense or the probability that the obligee will be insolvent is low.}

\footnote{The additional risk of immunity loss associated with dealing with a federally insured bank makes it relatively more costly, \textit{ceterus paribus}, to borrow from a federally insured bank than from a non-insured source.}
risk of non-immunity loss is different from that of an ordinary transferee. Unlike a typical transferee, the FDIC cannot negotiate with the failed bank over the price of the obligation.\textsuperscript{216} Although the FDIC cannot bargain with a failed bank for a reduction in the price of an obligation as a means of offsetting the cost of insurance, it can offset its aggregate expected non-immunity loss by raising the price all insured banks pay for federal deposit insurance coverage.\textsuperscript{217} Because the FDIC can pool its risk over all insured banks, it is likely to be able to insure against its risk of loss at a cost lower than that an obligor would incur.

If the FDIC can satisfy the form requirement of the FDIC immunity rule, it does not lose its immune status merely because it acquired the obligation outside the ordinary course of the transferee's business. The FDIC immunity rule relieves the FDIC from the "ordinary course purchaser" requirement of the holder in due course rule, but this deviation does not necessarily reduce efficiency. The holder in due course rule's ordinary course transaction requirement is based on the notion that the transferee is the cheaper acquirer of information as to the likelihood that the obligee will transfer the obligation outside his ordinary course. From the obligor's perspective, the probability of an FDIC liquidation or purchase and assumption transaction is virtually the same as the probability that the bank will become insolvent. (If the bank fails, the FDIC will be appointed receiver and will most likely either liquidate it and pay insured claims or arrange a purchase and assumption transaction.) The FDIC may be the cheaper acquirer of information regarding the probability of the bank's insolvency by virtue of its access to financial information as regulator. Even if this is the case, the obligor is still probably the cheaper acquirer of all the other information necessary for his expected loss calculation. If the obligor's defense is not based on a part of the bank's loan records, the obligor has cheaper access than the FDIC to information about the probability that he will acquire a claim or defense and the magnitude of such claim or defense if he acquires

\textsuperscript{216} See supra notes 21-28 and accompanying text.

\textsuperscript{217} The FDIC's ability to pool risk may result in a decrease in the transaction cost component of the cost of insurance.
one. Arguably, therefore, the obligor is the cheaper acquirer of most of the information needed for the expected immunity loss calculation.

Once the FDIC achieves immune status, its immunity extends to all claims and defenses that are not expressly preserved in the failed bank's official records, except defenses that would render the obligation void. Immunity for the FDIC from personal defenses is probably justified because the FDIC cannot police conduct giving rise to personal defenses (like voidable infancy) as cheaply as obligors can — the same reasoning that justifies the validity of real defenses against a holder in due course.

V. CONCLUSION

Federal law governing the FDIC's immunity is currently a muddle, with the outcome of a particular case turning on semantics and chance. The confusion is attributable in part to the existence of three distinct but concurrently applicable sources of immunity. It is also attributable to an absence of first principals guiding the courts. The absence of a coherent test for the application of the FDIC's immunity is most apparent when the obligation on which the FDIC seeks to recover is part of a bilateral contract.

This article proposes that the efficient allocation of loss should shape a rule of immunity for the FDIC. Courts applying the current law justify immunity for the FDIC based on furtherance of redistributional goals — shifting the cost of bank failure away from the FDIC. If the only goal of a rule of immunity for the FDIC is to redistribute loss from the federal deposit insurance fund to obligors, then a rule of absolute immunity would be optimal. A rule that immunizes the FDIC from all

218 See supra notes 169-171 and accompanying text.
219 See supra notes 191-192 and accompanying text.
220 In FDIC v. Leach, 772 F.2d 1262, 1270 (6th Cir. 1985) (Merritt, dissenting) (federal policy did not mandate a shifting of the cost of bank failure from the FDIC to obligors and that the "only certain effect [of the federal holder in due course rule] 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.") Accord, Miller & Meacham, supra note 8, at 633-35.
claims and defenses simply fixes a higher value on the failed bank's assets in the hands of the FDIC than such assets had in the hands of the failed bank, at the expense of obligors. Any vulnerability of the FDIC to claims or defenses will reduce the redistributive effect. If, on the other hand, at least part of the objective is to induce conduct that could reduce the loss created by bank failure — to induce allocative efficiency — a uniform rule of absolute immunity would not necessarily do the job. This is because in certain circumstances, the FDIC may be able to take precaution to avoid or insure against the loss at a lower cost than the obligor. If the FDIC were always immune, it would have no incentive to take precaution to avoid or insure against loss, even when it was in the better position to do so.

This article proposes a rule of immunity that deliberately considers allocative efficiency. Like the holder in due course rule, it allocates loss to the party who was in the better position to avoid it. The resulting rule eliminates much of the confusion and unpredictability of the current law and has the potential to affirmatively reduce the total loss from bank failure.

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221 See Montross, 923 F.2d at 357.