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A Precedent Embalms a Principle: The Expansion of the D'Oench, Duhme Doctrine

J. Michael Echevarria

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A PRECEDENT EMBALMS A PRINCIPLE: THE EXPANSION OF THE D'OEENCH, DUHME DOCTRINE

J. Michael Echevarria*

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* Associate Professor of Law, Southwestern University School of Law. B.A., University of California at Los Angeles, 1980; J.D., Harvard Law School, 1983. Invaluable research for the paper was provided by the following students: Scott Karol, Michael Magasinn, Christine Pecora, and Armen Tamzarian.
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'Twill be recorded for a precedent,
And many an error by the same example
Will rush into the state . . . .1

I. INTRODUCTION

In 1942 the United States Supreme Court in D’Oench, Duhme & Co. v. FDIC2 established a precedent of federal common law that has now embalmed the principle for which it originally stood.3 In D’Oench, the Court, for the express purpose of maintaining the nation’s confidence in the banking system, held that when the Federal Deposit Insurance Corporation (FDIC) takes over a failed bank, the commercial paper it acquires is not subject to certain common law defenses (such as lack of consideration) that are not apparent on the face of the paper. D’Oench was based on state common law authority that held that a maker of an accommodation note could not assert lack of consideration as a defense to her obligations because of her participation in a scheme (i.e., the creation of the note) designed to misrepresent the assets of the institution. Through the course of subsequent case law, D’Oench (now codified at 12 U.S.C. § 1823(e)) has been dramatically expanded in its application and now essentially precludes the assertion of fraud defenses or causes of action against successors to failed banks and savings and loan institutions (S&Ls). The expansion of D’Oench came at a time when savings and

loan failures were widespread and, in no small measure, were caused by the fraud \textit{D'Oench} removed from the realm of compensable actionable conduct. \textit{D'Oench}, which was borne of the systemic bank failures of the Great Depression and based on a body of state common law creating a prophylactic rule to prevent fraud, can only be viewed now as ironic in its application, given the causes of the current crisis gripping the nation's financial institutions.

Because of the existing common law protections that historically and presently exist, \textit{D'Oench} serves as a gap filler, catching within its net those bank customers against whom no historical common law defense would have been applicable. Those customers, by and large, are the passive victims of fraud. Is \textit{D'Oench} and its progeny now sustaining the nation's confidence in the banking system? The answer is obvious.\footnote{4}

This Article will trace the historic, economic, and legal history of the \textit{D'Oench}\textsuperscript{5} doctrine and compare it to the recent case of \textit{Bartram v. FDIC}\textsuperscript{6} to highlight the irony of the application of the doctrine and to justify a call for reform. Part One of this Article begins with a brief factual narrative of \textit{Bartram} as a demonstration of how \textit{D'Oench} currently applies. The Article then chronicles the creation of the FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) in the context of their historic precedents. Part Two concentrates on the development of the case law from the legal forebears of \textit{D'Oench} to its present progeny. Part Two also explores the consequences of the deregulation of S&Ls in the early 1980s. Finally, Part Three critiques the \textit{D'Oench} doc-


\footnote{5. With reference to \textit{D'Oench}, this Article includes the cases that directly apply \textit{D'Oench}, as well as cases that apply the purported statutory codification of \textit{D'Oench}, 12 U.S.C. § 1823(e) (1988 & Supp. If 1990), and the holder in due course cases which trace their lineage back to \textit{D'Oench} but have been decided under a broader federal common law rubric. The latter two lines of case law arguably would not have been created in the absence of \textit{D'Oench}.}

\footnote{6. 1 Cal. Rptr. 2d 614 (Cal. Ct. App. 1991) (holding that the \textit{D'Oench} doctrine protects the FDIC from fraud claims brought by former customers of a savings and loan), review denied, No. SO24456, 1992 Cal. LEXIS 2115 (Cal. Feb. 27, 1992).}
trine from the viewpoint of its fundamental unfairness and its ineffectivity. This Article finally reviews existing common law contract doctrines that provide the FDIC with ample legal protection. This Article concludes that given the already existing common law protections and the original rationale underlying D'Oench, the doctrine, including its statutory and federal common law heirs, should be abandoned.

II. HISTORICAL BACKGROUND

A. Bartram v. FDIC: Factual Summary

Donna and Harold Bartram and Vita and Joseph Tessitore (hereafter the Bartrams) were elderly couples residing in Southern California, who sought to feather their retirement nests by investing in real estate. The Bartrams owned four parcels of undeveloped land in Los Angeles County. On May 22, 1985, the broker employed to sell the land informed the Bartrams that he had a buyer willing to swap land with them. That buyer was Ramona Savings and Loan Association, a recently acquired thrift located at the time in Orange County, California. Two entrepreneurs, John L. Molinaro, a carpet salesman, and his next door neighbor, Donald P. Mangano, a real estate developer, had acquired Ramona in April 1984.

A little over a week after their broker informed them of the potential buyer, the Bartrams entered into a contract with Ramona whereby they agreed to transfer to Ramona two parcels they owned in consideration for thirty-two condominium units owned by Ramona. Unbeknownst to the Bartrams, Ramona was in serious financial jeopardy at the time, and its management—mainly in the person of Mr. Molinaro—was engaged actively in a concerted effort to divest Ramona of most of its real estate holdings to boost artificially Ramona's book value.

7. The facts in this section are not exclusively found in the reported decision, but also can be found in the appellate briefs filed by the parties. The author served as trial counsel for the FDIC in this matter and also drafted the FDIC's appellate brief. The facts presented here originate from the plaintiff's point of view because the complaint was dismissed prior to trial. The court concluded that even if every fact set forth was true, the complaint failed to state a cause as a matter of law.
10. Bartram, 1 Cal. Rptr. 2d at 615.
11. FDIC v. Molinaro, 901 F.2d 1490, 1491 (9th Cir. 1990).
12. Bartram, 1 Cal. Rptr. 2d at 615. A note for $1,130,850 constituted the difference in value between the Bartram's land and the higher-priced condominiums. Id.
13. See Molinaro, 901 F.2d at 1491. A joint investigation by the Federal Home Loan Bank Board and the California Department of Savings and Loan revealed that during
As originally contemplated, the transaction fell through, but was renegotiated in mid-June of the same year. Molinaro informed the Bartram's broker that Ramona allegedly had appraised the Bartram's land and discovered a deficiency of $600,000 between the value of their land and the condominiums. Molinaro proposed that the Bartrams make up the difference by executing promissory notes in the amount of the difference. While the Bartrams were initially skeptical, Molinaro represented that Ramona would develop the two parcels it was acquiring, thereby increasing the value of the adjacent land still owned by the Bartrams. The transaction closed in early July.

Nothing in the promissory notes or other transaction documents made mention of Ramona’s "obligation" to develop the two parcels Ramona was acquiring. In reality, at the time of the exchange Ramona had no intention of developing the parcels. Rather, it secretly found another purchaser, to whom it later sold the two parcels in a paper transaction, recording a phony $550,000 profit in the process. The latter sale was part of Molinaro's effort to divest Ramona of its real estate holdings and inflate its net worth.

In January 1986, after the Bartrams learned of Molinaro's deception, they brought suit in California Superior Court against Ramona, Molinaro, and their broker. The Bartrams asserted a single claim against Molinaro and Ramona for fraud in the inducement relating to the sale, for which they sought $600,000 in compensatory damages. Seven and one-half months later, the Federal Home Loan Bank Board declared Ramona insolvent and appointed the FSLIC to act as receiver. In its receivership capacity, the FSLIC succeeded to the rights, powers and privileges of Ramona, including the right, acting in the FSLIC’s corpo-

14. Bartram, 1 Cal. Rptr. 2d at 615.
15. Respondent's Brief at 2-3, Bartram (4th Civ. No. G009613). The Bartram's promissory note was therefore increased to $1,730,000. Id.
16. Bartram, 1 Cal. Rptr. 2d at 615.
17. Id.
18. Id.
19. Id.
20. Respondent's Brief at 3.
21. Id.
22. Bartram, 1 Cal. Rptr. 2d at 615.
23. Id. The damages represented the difference between the property's alleged market price and the contract price. Id.
24. Id.; see also FDIC v. Molinaro, 901 F.2d 1490, 1491 (11th Cir. 1990) (describing the history of Ramona Savings and Loan Association and FSLIC actions as receiver).
rate capacity, to prosecute claims against Ramona's former management.26

Among the assets the FSLIC in its receivership capacity acquired were the outstanding Bartram notes.27 Ultimately, the Bartrams defaulted on the notes and the FSLIC received its recourse by way of foreclosure against the underlying security (the condominiums).28 In the meantime, the FSLIC in its corporate capacity actively pursued civil action against Molinaro, among others, for various causes of action including fraud and breach of fiduciary duty.29 In its receivership capacity, the FSLIC was substituted for Ramona as a defendant in the suit filed by the Bartrams. As a consequence of changes in federal law, the FSLIC was abolished in the summer of 1989, and the FDIC succeeded the FSLIC in the litigation.30

The Bartram case went to trial in March 1990. The FDIC was in the unenviable position of, in essence, justifying and defending the actions of a person, John Molinaro, against whom they had been prosecuting a civil fraud action for over three years. Compounding the situation, in the preceding year Molinaro had been convicted of over thirty counts of bank

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26. Id.
28. Id.
29. FSLIC v. Molinaro, No. CV-86-6016-AHS (C.D. Cal. Sept. 14, 1987). The FSLIC's civil suit has been the subject of multiple dispositions in the United States Court of Appeals for the Ninth Circuit. See FSLIC v. Molinaro, Nos. 91-56423, 91-56212, 1993 U.S. App. LEXIS 3135 (9th Cir. Feb. 8, 1993) (affirming district court order for law firm of defendant to repay excessive attorney's fees and denying district court assessment of sanctions for appeal); FSLIC v. Molinaro, 923 F.2d 736 (9th Cir. 1991) (reversing district court imposition of Rule 11 sanctions on defendant's law firm); FSLIC v. Ferm, 909 F.2d 372 (9th Cir. 1990) (affirming district court order of accounting for bills submitted by law firm of defendant's ex-wife); FSLIC v. Molinaro, 901 F.2d 1490 (9th Cir. 1990) (affirming district court order of summary judgment against Molinaro to recover two million dollar dividend paid from a restricted account).
30. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, Title IV, § 401, 103 Stat. 183, 354; see also supra note 25. The Act provides that:

[n]o action or other proceeding commenced by or against the Federal Savings and Loan Insurance Corporation . . . shall abate by reason of the enactment of this Act, except that the appropriate successor to the interests of such Corporation shall be substituted for the Corporation . . . as a party to any such action or proceeding.

Id. § 401(f)(2), 103 Stat. at 356.
fraud as a result of a criminal referral made by the FSLIC to the United States Attorney.\footnote{31}

On the first day of the trial, the FDIC raised the exclusionary banner of \textit{D'Oench, Duhme & Co. v. FDIC}\footnote{32} for the first time.\footnote{33} In a motion in \textit{limine}, the FDIC sought to exclude from evidence one fact: the oral misrepresentation of Molinaro, arguing that it was the type of oral "agreement" made unenforceable under \textit{D'Oench}.\footnote{34} The trial court agreed, dismissing the case against the FDIC.\footnote{35} The California Court of Appeals affirmed the trial court's dismissal of the action.\footnote{36} While both rulings were consistent with the decisional law of the past fifty years, this did not necessarily make them fair.\footnote{37}

\textbf{B. The Great Depression and the Creation of the FDIC}

In 1928, no regulatory body supervised the nation's financial institutions.\footnote{38} Instead, only the Federal Reserve System, created in 1913, existed to regulate the money supply.\footnote{39} The Federal Reserve maintained money reserves, issued money in the form of bank notes, and loaned

\begin{footnotesize}
\begin{itemize}


\item 34. \textit{Id.} The motion in \textit{limine} sought exclusion of the oral misrepresentation or, in the alternative, dismissal of the complaint based on the fact that granting the motion in \textit{limine} effectively destroyed plaintiffs' one cause of action by removing an essential element, the misrepresentation itself. \textit{Id.}

\item 35. \textit{Bartram} v. FDIC, No. X-480140 (Cal. Sup. Ct. Mar. 27, 1990). Technically the court granted the FDIC's motion to dismiss, which was phrased as a motion for judgment on the pleadings. \textit{Id.}


\item 37. It should be noted that the Bartrams received a default judgment against Molinaro in the principal amount of $600,000. Molinaro, who was in prison at the time, was judgment proof, having had his assets frozen by the FSLIC a number of years prior to the Bartram matter, and having suffered numerous final money judgments in favor of the FSLIC (and later FDIC) in the same civil proceeding. \textit{See} FSLIC v. Molinaro, 901 F.2d 1490 (9th Cir. 1990) (affirming district court order of summary judgment against Molinaro to recover two million dollar dividend paid from a restricted account).


\item 39. \textit{Gerald Gunderson}, \textit{A New Economic History of America} 482 (1976).
\end{itemize}
\end{footnotesize}
money to banks. In early 1928, while the stock market was making impressive gains, the Federal Reserve took steps to retard excessive speculation by making credit more costly through restrictions on the money supply. The effect of this policy was to raise interest rates. Despite the Federal Reserve's efforts, the market continued its upward spiral. The Federal Reserve thereafter sent directives to member banks, urging them to make only productive loans, and to refuse all loans requested for speculation in securities.

Money remained tight through the first three quarters of 1929. By the autumn of 1929, the economy responded, with significant decreases in the levels of construction and industrial production. The stock market, however, did not respond, as stock prices continued to increase. On October 24, nearly thirteen million shares were traded, and the market suffered its most catastrophic loss in history, as American wealth in securities had been reduced by twenty-five billion dollars.

Theories abound as to the causes of the stock market crash. Some analysts speculate that the market crashed because stock prices were too high relative to their fundamental basis of value. Others state that stock purchases on the margin accentuated the decline by making the market more volatile. Still other market experts attribute the crash to the fact that investor expectations as represented by stock prices did not meet the reality of the market as represented by business profits. Despite the existence of numerous divergent theories, all analysts emphasize that the crash precipitated a major decline in real income. Between 1929 and

40. WILLIAM C. MELTON, INSIDE THE FED 4-7 (1985). "The [Federal Reserve Act] basically conceived of the Fed as a collection of supercorrespondent banks organized chiefly to improve the country's payments mechanism and to provide for seasonal currency needs, while supporting the soundness of banking through its role as lender of last resort."


43. Id. at 254.

44. Id. at 255-56. "The [Federal Reserve] Board believed the way to curb security speculation was to deny rediscounting privileges to member banks making loans on securities."


46. Id.

47. Id. "The [Federal Reserve] System raised discount rates to high levels; it couldn't stop the stock market, but, as far as business was concerned . . . its action came 'probably at just the right time to do maximum damage.'" Id.

48. Id. at 300; FRIEDMAN & SCHWARTZ, supra note 42, at 305-08.

49. FRIEDMAN & SCHWARTZ, supra note 42, at 305-06.

50. See GUNDERSON, supra note 39, at 471-75.
1930, real income fell by eleven percent; from 1930 to 1931 it declined by
nine percent; and from 1931 to 1932 income decreased by eighteen per-
cent.\textsuperscript{51} In the first four years of the Great Depression, real income
dropped by a whopping thirty-six percent.\textsuperscript{52}

This sudden economic downturn dramatically impacted on banks. In
October 1930, a crop failure in the corn belt spurred a banking crisis in
the Midwest, which had a ripple effect throughout the country.\textsuperscript{53} When
the dust finally settled, banks with an aggregate of $600 million in depos-
its had closed their doors.\textsuperscript{54} Runs on banks became frequent and banks
began to rearrange their portfolios, shifting a larger portion of their assets
into cash or securities readily converted to cash such as government
notes.\textsuperscript{55} A second bank crisis occurred in March 1931, and from February
through August of 1931 bank deposits fell by $2.7 billion.\textsuperscript{56}

By 1933, the unemployment rate stood at twenty-five percent, and the
gross national product had fallen by one-third since the stock market

\textsuperscript{51} Id. at 475.
\textsuperscript{52} See id.
\textsuperscript{53} FRIEDMAN & SCHWARTZ, supra note 42, at 308-09.
\textsuperscript{54} Id. at 310-11.
\textsuperscript{55} Id. at 311. Friedman and Schwartz observe that “currency held by the public
stopped declining and started to rise, so that deposits and currency began to move in oppo-
site directions, as in earlier banking crises. Banks reacted as they always had under such
circumstances, each seeking to strengthen its own liquidity position.”
\textsuperscript{56} Id. at 313-15. In 1932, one economic historian described the situation as follows:
Many of the nation’s banks were in shaky condition. Their profits had been re-
duced and frequently entirely eliminated by falling bond prices, defaulted loans
and mortgages, and the necessity of keeping a good portion of their assets in low-
return, liquid assets. Furthermore, the populace—with good reason—generally
considered the banks risky institutions in which to entrust their assets. So when a
few weak banks closed their doors in 1932, the depositors in the other banks
began to descend upon them, anxious to retrieve their assets before the same fate
befell them. It was, of course, a self-fulfilling prophecy. When large numbers of
people believe that a bank will fail, they act so that it does, in fact, fail.
\textsuperscript{58} Proclamation No. 2039, 48 Stat. 1689 (1933) (ordering the suspension of banking
transactions and vesting the Secretary of the Treasury with powers to oversee banking
functions); Proclamation No. 2040, 48 Stat. 1691 (1933) (extending the bank holiday be-

\textsuperscript{59} See FEDERAL DEPOSIT INSURANCE CORPORATION, FEDERAL DEPOSIT INSURANCE
In the face of this overwhelming systemic failure, Congress created and financed the FDIC as part of the Banking Act of 1933. A fundamental purpose of the FDIC was to safeguard the deposits of the general public and increase public trust in the banking system. To meet its statutory duty, the FDIC was given supervisory as well as regulatory control over federally insured banks. In its supervisory capacity, the FDIC was charged with conducting bank examinations and processing applications for bank insurance. As a regulator, the FDIC was given authority to propose, amend, and repeal the rules and regulations that specified its functions.

Under the statutory scheme created by Congress, deposit insurance was advanced as a method of restoring public confidence in the banking system by controlling the economic consequences of bank failure. Pursuant to this scheme, the FDIC insured its first deposit on January 1, 1934. See Banking Act of 1933, ch. 89, § 8, 48 Stat. 162, 168 (current version at 12 U.S.C. § 1811 (1988)). The Act stated that the duty of the FDIC was to purchase, hold, and liquidate the assets of national banks which have been closed by action of the Comptroller of the Currency, or by vote of their directors, and the assets of State member banks which have been closed by action of the appropriate state authorities, and by vote of their directors; and to insure, as hereinafter provided, the deposits of all banks which are entitled to the benefits of insurance under this section.

Pursuant to this scheme, the FDIC insured its first deposit on January 1, 1934. See Banking Act of 1933, ch. 89, § 8, 48 Stat. 162, 168 (current version at 12 U.S.C. § 1811 (1988)). The Act stated that the duty of the FDIC was to purchase, hold, and liquidate the assets of national banks which have been closed by action of the Comptroller of the Currency, or by vote of their directors, and the assets of State member banks which have been closed by action of the appropriate state authorities, and by vote of their directors; and to insure, as hereinafter provided, the deposits of all banks which are entitled to the benefits of insurance under this section.

The FDIC is a corporation originally established during the economic and banking crisis of the early 1930s when thousands of banks were forced to close their doors. It was created to restore and reinforce public confidence in the banking system, to promote safe and sound banking practices and the stability of banks, to obviate runs on banks by depositors, to safeguard deposits through deposit insurance, and to prevent the recurrence of the events of 1931 and 1932 which sapped banking strength and climaxed in the “bank holiday” of March, 1933.


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The main asset of the FDIC was, and continues to be, its insurance fund. Courts have historically assumed that the FDIC implicitly has the power, if not the mandate, to preserve and protect its fund. To this end, courts have consistently acknowledged that the government has the power to prosecute actions designed to deter acts that are destructive to the preservation of the FDIC.

C. The Thrift Mission and the Creation of the FSLIC

As far back as the early 1800s, mortgage money in the United States has been scarce. To increase its supply, associations formed to seek deposits from local citizens who received interest for the use of their funds. These associations expressly encouraged thrift among families, whose deposits were pooled and used to make mortgage loans to persons seeking to finance the construction and purchase of residences.

Prior to the Great Depression, these associations, commonly referred to as "building and loan associations" or "savings and loan associations" (S&Ls), were the principal financiers of home mortgages in the United States. By 1931, forty-six of the forty-eight states had laws providing for supervision of these institutions. There was, however, no federal agency or regulatory scheme controlling these institutions.

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67. FEDERAL DEPOSIT INSURANCE CORPORATION, supra note 59, at 40-46.
68. See, e.g., Doherty v. United States, 94 F.2d 495 (8th Cir.), cert. denied, 303 U.S. 658 (1938).
69. See id. at 498 (stating that "the creation of [the FDIC] was within the constitutional power of the government and the act is a proper basis for prosecutions for acts destructive of preservation of the agency thus created").
71. Id.
72. Id.
74. H. MORTIN BODFISH, HISTORY OF BUILDINGS AND LOANS IN THE UNITED STATES 124 (United States Building and Loan League 1931).
75. The stock market crash of 1929 had a great impact on S&Ls:

After the economy collapsed in 1929, hundreds of thousands of homeowners and farmers could no longer make the payments on their mortgages. Savings and loan associations foreclosed and found the property they held was virtually worthless because few could afford to purchase it. There was panic as depositors tried to withdraw their savings from the S&Ls. Hundreds of thrifts went broke. Because there was no national deposit insurance system, many S&L depositors lost their savings.

LEWIS, supra note 70, at ii.
From 1929 to 1934, Congress passed a comprehensive body of legislation, culminating in the creation of the FSLIC in 1934. Congress established the FSLIC to insure accounts in federal S&Ls and in qualifying state institutions. The FSLIC's powers paralleled those of the FDIC.

III. The Case Law and the Deregulation of the S&L Industry

A. The State Common Law Estoppel Cases

Prior to the Supreme Court's decision in D'Oench, state case law that originated before the turn of the century held that in the context of a banking transaction, the maker of an accommodation note is estopped from excusing her liability on the note by asserting lack of consideration as a defense. In the typical case, a promissory note payable to a bank is in default. The bank then has another party execute a substitution note...
which the bank carries on its records as an existing asset. The maker receives no consideration from the bank for making the note, but is promised that the bank will never collect on the note. If the bank should go into default and be placed in receivership, the receiver, as part of its statutorily mandated duties, will seek to collect the assets of the institution by, among other things, enforcing all the outstanding notes payable to the bank. The note maker’s defense of lack of consideration is invalid because the creation of the note constitutes a fraud on the bank’s depositors and creditors in that it has the tendency to overstate the value of the bank’s assets. The rule has its origin in the contract doctrine of illegality: the agreement between the bank and the accommodation maker not to enforce the note violates public policy and thus is not enforceable as part of a deceptive scheme. Since the rule is based on the traditional common law doctrine of illegality, it has no application when the bank itself seeks to enforce the note because the bank is considered in pari delicto with the maker.

The case of Pauly v. O’Brien is typical. On November 15, 1889, Naylor was insolvent and indebted to California National Bank of San Diego (National) in an amount exceeding $3700. Naylor’s obligation was evidenced by a promissory note secured by jewelry as collateral. At the behest of National’s vice president, the defendant gave a note to National in substitution for the Naylor note. The express reason for the creation

80. Id. § 2.03(5).
81. Id.
82. Normally no recovery, not even restitution, is permitted when a contract contravenes public policy. RESTATEMENT (SECOND) OF CONTRACTS § 197 (1981); JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 22-1, at 888 (3d ed. 1987); 2 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 5.9, at 75 (1990) (noting that “[c]ourts generally do not grant restitution under agreements that are unenforceable on grounds of public policy” (footnote omitted)). The contract is void ab initio. CALAMARI & PERILLO, supra, § 22-1, at 889. However, restitution may be available if the party seeking recovery is not considered equally at fault. FARNSWORTH, supra, § 5.9, at 77. “Such a claimant is said to be not in pari delicto (equally in the wrong) with the other party. Courts have applied this exception in favor of the victim of misrepresentation or oppression by the other party.” Id. (footnotes omitted). The party seeking recovery bears the burden of proof and is presumed to be in pari delicto in the absence of such proof. RESTATEMENT (SECOND) OF CONTRACTS § 198(b) cmt. b (1981); 6A ARTHUR L. CORBIN, CORBIN ON CONTRACTS §§ 1537-40 (1962); 15 SAMUEL WILLISTON, CONTRACTS §§ 1789-91 (3d ed. 1972). This principle explains why the estoppel cases in this Article apply to third parties and not original parties. It also demonstrates that the estoppel rule is grounded on the common law contract doctrine of illegality.
83. 69 F. 460 (S.D. Cal. 1895). The majority of the cases cited in this portion of the Article were expressly cited as precedent by the Supreme Court in D’Oench.
84. Id.
85. Id.
86. Id.
of the accommodation note was to remove the Naylor note from National's "past due" files. The bank then foreclosed upon the jewelry and recouped less than one-third of the amount owed on the original note. However, the Naylor note was entered as paid on National's books, and the defendant executed another note reflecting the amount still owed on the Naylor note. All notes endorsed by the defendant were executed without monetary consideration. National was eventually declared insolvent, and a receiver was appointed. The receiver sought to enforce the note executed by the defendant. The defendant argued, however, that the note was unenforceable for failure of consideration. While the court erroneously concluded that consideration was present, it also concluded, more importantly, that even if there was no consideration, the note was not enforceable because the transaction constituted a "trick to make it appear to the government and to the creditors and stockholders of the bank that it had a valuable note when in fact it did not have one."

87. Id.
88. Id. at 461.
89. Id.
90. Id. The court observed:

Each and all of the notes executed by the defendant, proceeds the agreed statement, "were given without "any other consideration than here stated, and that the only knowledge said Naylor had of the matter was that [the vice president] told him that the jewelry had been sold, and applied to the note. The Naylor note had been carried, and each of the O'Brien notes were carried, among the assets of the bank upon its books and in its statements to the comptroller, as an asset for their face."

91. Id. at 460.
92. Id.
93. Id. at 461.
94. Id. The court, in analyzing the evidence of consideration, held:

Not so, according to the agreed statement of facts, for it is there stated that it was executed in place of and to take up the note of Naylor, then represented by the bank officers to be past due, and to be secured by collaterals which were believed to be ample to pay it, and which they represented the bank wanted to get "out of the past-due notes," and which, together with the collaterals, were to stand as collateral to the note executed by the defendant, upon the execution of which the Naylor note was entered as paid on the books of the bank, and the defendant's notes was entered thereon "as a discount for its face." It thus appears that the defendant executed his first note, subsequently renewing it from time to time, and ultimately by the note in suit, for the purpose of having it take the place of the Naylor note, which, together with the collaterals, "were to be collateral to the note" given by him.

95. Id.
The *Pauly* court held that as a matter of "pure justice" a person could not avail himself of a defense arising from a deceitful transaction.\(^{96}\) Although there was no showing of scienter on the part of the defendant, the court opined that he could have no other purpose for voluntarily executing the note for no monetary consideration than to allow National's officers to deceptively and fraudulently record its assets.\(^{97}\) The court, however, failed to articulate a carefully constructed estoppel rule.

The court in *Putnam v. Chase*\(^ {98}\) came closer to enunciating a clear rule of estoppel. In *Putnam*, the bank's receiver sought to enforce an accommodation note executed by Chase in favor of the bank.\(^ {99}\) The defendant claimed that the note was executed "for the purpose of increasing its apparent assets, and tiding over financial difficulties."\(^ {100}\) In accordance with "good morals" and "sound public policy,"\(^ {101}\) the court held that under such circumstances the maker was estopped from asserting lack of consideration as a defense.\(^ {102}\) The court expressly held that the estoppel defense would have been available had the plaintiff been the bank since the bank was *in pari delicto*, thus implicitly acknowledging that the basis of its decision was the common law doctrine of illegality.\(^ {103}\)

The estoppel rule was most clearly elaborated in *Denny v. Fishter*.\(^ {104}\) In *Denny* the state banking commissioner, acting as receiver for a failed bank, sought to enforce the obligation of an accommodation maker on a note.\(^ {105}\) Evidence showed that the maker had no positive idea of committing any fraud; however, the court nonetheless deemed him liable.\(^ {106}\)

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96. *Id.* The court stated that in such a case "the result must be the same, for, when parties employ legal instruments of an obligatory character for fraudulent and deceitful purposes, it is sound reason, as well as pure justice, to leave him bound who has bound himself." *Id.*

97. *Id.* at 462.

98. 212 P. 365 (Or. 1923).

99. *Id.* at 366.

100. *Id.*

101. *Id.* at 367.

102. *Id.* at 366. The court noted:

It seems . . . to be well settled by the great weight of authority that, where a bank commissioner or other statutory receiver takes over the assets of an insolvent for the purpose of liquidation, such defense is not available, and the maker of a note given, as this one confessedly was, to deceive the bank examiner into a false finding as to the sufficiency of the bank's assets, is estopped from asserting such defense.

*Id.*

103. *Id.*

104. 36 S.W.2d 864 (Ky. 1931).

105. *Id.* at 865.

106. *Id.* at 867-68.
Relying on a note in the *Harvard Law Review*, the court delineated the parameters of an estoppel rule. More importantly, however, the court clearly articulated the need for an estoppel rule in the context of the banking business.

*Denny* and *Paulson*, while ostensibly phrased as postulating estoppel rules, analytically formulated rules based on the common law notion of illegality. Traditionally, the notion of equitable estoppel is premised on damage. Estoppel is not invoked unless its invocation prevents an injustice. In the state common law estoppel cases, however, there was no compelling evidence that any bank depositors or creditors were harmed. The damage found was all hypothetical. An illegality rule is prophylactic, seeking to prevent harm before it is accomplished. Without stating so, the courts in the state common law estoppel cases bifurcated the execution of the note from one of its terms (i.e., the agreement not to enforce the note) and treated that term as void because of illegality. Technically the rule is one of estoppel because the note maker is literally prevented or estopped from asserting lack of consideration as a defense to her contractual obligations.


108. *Denny*, 36 S.W.2d at 867. The court relied on the estoppel analysis when fraud is an element of the note:

By giving his note the maker causes a misrepresentation of the bank's assets. The misrepresentation may reach creditors through various channels, among which are published statements of the bank and reports of the bank examiner, an official created by the public to protect creditors. The very continuance in business of a bank which would have been closed by the examiner but for the deception is in a sense a misrepresentation. Many creditors may suffer change of position upon the faith of this misrepresentation.

Note, *supra* note 107, at 242 (*quoted in Denny*, 36 S.W.2d at 867).

109. The court quoted the Kansas Supreme Court's holding in *Cedar State Bank v. Olson*, 226 P. 995 (Kan. 1924):

The banking business is fraught with public concern. Banks do business through permission of the law subject always to its provisions for the protection of depositors, creditors, and stockholders. Public faith, credit, and honesty in business transactions are a bank's main assets. . . . The statute requires careful examination by the bank commissioner periodically in order that those who deal with banks may not be misled by appearances. To sanction any arrangement, 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 statutes.

*Id.* at 997 (*quoted in Denny*, 36 S.W.2d at 867).

110. See *Restatement (Second) of Contracts* § 139(1) (1979) (stating that "[a] promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce the action or forbearance is enforceable . . . if injustice can be avoided only by enforcement of the promise").
The passage of the Banking Act of 1933\textsuperscript{111} enacted laws that evidenced this prophylactic concern. The Act contained numerous provisions designed to protect bank depositors and creditors, including laws that established minimum capital requirements for banks and prohibited transactions tending to impair a bank's capital stock.\textsuperscript{112} The Act also made it a criminal offense for a bank officer or director to aid and abet any person in the violation of these laws.\textsuperscript{113}

The Supreme Court first addressed the state common law estoppel rule in the context of the National Banking Act in \textit{Deitrick v. Greaney}.\textsuperscript{114} In \textit{Deitrick}, Boston National Bank purchased 190 shares of its own capital stock in violation of federal law.\textsuperscript{115} The defendant, a bank officer, induced another individual to execute an accommodation note payable to the bank as part of a transaction to conceal the bank's ownership of the stock.\textsuperscript{116} The bank assured the defendant that the note would never be called due.\textsuperscript{117} When the bank became insolvent and was placed in receivership, the receiver sued the defendant for the sums owing on the note.\textsuperscript{118} The trial court found for the receiver, holding that the defendant accommodation note maker was estopped from employing a lack of consideration defense.\textsuperscript{119} The United States Court of Appeals for the First Circuit reversed the trial court's decree as it pertained to the note maker's liability,\textsuperscript{120} and the Supreme Court reversed the appellate court.\textsuperscript{121}

In \textit{Deitrick}, the execution of the note itself was not violative of the capital stock law; however, criminal liability could be predicated on the


\textsuperscript{112} Id. §§ 16, 17, 48 Stat. at 184-86 (codified as amended at 12 U.S.C. §§ 51, 83 (1988)).

\textsuperscript{113} Id. § 19, 48 Stat. at 187 (codified as amended at 18 U.S.C. §§ 334, 656, 1005 (1988)).

\textsuperscript{114} 309 U.S. 190 (1940), superseded by statute as stated in Gunter v. Hutcheson, 674 F.2d 862 (11th Cir.), cert. denied, 459 U.S. 1059 (1982).

\textsuperscript{115} Id. “The obvious purpose of prohibiting the purchase by a bank of its own stock is to prevent the impairment of its capital resources and the consequent injury to its creditors in the event of insolvency.” Id. at 195.

\textsuperscript{116} Id. at 192. In a complicated series of transactions, the proceeds of the promissory note were deposited in another bank to the credit of the defendant, who then paid the proceeds to the bank for the shares of stock. Id. The shares were then transferred to the party who had executed the note, id., and later defendant himself executed a promissory note to the bank. Id.

\textsuperscript{117} Id.

\textsuperscript{118} Id. at 193.


\textsuperscript{120} Greaney v. Deitrick, 103 F.2d 83, 89 (1st Cir. 1939), rev'd, 309 U.S. 190 (1940).

\textsuperscript{121} Deitrick, 309 U.S. at 201.
defendant's status as an aider and abettor. The problem was that the action was a civil case for enforcement of a note. The Court began its opinion by noting that the purpose of the National Banking Act was to protect bank depositors and creditors by, among other things, preventing banks from impairing their own capital stock. The bank clearly violated the statute by purchasing its own stock and defendant was clearly aware of the unlawful purpose of the entire transaction. The Court treated defendant's participation as unlawful and stated that if defendant "were free to set up the unlawful agreement as a defense and thus cast the loss from the unlawful stock purchase on the creditors of the bank... he would be enabled to defeat the purpose of the statute by taking advantage of an agreement which it condemns as unlawful."

The Court, however, correctly chose not to fashion an estoppel rule because the record was barren of any evidence that depositors or creditors had been damaged. Rather, the Court fashioned an illegality rule that made the agreement not to enforce the note unenforceable as a prophylactic way of preventing circumvention of the underlying capital impairment statute.

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122. Id. at 194. "To insure performance of these duties and as a safeguard to creditors and the public, violation of the provisions of the [National Banking] Act by any director or officer of the bank or by any person aiding or abetting him, is made a criminal offense, and in the event of such a violation, the association may be required to forfeit all its rights and privileges." Id.

123. Id. at 194; see also supra note 102. The Court commented:

The purposes [of the Act] would be defeated and the command of the statute nullified 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, and if he remained free to set up that the obligation was, in effect, fictitious, intended only to aid in the accomplishment of the injury at which the statute is aimed.

Deitrick, 309 U.S. at 195.


125. Id. at 196.

126. Id. at 198. The Court noted that "as the purpose of the statute is to protect creditors of the bank from the hazard of violations of the Act... it is immaterial that the bank's officers were participants in the illegal transaction, or that the receiver has not shown that the creditors have been deceived or specifically injured as the result of the illegal contract." Id. (emphasis added) (citation omitted).

127. Id. The Court stated:

[The doctrine with which we are now concerned is not strictly that of estoppel as thus defined. It is a principle which derives its force from the circumstances that respondent's act, apart from its possible injurious consequences to creditors, is itself a violation of the statute; and that the statute, read in the light of its purposes and policy, precludes resort to the very acts which it condemns, as the means of thwarting those purposes by visiting on the receiver and creditors whom he represents the burden of the bank's unlawful purchase.

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The case law prior to *D'Oench* demonstrated a policy concern with transactions that tended to undermine the public's confidence in the accuracy of the books and records of the financial institutions in which it deposited money.\(^1\) The concern did not focus on any damages caused, but on the undermined confidence of the public.\(^2\) This concern led to the creation of a rule that, while ostensibly phrased as estoppel, was actually more consistent with traditional contract rules regarding the enforceability of illegal bargains.\(^3\) Given the gravity of the Great Depression,

\[\ldots\] It is the evil tendency of the prohibited acts at which the statute is aimed, and its aid, in condemnation of them, and in preventing the consequences which the Act was designed to prevent, may be invoked by the receiver representing the creditors for whose benefit the statute was enacted. \(^4\)

Id. at 198-99 (citations omitted).

Actually the rule fashioned by the Court had elements of both estoppel and illegality. If the creation of the note was an integral part of the criminal transaction, which it clearly was, the entire transaction would be void. However, the Court bifurcated the execution of the note from the agreement not to enforce the note, treating the side agreement as illegal. \(^5\) Id. at 198. By doing so, the Court took the only appropriate step: it mixed notions of estoppel with illegality by affirming the validity of the note but estopping the maker from raising a defense of lack of consideration. \(^6\) Id. at 198-99. The overriding concern in *Deitrick*, similar to the state common law estoppel cases, was the misrepresentation created by the creation of the accommodation note. \(^7\) Id. at 198.

\(^128\). See *supra* notes 77-110 and accompanying text.

\(^129\). See *supra* notes 77-110 and accompanying text.

\(^130\). See Niblack v. Farley, 122 N.E. 160, 162 (Ill. 1919) (holding that "[i]t would be contrary to public policy and good morals to permit defendant to take advantage of the fraudulent agreement with the bank as against the rights of creditors"); Iglehart v. Todd, 178 N.E. 685, 689 (Ind. 1931) (stating that "[t]he liability of a maker of accommodation paper rests upon the principle of estoppel, and arises only when the rights of third parties intervene—as to which parties he is estopped from denying liability"); Cedar State Bank v. Olson, 226 P. 995, 997 (Kan. 1924) (holding that "[h]aving given the note with the avowed object of having it appear as an asset for purposes of examination, [a party] is estopped from asserting a secret understanding that she was not to be held liable"); Parker v. Parker, 282 N.W. 897, 900 (Mich. 1938) (stating that "[t]he maker of an unenforceable note is estopped from denying liability on the ground of its fictitious character"); German-American Fin. Corp. v. Merchants' & Mfrs.' State Bank, 225 N.W. 891, 893 (Minn. 1929) (finding that party was estopped from asserting rights under fraudulent note); Schmid v. Haines, 178 A. 801, 803 (N.J. 1935) (finding that "an accommodation party to a note given . . . to deceive the bank examiner into a false finding as to the sufficiency of the bank's assets, is estopped from asserting such defense"); Mount Vernon Trust Co. v. Bergoff, 5 N.E.2d 196, 197 (N.Y. 1936) (holding that "[p]ublic policy requires that a person who, for the accommodation of the bank, executes an instrument which is in form a binding obligation, should be estopped from thereafter asserting that simultaneously the parties agreed that the instrument should not be enforced"); Valley v. Devaney, 194 N.W. 903, 906 (N.D. 1923) (stating that "[w]here a note or other obligation is given to a bank with the avowed object of its appearing as assets for purposes of public examination, those who purport to be liable upon the obligation are estopped"); Ohio *ex rel.* Lattanner v. Hills, 113 N.E. 1045, 1047 (Ohio 1916) (applying rule of estoppel on the grounds that "it would . . . be entirely inequitable to permit the defendant to avert liability on his note on the ground that there
and the massive bank failures, this “perceptions” concern became paramount in the jurisprudence that followed.

B. D’Oench, Duhme & Co. v. FDIC

In 1926, D’Oench, Duhme & Co., a securities dealer, sold certain bonds to Belleville Bank & Trust Co. and executed certain notes payable to the bank. The bonds later went into default, and in 1933, D’Oench executed renewal notes in favor of the bank to enable the bank to carry the renewal notes and not show any past due bonds on its books and records. The notes on their face were non-negotiable. A receipt to the notes expressly provided that the notes would not be called due. Interest payments on the notes were thereafter made to keep them “as live paper.” D’Oench was aware that the renewal notes were executed so that the past due bonds would not appear among the assets of the bank. In 1935, the bonds were charged off the bank’s records. Three years later, the FDIC acquired the notes as part of the collateral securing a one million dollar loan made in connection with the assumption of the bank’s deposit liabilities by another institution. No evidence revealed that the execution of the accommodation notes damaged any of the bank’s depositors or creditors.

The FDIC sued D’Oench to enforce the notes. D’Oench defended on the grounds of lack of consideration. The trial court held that, under state law, the FDIC was a holder in due course and acquired the notes free from all personal defenses. The United States Court of Appeals for the Eighth Circuit affirmed.

was a want or failure of consideration for said note”); Arthur v. Brown, 74 S.E. 652, 654 (S.C. 1912) (applying rule of estoppel for parties who put forward a fraudulent note).


132. D’Oench, 315 U.S. at 454.

133. Id.

134. Id.

135. Id. The notes stated: “This note is given with the understanding it will not be called for payment. All interest payments to be repaid.” Id. (emphasis added).

136. Id.

137. Id.

138. Id.

139. Id. The FDIC had insured the bank since January 1, 1934. Id.

140. Id.

141. Id. at 453-54.

142. Id.

143. Id. at 455.

144. D’Oench, Duhme & Co. v. FDIC, 117 F.2d 491 (8th Cir. 1941), aff’d, 315 U.S. 447 (1942), superseded by statute as stated in Gunter v. Hutcheson, 674 F.2d 862 (11th Cir.), cert. denied, 459 U.S. 826 (1982).
The *D'Oench* case came before the Supreme Court in the wake of its decision four years earlier in *Erie Railroad v. Tompkins* and ostensibly presented a choice of law issue. Rather than simply affirming the matter under state law, however, the Court chose to fashion a rule of federal common law. Writing for a unanimous court, Justice Douglas examined the Federal Reserve Act and found that it reflected a federal policy to protect the FDIC "and the public funds which it administers, against misrepresentation as to the securities or other assets in the portfolios of the banks which [the FDIC] insures." Justice Douglas concluded that if D'Oench had acted intentionally to deceive the FDIC, *Deitrick* would have been on point. The Court interpreted *Deitrick* as creating an estoppel rule, which made the lack of consideration defense unavailable to accommodation note makers.

Since D'Oench could not have acted to deceive the FDIC because the FDIC had not been created at the time the renewal notes were executed, Justice Douglas turned to the state common law estoppel cases as authority for a broader estoppel rule not based on a scienter requirement and

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145. 304 U.S. 64 (1938).
146. *D'Oench*, 315 U.S. at 455-56. The petitioner D'Oench claimed that the contract was governed by the laws of Missouri, and it would be "against the public policy of Missouri to hold a citizen of Missouri liable on an accommodation note under the facts of this case." *Id.* at 449. The petitioner further argued that under *Klaxon Co. v. Stentor Electric Manufacturing Co.*, 313 U.S. 487 (1941), a federal court sitting in Missouri must apply Missouri's conflict of law rules; that if, as was the case here, Illinois law was not pleaded or proved, a Missouri court would have ascertained Illinois law from Missouri decisions, since in such a case Illinois law would be presumed to be the same as Missouri law; and that the District Court was bound to follow that same course. *D'Oench*, 315 U.S. at 455.
147. *Id.* at 459.
148. *Id.* at 457. The court cited section 12B(s) of the Federal Reserve Act, which stated:

> Whoever, for the purpose of obtaining any loan from the [FDIC] . . . or for the purpose of influencing in any way the action of the [FDIC] under this section, makes any statement, knowing it to be false, or willfully overvalues any security, shall be punished by a fine of not more than $5,000, or by imprisonment for not more than two years, or both.

Banking Act of 1933, ch. 89, § 8, 48 Stat. 162, 177. The Court also relied on subsection (y) of the Act, which provided for insurance for the bank under the aegis of the FDIC. *D'Oench*, 315 U.S. at 457.
149. *D'Oench*, 315 U.S. at 457. The Court noted that under *Deitrick*, "the defendant could not rely on his wrongful act to defeat the obligation as against the receiver of the bank." *Id.* at 458.
150. *Id.* The Court observed that the rule prohibiting an accommodation note maker from asserting lack of consideration as a defense was not limited to violations of a statute, as "an accommodation maker is not allowed that defense as against the receiver of the bank and its creditors, or at times even as against the bank itself, where his act contravenes a general policy to protect the institution of banking from secret agreements." *Id.*
not premised on a theory of damage. He concluded that the root of the rule did not lie in injury, but rather in the "'evil tendency' " created by the acts. Justice Douglas reasoned that even if D'Oench actually did not know the note was used to deceive, its knowledge would be presumed since "[p]lainly one who gives such a note to a bank with a secret agreement that it will not be enforced must be presumed to know that it will conceal the truth from the vigilant eyes of the bank examiners."

The Court then fashioned the D'Oench rule, a rule that would become imbedded in the judicial system. The Court stated:

The test is whether the note was designed to deceive the creditors or the public authority, or would tend to have that effect. It would be sufficient in this type of case that the maker 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.

Because the Court fashioned a rule of federal common law, it did not view the animating force behind the rule as the actual banking public, but deemed the public's federal representative, the FDIC, to be the impetus for the rule. Although the lower court's decision was premised on a finding that the FDIC was a holder in due course, Justice Douglas' opinion made no mention of this issue.

In a concurring opinion, Justice Frankfurter objected to the creation of a federal common law rule, expressing the opinion that D'Oench could be

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151. Id.; see also cases cited supra note 130. The court cited Mount Vernon Trust Co. v. Bergoff, 5 N.E.2d 196 (N.Y. 1936), which held that "[p]ublic policy requires that a person who, for the accommodation of the bank executes an instrument which is in form a binding obligation, should be estopped from thereafter asserting that simultaneously the parties agreed that the instrument should not be enforced." Id. at 197 (quoted in D'Oench, 315 U.S. at 459).
152. D'Oench, 315 U.S. at 459 (quoting Deitrick v. Greaney, 309 U.S. 190, 198 (1940)). The Court stated:

Those principles are applicable here, because of the federal policy evidenced in this Act to protect [the FDIC], a federal corporation, from misrepresentations made to induce or influence the action of [the FDIC], including misstatements as to the genuineness or integrity of securities in the portfolios of banks which it insures or to which it makes loans.

Id.
153. Id. at 460.
154. Id.
155. Id. at 459-60. Such an intent is witnessed by the Court's statement that "[c]learly [the FDIC] is a member of the creditor class which the banking authorities were intended to protect." Id. at 460.
156. Justice Frankfurter, in a separate concurrence, was the only member of the court to acknowledge the possibility of the FDIC as a holder in due course. Id. at 463 (Frankfurter, J., concurring).
decided solely on state common law precedent. Justice Frankfurter found no support in Justice Douglas' opinion from either federal statutes or Deitrick. Justice Jackson, in his separate concurrence, grounded the D'Oench rule on equitable principles, implicitly acknowledging that absent some deceptive arrangement, the D'Oench rule would not apply and such cases would be governed by normal state law rules concerning commercial paper.

In large measure, the Supreme Court's decision in D'Oench was based on the state common law estoppel precedents and was similarly framed in terms of a rule of estoppel. The estoppel rule was of course relaxed: there was no strict scienter requirement and no damage requirement. By failing to predicate the rule on a more sound basis of illegality, the Court left the door open for its application to situations where the books and records of the financial institution do not accurately reflect the transaction. If the rule had been predicated solely on the involvement of the note maker in an illegal transaction or, at the very least, a transaction contrary to public policy, the rule would turn on the culpability of the maker. By fashioning a rule based on the "evil tendency" created by certain transactions, the Court focused more on the effect of the transactions on the perceived status (i.e., paper value) of the institution, rather than on the participation or culpability of the defendant.

157. Id. at 463-64. Justice Frankfurter noted that "[w]ere this Court, in the absence of federal legislation, to make its own choice of law, Illinois or Missouri law would furnish the governing principles." Id. (citations omitted).
158. Id. Justice Frankfurter commented:

Of course the policy expressed by the Federal Deposit Insurance Act might be violated, as the National Bank Act was violated in the Deitrick case, wholly apart from any question of estoppel or proof of loss to the [FDIC]. Our difficulty is that the statute cannot be stretched to fit this case. And it seems unnecessary to force such a result when a solution according to settled doctrines is available. Id. at 465.
159. Id. at 473-74 (Jackson, J., concurring). Justice Jackson stated that "[t]he [FDIC] would succeed only to the rights which the bank itself acquired where ordinary and good-faith commercial transactions are involved." Id. at 474.
160. See supra note 130.
161. Justice Douglas noted that "[t]hough petitioner was not a participant in this particular transaction and, so far as appears, was ignorant of it, nevertheless it was responsible for the creation of the false status of the note in the hands of the bank." D'Oench, 315 U.S. at 461 (majority opinion). Justice Douglas also observed that "[t]he federal policy expressed in the Act, like its counterpart in state law, is not dependent on proof of loss or damage caused by the fraudulent practice." Id.
162. The Court noted that "[t]he[] provisions [of the Federal Reserve Act] reveal a federal policy to 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." Id. at 457.
D'Oench, however, can be justified on its facts. An accommodation note maker, almost by definition, executes a contract he knows will not be enforced. What purpose can the note have other than artifice? Moreover, how can a person not be at least negligent in signing on to such an agreement? If D'Oench had been thereafter limited to these types of collusive arrangements (the creation of a phony contract), its present application would not be so problematic. In large measure, the current problems in the case law can be directly traced back to the sweeping language used by the Court in its opinion.

C. D'Oench's Progeny

1. 12 U.S.C. § 1823(e)

In 1950, eight years after the Supreme Court decided D'Oench, Congress amended the Federal Deposit Insurance Act to allow the FDIC to rely exclusively on the facial validity of a closed bank's books and records. Section 1823(e) of Title 12 provides that any agreement infringing upon the interests of the FDIC in an asset, acquired under its corporate capacity, is invalid unless certain conditions are met. Congress' enactment of section 1823(e) raises the question whether it represents a statutory codification of the D'Oench rule. The sparse legislative history behind section 1823(e) reveals that, in enacting the stat-

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

Id.

166. The Chairman of the FDIC at the time testified before the House of Representatives Committee on Banking and Currency that "[t]he bill before your committee . . . may be characterized as a codification of the law pertaining to the Federal Deposit Insurance Corporation." Amendments to Federal Deposit Insurance Act, 1950: Hearings on S. 2822 Before the House Comm. on Banking and Currency, 81st Cong., 2nd Sess. 19 (1950) (statement of Maple T. Harl, Chairman, FDIC).
ute, Congress was not interested in expanding the FDIC's existing powers, but sought instead to define them more rigidly.\textsuperscript{167} Similar to \textit{D'Oench}, section 1823(e) invalidates claims or defenses against the FDIC based on secret side agreements. For example, the accommodation note maker's oral agreement with the bank not to enforce the note is invalid under both \textit{D'Oench} and the statute.\textsuperscript{168} Section 1823(e)'s technical requirements, however, are narrower in the sense that so long as the nonenforcement agreement becomes an official bank record it is enforceable.\textsuperscript{169} Of course, in the context of an accommodation note, officially recording its unenforceability utterly defeats the purpose of artificially inflating an institution's asset value. Furthermore, section

\textsuperscript{167} The following discussion between Congressman Multer and the director of the FDIC, Earl Cook, illustrates this concern:

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

\textbf{Mr. COOK.} I think that statement of yours covered the grounds where you are properly supported by such agreements and are not dependent upon oral agreements that have no binding effect.

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

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

\textit{Id.} at 41-42. This concern is reinforced by debate from the House of Representatives:

\textbf{It was never the intention of Congress to give to the [FDIC] a stronger position than that of the bank and the adoption of the amendment, my amendment is offered to prove that heretofore it was the intent of Congress that any agreement in the absence of fraud, was binding on the [FDIC].}

\textbf{86 CONG. REC. 10,732 (1950) (statement of Rep. Walter).} The Congressman's assertion that the amendment would not give the FDIC a stronger position than the bank is wrong as a matter of law. A better assertion would have been that the amendment would not change existing common law nor give the FDIC a stronger position than an ordinary successor of a bank (a receiver) or acquirer of a bank's assets (a potential holder-in-due-course). A receiver of a bank under the common law does not merely stand in the shoes of the bank, because at least in theory the receiver represents different interest such as the interests of creditors of the bank. For this reason, an estoppel argument that could be asserted by a receiver may not be available to a bank. Section 1823(e) codifies this principle. \textit{See 12 U.S.C. § 1823(e) (1988).}

\textbf{168. See infra notes 356-58.}

\textbf{169. See 12 U.S.C. § 1823 (requiring that a nonenforcement agreement "shall have been, continuously, from the time of its execution, an official record of the bank").}
1823(e) is narrower than *D’Oench* because, at the time of its passage, it applied expressly to the FDIC in its corporate capacity and not its receivership capacity.\(^{170}\)

At the same time, however, the statute is broader than *D’Oench* in that it lacks a scienter requirement.\(^{171}\) While *D’Oench* involved a situation where the note maker’s culpability was at least presumed,\(^{172}\) section 1823(e), by not limiting its application to specified arrangements (e.g., accommodation notes), invalidates all arrangements falling outside of its strictures regardless of the culpability of the bank customer.\(^{173}\) Moreover, the statute says nothing about the existence of a “deceptive scheme” or the ignorance of the FDIC with respect to the scheme.\(^{174}\)

This discussion leads one back to the question of whether the statute codified *D’Oench*.\(^{175}\) Given the relative propinquity in time to *D’Oench* and Congress’ obvious awareness of the case, the statute would appear to

\(^{170}\) See H.R. REP. NO. 2564, 81st Cong., 2d Sess. 5 (discussing the principal changes in the Federal Deposit Insurance Act that govern the FDIC in its corporate capacity).


\(^{172}\) *D’Oench*, Duhme & Co., v. FDIC, 315 U.S. 447, 460 (1942) (“Plainly one who gives such a note to a bank with a secret agreement that it will not be enforced will be presumed to know that it will conceal the truth from the vigilant eyes of the bank examiners.”), superseded by statute as stated in *Gunter v. Hutcheson*, 674 F.2d 862 (11th Cir.), cert. denied, 459 U.S. 826 (1982).


\(^{174}\) Id. A number of cases expressly hold that whether or not the FDIC has knowledge of a defense at the time it acquires the asset is irrelevant for purposes of section 1823(e). See FDIC v. Investors Assocs. X., Ltd., 775 F.2d 152, 155-56 (6th Cir. 1985) (stating that “[r]egardless of the FDIC’s knowledge of the circumstances surrounding the transaction, the fraudulent scheme is still contrary to public policy and the wrongdoer should not be able to benefit from something that transpired during the course of such scheme?”); FDIC v. Merchants Nat’l Bank, 725 F.2d 634, 640 (11th Cir.) (noting that “[i]f in undertaking a purchase and assumption transaction FDIC’s closed-bank division were held to matters of which the open-bank examiners had actual knowledge, but beyond the scope of Sec. 1823(e), the protection of Sec. 1823(e) would be lost”), cert. denied, 469 U.S. 829 (1984); FDIC v. de Jesus Velez, 678 F.2d 371, 375 (1st Cir. 1982) (stating that “[k]nowledge by the FDIC ... [is] not relevant”); FDIC v. MM&S Partners, 626 F. Supp. 681, 684 (N.D. Ill. 1985) (holding that “the need for certainty and the conclusive presumption of maker knowledge that he is deceiving the FDIC when he knows his collateral agreement has not met § 1823(e) standards makes FDIC knowledge irrelevant”); FDIC v. First Mortgage Investors, 485 F. Supp. 445, 451 (E.D. Wis. 1980) (invalidating any knowledge requirement because “the FDIC need not go beyond the bank records in performing its functions”).

For this reason, section 1823(e) is not truly analogous to a holder-in-due course statute that would require for its application that the party acquiring the commercial paper have no notice of any personal defenses to which the paper is subject. See, e.g., U.C.C. § 3-302(a)(2)(vi) (1990) (requiring that a holder in due course takes the instrument “without notice that any party has a defense or claim in recoupment”). Of course, subsequent case law has erroneously treated section 1823(e) as conferring holder in due course status to the FDIC. See infra notes 271 and 276.

\(^{175}\) A number of cases have expressly held that 1823(e) is a codification of *D’Oench*. See FDIC v. Van Laanen, 769 F.2d 666, 667 (10th Cir. 1985); FDIC v. Blue Rock Shopping
be, if not a codification of *D'Oench*, at least an attempt to define more technically its parameters. Section 1823(e), by virtue of its expansive language (i.e., the lack of a scienter requirement or an ignorance or damage requirement), is not so much a rule of estoppel as it is a rule based on notions of illegality. Section 1823(e) is a prophylactic rule making certain agreements strictly unenforceable and can be viewed as a federal statute of frauds and corporate authority requirement.\footnote{76}

2. Expansion Through the Case Law

a. Party Expansion

For the first thirty years of its resilient life, courts often cited *D'Oench* as an example of federal common law,\footnote{77} but rarely relied upon the holding for any substantive proposition.\footnote{78} The Supreme Court did not revisit the issues raised in *D'Oench* until 1987,\footnote{79} and expansion of its holding did not begin until the late 1970s and early 1980s. Since that time, *D'Oench* has been expanded in two areas: (1) the parties for whom the *D'Oench* doctrine applies;\footnote{80} and (2) the claims and defenses against which the doctrine has attached.\footnote{81}

Expansion of the parties to which *D'Oench* applies is the less problematic area. Although the expansion occurred recently, it can trace its lineage directly to the original rationale of *D'Oench*. The parties for whom *D'Oench* is applicable have been expanded in three categories.

First, *D'Oench* on its face created a federal common law rule of estoppel for the FDIC based on the national interest in uniformly protecting federally insured banks.\footnote{82} Given this logic, it would be natural to expect

\footnote{76} See Kevin A. Palmer, *The D'Oench Doctrine: A Proposal For Reform*, 108 Banking L.J. 565, 569 (1991) (avoiding payment of a debt should be supported by a written agreement and authorized by appropriate bank officials).


\footnote{78} From 1942 to 1970, there appears to be only one court of appeals case substantively decided under *D'Oench*. See *FDIC v. Alker*, 151 F.2d 907 (3rd Cir. 1945), cert. denied, 327 U.S. 799 (1946).


\footnote{80} See infra notes 184-85, 188-89.

\footnote{81} See infra note 193.

\footnote{82} See infra note 297.
it to be of equal importance and applicability to the FSLIC.\footnote{183} Since 1945, therefore, the policies enunciated in \textit{D'Oench} have been held to be applicable to cases involving the FSLIC,\footnote{184} although it was not until the past several years that courts have held expressly that \textit{D'Oench} applies with equal force to the FSLIC.\footnote{185}

Second, the \textit{D'Oench} case involved the FDIC acting in its corporate capacity to facilitate the transfer of a failed bank's assets to another bank.\footnote{186} The FDIC, by statute, may act in two distinct capacities: (1) as a receiver for a failed bank, and (2) as an independent federal corporation.\footnote{187} Although \textit{D'Oench} technically involved the FDIC acting only as a federal corporation, based on the Court's reliance on the state common law estoppel cases (which invariably involved state receivers), \textit{D'Oench} would logically seem to apply to the FDIC in its receivership capacity as well.\footnote{188} To the extent there was any ambiguity as to the scope of \textit{D'Oench}’s application, subsequent case law has stated clearly that

\begin{enumerate}
\item The FSLIC was created in 1934 and made part of the Federal Home Loan Bank Board. See National Housing Act, ch. 847, Title IV, 48 Stat. 1246, 1255 (1934). The FSLIC was designed to insure depositors’ accounts in federal S&Ls and qualifying state institutions. \textit{Id.} § 403, 48 Stat. at 1257.

\item See, \textit{e.g.}, FSLIC v. Kearney Trust Co., 151 F.2d 720, 725 (8th Cir. 1945) (stating that, if the policy espoused in \textit{D'Oench} were not controlling, “the consequences resulting from violations of the statutory prohibitions enacted by Congress for the protection of these national institutions would be subject to conflicting local laws unrelated to the uniform purpose of the Acts”).

\item See, \textit{e.g.}, FSLIC v. Two Rivers Assocs., Inc., 880 F.2d 1267 (11th Cir. 1989) (holding that the federal policy should protect the FSLIC as it protects the FDIC); Taylor Trust v. Security Trust Fed. Sav. & Loan Ass’n, 844 F.2d 337, 344 (6th Cir. 1988) (holding that the result in \textit{D'Oench} applies); FSLIC v. Lafayette Inv. Properties, Inc., 855 F.2d 196, 198 (5th Cir. 1988) (determining that the common law doctrine established by \textit{D'Oench} applies to both the FDIC and the FSLIC); Firstsouth, F.A. v. Aqua Constr., Inc., 858 F.2d 441, 443 (8th Cir. 1988) (holding that 12 U.S.C. § 1823(e), which codifies the holding in \textit{D'Oench}, can be used to protect the FSLIC).

\item See \textit{D'Oench}, Duhme & Co. v. FDIC, 315 U.S. 447, 461 (1942) (noting that “respondent [FDIC] is suing here to protect its rights as an insurer”), \textit{superseded by statute as stated in Gunter v. Hutcheson, 674 F.2d 862 (11th Cir.), cert. denied, 459 U.S. 826 (1982).}

\item See 12 U.S.C. § 1821(a)(1) (1988 & Supp. III 1991) (stating that in its corporate capacity, the FDIC “shall insure the deposits of all insured banks as provided in this chapter”); \textit{id.} § 1822(a) (stating that its receiver capacity, the FDIC “as receiver of a closed national bank... shall have the right to appoint an agent or agents to assist in its duties as such receiver”); \textit{see also} 1 MICHAEL P. MALLOY, THE CORPORATE LAW OF BANKS § 1.3.3, at 47-52 (1988). The same was also true of the FSLIC. \textit{Id.} § 1.3.4, at 54.

\item The state common law estoppel cases, although phrased in terms of estoppel rules, more properly have their etymology in the contract notion of illegality. \textit{See} cases cited \textit{supra} note 130. For this reason the rule does not, and should not, apply to the actual contracting parties, but instead to innocent third parties such as receivers, conservators, assignees, or purchasers for value.
\end{enumerate}
D'Oench does apply to the FDIC, and the FSLIC, in its receivership capacity.\textsuperscript{189}

Finally, in the late 1980s, courts began to hold that the protections of D'Oench were available not only to the FDIC and FSLIC in their respective capacities, but also to assignees of these entities and to persons purchasing assets from these entities.\textsuperscript{190} For example, D'Oench protection has been accorded to private parties who purchase notes of failed banks acquired by the FDIC.\textsuperscript{191} This too is logical given the fact that the underlying justification for the D'Oench rule is illegality (i.e., public policy) and therefore third parties who are not \textit{in pari delicto} should be allowed to avail themselves of the rule.\textsuperscript{192}

\textsuperscript{189} See, e.g., FDIC v. McClanahan, 795 F.2d 512, 516 (5th Cir. 1986) (noting that "[t]he judicial trend has been to extend the protection afforded the FDIC under the D'Oench doctrine and 12 U.S.C. § 1823(e) to the FSLIC, both in its corporate capacity and when acting as receiver of a failed institution"), \textit{superseded by statute as stated in Resolution Trust Corp. v. Ross}, No. 89-1431, 1990 U.S. Dist. LEXIS 14292 (E.D. La. Oct. 22, 1990); FDIC v. First Nat'l Fin. Co., 587 F.2d 1009, 1012 (9th Cir. 1978) (holding that the express language in \textit{D'Oench} refers to receivers as well as creditors).

\textsuperscript{190} See FDIC v. Newhart, 892 F.2d 47, 49-50 (8th Cir. 1989) (applying section 1823(e) to a purchaser of assets from the FDIC); Beverly Hills Sav. v. Highfield Assocs., No. 87-259-M, 1987 U.S. Dist. LEXIS 14019 (D.N.M. Aug. 28, 1987) (applying the rule of D'Oench to a purchaser of assets from the FSLIC).


\textsuperscript{192} See supra note 82.
b. Substantive Expansion (Holder-in-Due-Course Status)

The more dramatic expansion of \textit{D'Oench} has occurred in the area of its substantive application. \textit{D'Oench} has become a "super" holder-in-due-course statute for the federal government and now effectively precludes the assertion not only of claims or defenses based on lack of consideration, but also claims or defenses based on traditional defenses such as waiver, estoppel, laches, fraud in the inducement, usury, accord and satisfaction, and the like.\textsuperscript{193} Beginning in the early 1970s and culminating with the Supreme Court's 1987 decision in \textit{Langley v. FDIC},\textsuperscript{194} the case law traced three often indistinct paths: (1) cases based solely on \textit{D'Oench};\textsuperscript{195} (2) cases based on section 1823(e);\textsuperscript{196} and (3) cases based on broad notions of federal common law.\textsuperscript{197}

i. \textit{D'Oench} Cases

Cases involving the FSLIC or the FDIC in its receivership capacity were decided under \textit{D'Oench}. In early cases, courts construed the application of \textit{D'Oench} as narrow and equitable, often turning on the culpability of the defendant.\textsuperscript{198} \textit{FDIC v. Meo},\textsuperscript{199} a typical example of early case law, involved Meo and three associates (collectively "Meo") who contracted to purchase 1000 shares of a bank's common stock.\textsuperscript{200} To purchase the stock, Meo executed promissory notes in favor of the bank.\textsuperscript{201} The bank, however, issued and transmitted 1000 shares of voting trust certificates in the name of the purchasers without their knowl-


\textsuperscript{194} 484 U.S. 86 (1987).

\textsuperscript{195} See infra notes 199-232.

\textsuperscript{196} See infra notes 233-77.

\textsuperscript{197} See infra notes 278-320.

\textsuperscript{198} FDIC v. Meo, 505 F.2d 790, 792 (9th Cir. 1974); In re Longhorn Sec. Litig., 573 F. Supp. 278, 281 (W.D. Okla. 1983); FDIC v. Oehlert, 252 N.W.2d 728, 730 (Iowa 1977).

\textsuperscript{199} 505 F.2d 790 (9th Cir. 1974).

\textsuperscript{200} Id. at 791.

\textsuperscript{201} Id.
Unaware of what had transpired, Meo executed a new note to evidence his debt for the balance due for his stock purchase. When the bank became insolvent, the FDIC was appointed receiver and sought to enforce the outstanding note. Meo refused to pay, and the FDIC sued. It was not until after the litigation commenced that Meo learned that the bank did not purchase the common stock for which he contracted.

Claiming that he purchased common stock that he never received, Meo defended his liability on the basis of a lack of consideration. The FDIC, relying on *D'Oench*, argued that Meo was estopped from raising lack of consideration as a defense, presumably because the new promissory note did not refer to the stock. The United States Court of Appeals for the Ninth Circuit stated that *D'Oench* was decided on "very narrow grounds" and was essentially limited to accommodation note makers who entered into secret agreements. The court stated that the necessary predicate to *D'Oench* was a showing that "the maker lent himself to a scheme or arrangement whereby the banking authority... was or was likely to be misled."

The *Meo* court found that *D'Oench* did not apply because the note maker was "wholly innocent" with respect to the bank's wrongful conduct. In doing so, the court relied on Justice Jackson's concurrence in *D'Oench*, which stressed that the *D'Oench* estoppel rule had no application "where ordinary and good-faith transactions are involved." *Meo* is consistent with the clear rationale of *D'Oench:* to prevent collusion.
sive arrangements between borrowers and bank officers.\textsuperscript{213} The distinction between innocent borrowers and those who could be said to be \textit{in pari delicto} with the defalcating bank officers was more clearly delineated in \textit{FDIC v. Oehlert}\.\textsuperscript{214}

In \textit{Oehlert}, bank officers fraudulently assured an accommodation note maker that his note would never be called due.\textsuperscript{215} The borrower executed the note to enable a third party to borrow money from the bank.\textsuperscript{216} When the bank went into receivership, the FDIC sought to enforce the note.\textsuperscript{217} Predictably, the maker defended his liability on the basis of a lack of consideration.\textsuperscript{218} The Supreme Court of Iowa, applying federal law, held that \textit{D'Oench} estopped the maker from asserting lack of consideration as a defense.\textsuperscript{219} The \textit{Oehlert} court expressly held that \textit{D'Oench} applied to situations where the borrower and the bank "perpetuate a fraud on the bank's creditors, depositors and examiners" but not where the bank perpetuates a fraud on the borrower.\textsuperscript{220} The court had little trouble in reconciling the \textit{D'Oench} holding with the facts of \textit{Oehlert} because an "'accommodation maker joins in the perpetuation of a scheme which is essentially deceitful.'"\textsuperscript{221}

The fact that \textit{D'Oench} clearly did not apply to situations where the borrower was defrauded by a bank was confirmed a few years later in \textit{Id.} (footnote omitted).

\textsuperscript{213} \textit{Id.} The Court concluded:

A bona fide borrower, like Meo, is not an insurer of financial representations of the bank with whom he conducts business. We conclude that a bank borrower who was neither a party to any deceptive scheme involving, nor negligent with respect to, circumstances giving rise to the claimed defense to his note is not estopped from asserting such defense against the bank's receiver.

\textit{Id.} (footnote omitted).

\textsuperscript{214} 252 N.W.2d 728 (Iowa 1977).
\textsuperscript{215} \textit{Id.} at 729-30.
\textsuperscript{216} \textit{Id.} at 729.
\textsuperscript{217} \textit{Id.} at 730.
\textsuperscript{218} \textit{Id.}
\textsuperscript{219} \textit{Id.} at 730, 732. The court held:

The essence of the \textit{D'Oench} line of decisions is that when a person joins with a bank in creating paper which is ostensibly valid, he will not be heard to say against depositors, creditors, examiners, FDIC, or receivers that the paper is not valid, notwithstanding absence of consideration, assurances of nonliability, or fraud. The ostensible debtor is in pari delicto by his very act of aiding in misleading others.

\textit{Id.} at 730-31.
\textsuperscript{220} \textit{Id.} at 730. The borrower here was defrauded by the bank because the bank lied about its intention of not calling the note due. \textit{Id.} at 729. That fraud, however, was collateral or tangential to the fraud the borrower intended to commit by signing a phony document. \textit{Id.} at 732. It would probably be more accurate to say that \textit{D'Oench}, at least as it was initially interpreted, was not meant to reach cases where the only defrauded party was the borrower.

\textsuperscript{221} \textit{Id.} at 732 (quoting Rainey v. Jackson, 14 P.2d 1025, 1027 (Cal. Ct. App. 1932)).
In *Longhorn Securities*, the plaintiff investors were induced to purchase interests in certain limited partnerships based on false and misleading representations by the bank's officers. The bank, in part, loaned money to plaintiffs to enable them to purchase the interests. The loans were secured by standby letters of credit and the bank represented to investors that the loans would be paid out of the production income of the partnerships and their letters of credit would be released upon such payment. When the partnership failed, the bank called due the letters of credit. Subsequently, the bank became insolvent and the FDIC was appointed receiver. The investors alleged fraud in the inducement to relieve them of their obligations under the letters.

The FDIC moved to dismiss the plaintiff-investors' complaint based on their contention that, based on the holding in *D'Oench* and as successors to the Bank, they were entitled to the notes. The United States District Court for the Western District of Oklahoma, relying heavily on Justice Jackson's concurrence, held that *D'Oench* did not apply and denied the FDIC's motion to dismiss. The court held that the plaintiffs were the "innocent victims" of a "fraudulent scheme," and therefore could not have been said to have "contributed to a plan to deceive" the FDIC. Moreover, the court noted that plaintiff's fraud claim was based not on a secret agreement, but on a false representation.

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223. *Id.* at 281. These misrepresentations included "the quality and ability of partnership management; the success of previous Longhorn limited partnerships; the availability of producing wells to any partnership not generating sufficient revenue; [and] the creditworthiness of the partnerships." *Id.*
224. *Id.*
225. *Id.*
226. *Id.*
227. *Id.*
228. *Id.*
229. *Id.* at 279.
230. *Id.* at 280-81 (citing *D’Oench, Duhme & Co. v. FDIC*, 315 U.S. 447, 474 (1942) (Jackson, J., concurring), *superseded by statute as stated in Gunter v. Hutcheson*, 674 F.2d 862 (11th Cir.), *cert. denied*, 459 U.S. 826 (1982)). The court noted that:

there are four elements necessary to the assertion of *D’Oench, Duhme* estoppel:

1. the FDIC must be the party against whom the claim or defense is asserted,
2. the party asserting the claim or defense must have lent himself
3. to a secret agreement
4. that deceived or would tend to deceive the FDIC.

*Id.*
231. *Id.* at 281. The court drew a comparison between *Longhorn Securities* and *FDIC v. Meo*, 505 F.2d 790 (9th Cir. 1974), asserting that like Meo, the plaintiff investor was free of any wrongdoing and could not be estopped from arguing the lack of consideration against the FDIC. *Longhorn Securities*, 573 F. Supp. at 282.
ii. The § 1823(e) Cases

Courts in the mid-1970s and early 1980s applied *D'Oench* as part of the nebulous body of "federal common law" and limited its application to cases where the borrower could validly have been said to have participated in a fraudulent scheme. Subsequent courts, however, deciding cases under the statutory codification of *D'Oench*, section 1823(e), took a more expansive route. The cases construed section 1823(e) as a strict liability statute that applied not only to independent side agreements (for example, an agreement not to call a note due), but also to oral terms not contained in written agreements.

In *Dasco, Inc. v. American City Bank & Trust Co., N.A.*, the bank contacted plaintiffs, expressing a desire to have plaintiffs develop certain real property for commercial and residential use. The bank induced plaintiffs to purchase the property and to secure their obligations by executing a promissory note in the amount of $1.45 million, backed additionally by plaintiff's personal guarantees. The parties entered into an oral agreement that stated that, in the event the property could not be developed by a certain date, plaintiffs could merely deed the property back to the bank, which would then cancel the notes and guarantees. Unable to develop the property pursuant to the parties' agreed schedule, plaintiffs met with bank officers who informed them that the note and guarantees were cancelled. However, plaintiffs acquiesced to the bank's

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233. An example of the application of "federal common law" in this area is shown in *Gunter v. Hutcheson*, 674 F.2d 862 (11th Cir.), cert. denied, 459 U.S. 826 (1982), and *United States v. Kimbell Foods, Inc.*, 440 U.S. 715 (1979). For a discussion of these decisions, see infra notes 278-319.

234. *D'Oench*, 315 U.S. at 474. *D'Oench* could not be construed as a strict liability rule because it is grounded on a policy of preventing arrangements that tend to deceive the FDIC in its evaluation of the financial worth of an institution it takes over. Thus, to the extent that the FDIC may have prior knowledge as to the existence of an oral agreement (which might defeat or diminish its interest in an asset), *D'Oench* logically should not apply (a position later cases do not take, however). Section 1823, however, makes no mention of the FDIC's knowledge regarding the existence of such an agreement. The statute, rather mechanically, merely turns on whether or not the agreement was recorded as an official record of the bank. Thus, courts have consistently held that the FDIC's knowledge under the statute is irrelevant. See, e.g., *Federal Deposit Ins. Co. v. First Mortgage Investors*, 485 F. Supp. 445, 451 (E.D. Wis. 1980).


237. *Id.* at 768.

238. *Id.*

239. *Id.* The oral agreement was not reduced to writing. *Id.*

240. *Id.*
request that title to the property remain in their names until the property could be developed.\textsuperscript{241}

The bank became insolvent,\textsuperscript{242} and when the FDIC assumed control, it promptly refused to recognize the cancellation of the debt instruments.\textsuperscript{243} Plaintiffs brought suit in federal district court to resolve the issue of the enforceability of their oral agreement.\textsuperscript{244} The United States District Court for the District of Nevada, relying on section 1823(e), held that the oral agreement was unenforceable, thereby obligating the plaintiffs to indemnify the bank for the $1.45 million in promissory notes and personal guarantees.\textsuperscript{245} Unlike an accommodation note maker, the plaintiff-borrowers in \textit{Dasco} did not even arguably lend themselves to a deceptive scheme.\textsuperscript{246} The court, however, read section 1823(e) as a strict liability statute, which allowed the FDIC to ignore any oral agreement that tended to diminish or defeat its right or interest in an acquired asset.\textsuperscript{247}

Similarly, in \textit{FDIC v. Vogel},\textsuperscript{248} defendants Vogel and Spitz executed written guarantees in consideration of an oral promise by the bank to loan the guarantors $2 million.\textsuperscript{249} The loan was never funded,\textsuperscript{250} and when the underlying obligation went into default, the FDIC sought recovery under the guarantees.\textsuperscript{251} Defendants alleged as a defense and set-off that their guarantees were attained in return for a promise by the bank for the $2 million loan, and since the loan was never funded, the guarantors lacked consideration.\textsuperscript{252} Since the loan was not in writing and its enforcement would have had the effect of diminishing the FDIC's interest

\begin{itemize}
\item \textsuperscript{241} \textit{Id.} at 768-69. The bank stated that no liability would accrue to plaintiffs with respect to the note. \textit{Id.} at 769.
\item \textsuperscript{242} \textit{Id.}
\item \textsuperscript{243} \textit{Id.} The FDIC “refuse[d] to accept a deed to the real property and to effect cancellation of the documents as per the aforementioned oral agreement, and demand[ed] payment of the principal plus interest from the plaintiffs.” \textit{Id.}
\item \textsuperscript{244} \textit{Id.}
\item \textsuperscript{245} \textit{Id.} at 770.
\item \textsuperscript{246} \textit{Id.} at 769. It could be argued that by allowing themselves to remain as record title holders, the plaintiffs participated in a deceptive scheme. However, that fact appears to be superfluous to the court's holding. \textit{Id.}
\item \textsuperscript{247} \textit{Id.} at 770. The court concluded:

\begin{itemize}
\item 12 U.S.C. \textsection 1823(e) and the case law decided thereunder allow the FDIC in its corporate capacity to ignore oral agreements which tend to diminish or defeat its right, title or interest in any asset acquired by it in a purchase and assumption agreement. This law is based not on a theory of holder in due course status but, rather, on a federal public policy protecting the institution of banking.
\end{itemize}
\item \textsuperscript{248} \textit{Id.}
\item \textsuperscript{249} \textit{Id.} at 661.
\item \textsuperscript{250} \textit{Id.}
\item \textsuperscript{251} \textit{Id.} at 662.
\item \textsuperscript{252} \textit{Id.}
\end{itemize}
in the guarantees, the district court found as a matter of law that defendants’ lack of consideration defense was barred by section 1823(e).\textsuperscript{253}

Like Dasco, Vogel did not involve an accommodation note maker or any deceptive scheme. Vogel, however, went further than Dasco. While Dasco merely invalidated an oral condition to an agreement, Vogel invalidated an entire agreement that would have negated the formation of a contract, the creation of the guarantees.

Arguably, both cases were properly decided under a literal reading of section 1823(e). One issue not decided by either case, however, was the status of a fraud in the inducement defense. The statute clearly does not confer holder-in-due-course (HDC) status on the FDIC.\textsuperscript{254} If the FDIC were a HDC under section 1823(e), then the borrower could not assert

\begin{quote}
253. \textit{Id.} at 663-64. The court, citing Dasco, held that section 1823 “allows the FDIC, when it has purchased assets in its corporate capacity, to disregard oral agreements which would diminish or defeat its interest in any asset so purchased.” \textit{Id.} at 663. The court similarly disregarded the plaintiffs’ assertion that section 1823 acts as a statute of frauds to support detrimental reliance, stating that “[t]o judicially engraft an exception based on partial performance of an oral contract with the closed bank or detrimental reliance on an oral promise made by the closed bank is simply to ignore the clear phrasing of the statute.” \textit{Id.}

254. The FDIC would not qualify for holder in due course status under the Uniform Commercial Code. Section 3-302(3) of the Code provides that a purchaser for value is not a holder in due course if he becomes a holder of an instrument “(a) by purchase of it at judicial sale or by taking it under legal process; or (b) by acquiring it in taking over an estate; or (c) by purchasing it as part of a bulk transaction not in regular course of business of the transferor.” U.C.C. § 3-302(3) (1990). When the FDIC is appointed receiver and takes over a bank, its acquisition of the bank’s commercial paper is part of a bulk transaction not in the ordinary course of business. See FDIC v. Galloway, 613 F. Supp. 1392, 1397 (D. Kan. 1985) (“[T]he transfer of financial instruments to the FDIC . . . is not ‘in the ordinary course of business.’ Thus . . . [the] FDIC would still not be a holder in due course under [state] law.” (quoting Gunter v. Hutcheson, 674 F.2d 862, 872 (11th Cir.), cert. denied, 459 U.S. 826 (1982)), rev’d, 856 F.2d 112 (10th Cir. 1988); FDIC v. Webb, 464 F. Supp. 520, 524 (E.D. Tenn. 1978). Additionally, the FDIC is not a “holder” because a “holder” acquires an instrument through “negotiation” by indorsement, a method of acquisition not used by the FDIC in its typical purchase and assumption transaction. Fred H. Miller & Scott A. Meacham, \textit{The FDIC and Other Financial Institution Insurance Agencies as “Super” Holders in Due Course: A Lesson in Self-Pollinated Jurisprudence}, 40 OKLA. L. REV. 621, 623 (1987); John C. Platt & Ricki S. Darby, \textit{A Primer on the Special Rights and Immunities of the Federal Deposit Insurance Corporation}, 11 OKLA. CITY U. L. REV. 683, 711 (1986). That the FDIC would ordinarily not be considered a holder in due course makes sense given that a successor in interest assumes all the rights and, more importantly, all the liabilities of the predecessor. \textit{See} Third Nat’l Bank v. Hardi-Gardens Supply, Inc., 380 F. Supp. 930, 939 (M.D. Tenn. 1974) (stating that “[a] purchaser with notice of such limitations may be a holder in due course, but he takes the instrument subject to the limitation”); Pugatch v. David’s Jewelers, 278 N.Y.S.2d 759, 764 (N.Y. Civ. Ct. 1967) (stating that “the transferee acquires no more protected interest than the transferor had”).
\end{quote}
fraud in the inducement as a defense to his obligations under the instrument. 255

Earlier cases decided under section 1823(e) preserved the borrower's defense of fraud in the inducement. 256 *FDIC v. Webb* 257 is illustrative. In *Webb*, defendant borrowers executed several notes in blank to secure their purchase of stock. 258 The notes were held by the bank and defendants alleged that they were induced to borrow money from the bank and execute the notes as security based on fraudulent representations by the bank's directors regarding the solvency of the corporation whose stock was being purchased. 259 It was also defendant's understanding that the bank would later add terms to the blank notes making the notes renewable for a ten-year period at four and one-half percent interest. 260 The bank did not execute the notes in a manner consistent with the borrowers' oral authorization, and after the notes became due and the FDIC was appointed receiver for the bank, the FDIC sought to enforce the notes. 261

Defendants alleged a number of affirmative defenses to their obligations. 262 Defendants asserted that based on their oral understanding, the notes were not in default because they were renewable. 263 The United States District Court for the Eastern District of Tennessee rejected this argument based on section 1823(e) because the transaction was premised on an unrecorded oral agreement that clearly defeated the FDIC's interest in the assets it acquired. 264 Significantly, the court held that since the FDIC was not a HDC, to the extent defendants could prove a defense based on fraudulent inducement such as misrepresentations regarding the corporation's solvency, the defense could be asserted against the FDIC to defeat the FDIC's interest in the notes. 265

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255. A HDC is only subject to real defenses such as incompetency, fraud in the factum, illegality, and the like, but not to such personal defenses such as fraud in the inducement. *See* U.C.C. § 3-305 (1990).

256. It should be noted that some courts recognized that a fraud in the inducement defense potentially presents an exception to section 1823(e). *See* FDIC v. Lattimore Land Corp., 656 F.2d 139, 146 (5th Cir. 1981) (finding a fraud in the inducement defense invalid under Georgia law).


258. *Id.* at 523.

259. *Id.* at 524.

260. *Id.* at 523.

261. *Id.*

262. *Id.* at 523-24.

263. *Id.* at 523.

264. *Id.* at 524. The court rejected the defendant's offer of written evidence under section 1823(e) because "[t]he statement does not provide the specific terms of Mr. Webb's loan nor was it executed by the bank and Mr. Webb at the time of the loan." *Id.* at 523.

265. *Id.*
On its face, the court's holding would appear to be contradictory inasmuch as the oral agreement to fill in the terms of the notes arguably could have also been the basis for a fraud in the inducement defense, i.e., promissory fraud. Since the procedural posture of the case involved a summary judgment motion, a promissory fraud theory arguably presented a material issue of fact. The court presumably made a distinction, adopted by later courts, between promissory and nonpromissory misrepresentations. While the former falls within the scope of section 1823(e), the latter falls outside the purview of the statute. The distinction makes at least limited sense in that promissory fraud would present a convenient way to avoid section 1823(e). The borrower could always allege that he was fraudulently induced to execute the note because of promises made by the bank that it never intended to keep. Where the misrepresentation does not imply a mutual agreement, however, section 1823(e) on its face clearly does not apply, assuming, of course, that Congress did not intend to confer HDC status on the FDIC by virtue of the statute.

Other federal courts, however, concluded that Congress did intend to confer HDC status of the FDIC under section 1823(e). The same year Webb was decided, the United States District Court for the Eastern District of Wisconsin in FDIC v. Rockelman, held that the statute operates...
ated to grant the FDIC the benefits of HDC status that it would otherwise lack. The court’s conclusion was not based on any statutory authority, case law, or legislative history. The court also held that a fraud in the inducement theory was not valid against the FDIC, although it technically had no status as an HDC. The fraud theory in Rockelman was not premised on an alleged oral agreement, but rather on representations made to the plaintiff with regard to the value of the corporate stock purchased.

Two years later, the United States Court of Appeals for the Sixth Circuit in FDIC v. Lauterbach affirmed a district court’s grant of summary judgment in favor of the FDIC in response to a challenge by defendants based on a fraud in the inducement theory. The Sixth Circuit held that section 1823(e) “clothed the FDIC . . . with the same protection from the defense of fraud in the inducement accorded a holder in due course of a negotiable instrument.”

iii. Gunter v. Hutcheson

By the early 1980s, the scope and breadth of D’Oench and section 1823(e) was somewhat muddled. The cases interpreting section 1823(e) seemingly loosened D’Oench from its equitable moorings by premising liability on a mechanistic view of the statute. Moreover, the section 1823(e) cases, or at least the trend of those cases, created a super HDC status in the FDIC in the absence of statutory authority or legislative history.

The discharge of the debt from the original stock purchase. Id. at 1001. When the bank failed and the FDIC as receiver sought to enforce the note, defendant alleged fraud in the original purchase based on failure of consideration and failure to disclose material information. Id.

272. The court observed:

[A]lthough the FDIC, in its corporate capacity, is not a holder in due course within the meaning of that term under the Uniform Commercial Code, Congress intended by means of section 1823 to clothe the Corporation with the protections afforded a holder in due course and shield the Corporation against many defenses that would otherwise be available.

Id. at 1003.

273. Id.

274. Id. at 1000.

275. 626 F.2d 1327 (7th Cir. 1980).

276. Id. at 1338.

277. Id. at 1330 (footnote omitted); see also FDIC v. Rosenthal, 477 F. Supp. 1223, 1226 (E.D. Wis. 1979), aff’d mem., 631 F.2d 733 (7th Cir. 1980); FDIC v. Balistreri, 470 F. Supp. 752, 756 (E.D. Wis. 1979) (holding that only defenses involving fraud in the factum are available against the FDIC in its corporate capacity); FDIC v. Hanrahan, No. 76-C-594 (E.D. Wis. Jan. 8, 1979) (denying application to intervene as of right because not timely made under the Federal Rules), aff’d, 612 F.2d 1051 (7th Cir. 1980); FDIC v. James T. Barry Co., 453 F. Supp. 81, 83 (E.D. Wis. 1978) (holding the FDIC to be insulated from any claims that defendant had against the bank).
In 1982, these two lines of case law spawned a third, with the United States Court of Appeals for the Eleventh Circuit’s opinion in *Gunter v. Hutcheson*.

In December 1974, the Gunters purchased the majority of the outstanding common stock of a bank for $5.5 million, securing their obligation by signing two promissory notes. The Bank induced them to purchase the stock by fraudulent representations of the bank’s officers concerning future actions of the bank and the bank’s financial condition. Two months later, the FDIC declared the bank insolvent and was appointed receiver. The Gunters sued the bank’s former officers and directors for fraud, seeking to rescind the promissory notes now held by the FDIC. The FDIC, in turn, counter-claimed for payment under the notes.

The FDIC moved for summary judgment, arguing that the Gunters’ claims were barred by both section 1823 and federal common law. The Eleventh Circuit affirmed the district court and granted the summary judgment motion. However, the court of appeals did not find that the FDIC was protected by either section 1823 or the federal common law of *D’Oench*.

The court first considered the Gunters’ claims in light of section 1823(e). Although certain alleged misrepresentations such as a promise by the bank to defer interest payments on the notes were based upon agreements between the parties, other alleged misrepresentations such as representations concerning the financial condition of the bank could not arguably have been claimed to be “agreements.” The court implicitly distinguished between promissory representations and non-promissory representations, with the latter falling outside the scope of section 1823(e). The court adopted a rather strict interpretation of “agreement” under the statute, and contrasted it with a claim of fraudulent in-

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278. 674 F.2d 862 (11th Cir.), cert. denied, 459 U.S. 826 (1982).
279. *Id.* at 866.
280. *Id.*
281. *Id.*
282. *Id.*
283. *Id.*
284. *Id.*
285. *Id.* at 877.
286. *Id.* at 871-73.
287. *Id.* at 866-67.
288. *Id.* at 867.
289. *Id.*
ducement, which negates the existence of an agreement. For this reason, the court concluded that section 1823(e) did not apply.

Instead of relying on section 1823(e) or \textit{D'Oench}, the \textit{Gunter} court relied on broad principles of federal common law to fashion a rule that protected the FDIC from ordinary fraud claims. The court placed heavy emphasis upon the Supreme Court's decision in \textit{United States v. Kimbell Foods, Inc.} \textit{Kimbell}, which was not decided under \textit{D'Oench}, held that to determine when and how to fashion an applicable rule of federal common law, a court must engage in a two-step process. First, the court must decide whether federal law is at all applicable. Second, the court then must fashion the contours of a uniform rule of federal common law by balancing three factors: "[w]hether the federal program was one which by its nature required nationwide uniformity, whether adopting the state law would frustrate the specific objectives of the federal program, and whether applying a federal rule would disrupt commercial relations predicated on state law." In \textit{Gunter}, the first part of the analysis—determining whether federal law applies—was simple: In \textit{D'Oench}, the Supreme Court created a federal common law rule to administer the national banking system. Thus, federal law governed. Next, the issue for the court was whether a new uniform rule should be created. The court concluded that uni-

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290. \textit{See id.} The court's reasoning, essentially holding that only non-promissory representations are outside the scope of the statute, is under-inclusive. Presumably, the court reached this holding because the non-promissory misrepresentations would have undermined the formation of the contract. However, promissory misrepresentation may be the basis of a just contract formation defense as easily as a non-promissory misrepresentation. The only difference between the two is the standard of proof required for making out a prima facie case.

291. \textit{Gunter}, 674 F.2d at 867.
292. \textit{Id.} at 871-73.
294. \textit{Id.} at 726-29.
295. \textit{Id.} at 726. The Court noted that "[w]hen Government activities 'arise' from and [bear] heavily upon a federal ... program,' the Constitution and Acts of Congress 'require' otherwise than state law govern of its own force. ' " \textit{Id.} at 726-27 (quoting \textit{United States v. Little Lake Misere Land Co.}, 412 U.S. 580, 592-93 (1973) (alterations in original)).
296. \textit{Gunter}, 674 F.2d at 868. "Whether to adopt state law or to fashion a nationwide federal rule is a matter of judicial policy 'dependent upon a variety of considerations always relevant to the nature of the specific governmental interests and to the effects upon them of applying state law.' " \textit{Kimbell Foods}, 440 U.S. at 728 (quoting \textit{United States v. Standard Oil Co.}, 332 U.S. 301, 310 (1947)).
297. \textit{Gunter}, 674 F.2d at 869.
298. \textit{Id.} The court's holding was derived from the fact that "the FDIC operates under authority derived from a specific statutory scheme passed by Congress in exercise of a 'constitutional function of power' to protect and stabilize the banking industry." \textit{Id.}
299. \textit{Id.}
formity was necessary based on the factors outlined in *Kimbell*. The court reasoned that because of the nature of the FDIC, a uniform rule was required because of the FDIC's prevalence in insuring banks throughout the nation and because of the necessity of the FDIC to make overnight decisions when dealing with failed banks. The court concluded that in the absence of a nonliability rule for fraud, the FDIC's statutory mandate would be frustrated. The *Gunter* court felt that to allow a borrower to allege fraud in the inducement, even where based on a nonpromissory representation, and to escape liability would provide a back door to avoid the strictures of section 1823(e).

The *Gunter* court concluded by fashioning the following rule:

Accordingly, we hold that as a matter of federal common law, the FDIC has a complete defense to state and common law fraud claims on a note acquired by the FDIC in the execution of a purchase and assumption transaction, for value, in good faith, and without actual knowledge of the fraud at the time the FDIC entered into the purchase and assumption agreement.

*Gunter* essentially created super-HDC status for the FDIC. Unlike *Rockelman*, *Gunter* did not rely on legal sophistry by holding that Congress intended to confer HDC status on the FDIC in section 1823(e). Rather, the *Gunter* court perceived its holding as merely a logical extension of *D’Oench*. Presumably, the rationale for *Gunter*'s rule was to

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300. Id.
301. Id. The court felt that:
   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 bank failure.

Id.
302. Id. at 869-70. The court observed that “[i]f the FDIC’s right to collect on returned assets, however, were subject to fraud claims of which the FDIC lacked knowledge, estimating its potential loss from a purchase would be impossible.” Id. at 870.
303. Id. The court noted:
   [I]f an obligor could assert that the failure of a bank to perform certain promises constituted fraud and grounds for rescission, the obligor would successfully thwart the “no agreement” protection of § 1823(e) “by asserting as fraudulent the same unwritten agreement of which a breach . . . may not under § 1823(e) be asserted against the FDIC.”

Id. at 871-72 (quoting FDIC v. Lattimore Land Co., 656 F.2d 139, 146 n.13 (5th Cir. 1981) (omission in original)).
304. Id. at 873.
305. Id. at 872 n.14. The court observed that *D’Oench* and Deitrick v. Greaney, 309 U.S. 190 (1940), “chronicle a broadening protection for the FDIC founded on federal poli-
facilitate purchase and assumption transactions\(^3\) by the FDIC by allowing it to rely on the face value of the commercial paper of the institution.\(^7\)

Post-*Gunter* case law confirms that courts generally interpret *Gunter* as creating HDC status for the FDIC.\(^8\) In *FDIC v. Galloway*,\(^9\) bank officers induced the defendant to execute a guarantee by misrepresenting the creditworthiness of the original obligor.\(^10\) When the FDIC assumed control, it sought to enforce the guarantees.\(^11\) The *Galloway* court noted that the FDIC was a HDC by virtue of federal common law developed in cases such as *Gunter*.\(^12\) However, the court's interpretation of the

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\(^3\) See *Gunter*, 674 F.2d at 869-70. As an insurer of a bank, the FDIC's primary duty upon failure of a bank is to pay bank depositors up to the insured amount. There are two ways the FDIC may go about this. First, it may liquidate the assets of the bank, paying amounts recouped to depositors, and making up any shortfall from its insurance fund. The major disadvantage with this, of course, is that the significant disruption in the bank's activity is not the best way of promoting public confidence in the banking system. No one likes to see a bank close its doors. A second and preferred method employed by the FDIC is a "purchase and assumption" transaction, whereby the FDIC attempts to arrange for another bank to purchase the failed bank and to reopen it without any interruption in its operations. In purchase and assumption transactions the FDIC typically wears two hats: it is appointed receiver for the failed institution and the receiver assigns to the FDIC (in its corporate capacity) the assets of the institution, with the corporation working out the purchase and assumption transaction with another bank. For a good discussion regarding the mechanics and utility of purchase and assumption transactions, see Kevin J. Foley, Note, Federal Deposit Insurance Corporation v. Wood: The FDIC, The Failed Bank, and the Seemingly Insurmountable Presumption, 17 U. Tol. L. Rev. 693, 696-98 (1986); Platt & Darby, supra note 254, at 686-92.

\(^7\) *Gunter*, 674 F.2d at 870. The *Gunter* court noted:

> [T]he FDIC must have some method to evaluate its potential liability in a purchase and assumption versus its potential liability from a liquidation. Because of the time constraints involved, 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.

*Id.*

\(^8\) *Gunter* did not strictly hold that the rule it created was synonymous with HDC status. One subsequently decided case cited *Gunter* as expressly holding that under federal common law the FDIC is a HDC. *FDIC v. Wood*, 758 F.2d 156, 161 (6th Cir.), *cert. denied*, 474 U.S. 944 (1985). The United States Court of Appeals for the Sixth Circuit held in *Wood* that when the FDIC (in its corporate capacity) acquires assets as part of a purchase and assumption transaction, it takes all the commercial paper as a HDC. *Id.* Accordingly, the FDIC was immune from a usury defense and also had no duty to investigate, privileges normally accorded to HDCs. *Id.* at 161-62.


\(^10\) *Id.* at 1396-97.

\(^11\) *Id.* at 1396.

\(^12\) *Id.* at 1397. Moreover, section 1823(e) and *D'Oench* arguably did not apply since the guarantors obligation was not premised on an "agreement." *Id.* at 1403.
Gunter line of authority was narrow. The court, in essence, construed the new federal common law rule to confer on the FDIC rights no greater than a HDC.\textsuperscript{313} Thus, since HDC status only attaches to holders of negotiable instruments and a guarantee is not a negotiable instrument,\textsuperscript{314} the FDIC was subject to the guarantors' fraud in the inducement defense.\textsuperscript{315}

Of course, the reasoning of Gunter was broad enough to confer on the FDIC a status greater than that of an ordinary HDC. Gunter was based on a new rule created under the Kimbell analysis, with an eye toward facilitating FDIC purchase and assumption transactions.\textsuperscript{316} Because the FDIC upon assumption of a bank inherits much more than negotiable instruments, which it may attempt to sell in bulk to an acquiring bank, to be consistent with Gunter a court should confer HDC status, or "super" HDC status, on the FDIC for all assets it receives. Some courts have followed this rationale to confer such broad power on the FDIC.\textsuperscript{317} Similar to Gunter itself, the post-Gunter cases all arose in a context in which section 1823(e)—which in many respects evinces a much broader policy than D'Oench—was potentially applicable.\textsuperscript{318} By 1986, the case law ex-

\textsuperscript{313} Id. at 1401-02. The court analyzed the Supreme Court's holding in Kimbell Foods and the United States Court of Appeals for the Eleventh Circuit's decision in FDIC v. Gulf Life Ins. Co., 737 F.2d 1513 (11th Cir. 1984), to determine the FDIC's rights against non-negotiable instruments. Galloway, 613 F. Supp. at 1401. While Gulf Life held that the FDIC could obtain holder in due course status for non-negotiable instruments, Gulf Life, 737 F.2d at 1517-18, the Galloway court felt that such an extension "underestimated the extent to which its results dashes the [holder of the non-negotiable instrument]'s commercial expectation." Galloway, 613 F. Supp. at 1402. The Galloway court suggested an alternative view, "separat[ing] a failed bank's financial instruments into negotiable and non-negotiable instruments." Id.

\textsuperscript{314} Generally, guarantees are not negotiable instruments since they do not contain an unconditional promise or order to pay a sum certain in money. See U.C.C. § 3-104(a) (1990).

\textsuperscript{315} Galloway, 613 F. Supp. at 1402. The court held that "[w]here non-negotiable instruments are obtained by the FDIC, then, we would 'decline to override intricate state laws of general applicability on which private creditors base their daily transactions.' " Id. (quoting United States v. Kimbell Foods, Inc., 440 U.S. 715, 729 (1979)).

\textsuperscript{316} Gunter v. Hutcheson, 674 F.2d 862, 868-70 (11th Cir.), cert. denied, 459 U.S. 826 (1982).

\textsuperscript{317} In Federal Sav. & Loan Ins. Corp. v. Gulf Life Ins. Co., 737 F.2d 1513 (11th Cir. 1984), the United States Court of Appeals for the Eleventh Circuit held that the federal common law rule created in Gunter extended to non-negotiable instruments, such as insurance policies. Id. at 1517.

panded to such an extent that *D'Oench* itself was perceived as creating HDC status.\(^{319}\)

The case law in the lower courts from 1942 to 1986 can be viewed as a continuous expansion of *D'Oench* from a prophylactic rule based on illegality to one based on public policy. Specifically, the focus of the rule has shifted from the "deceptive scheme" to ways of facilitating bank takeovers.\(^{320}\) The United States Supreme Court did not revisit *D'Oench* again until 1987.

c. **Langley v. FDIC\(^{321}\)**

The Langleys borrowed money from the bank in order to purchase certain real property owned by the bank.\(^{322}\) The Langleys' purchase was secured by a note, collateral mortgage, and personal guarantees.\(^{323}\) The bank made material misrepresentations to the Langleys concerning the acreage, mineral deposits, and encumbrances on the land.\(^{324}\) No reference to the alleged misrepresentations, however, appeared on any of the transaction documents.\(^{325}\) When the Langleys defaulted on their note and the bank sued,\(^{326}\) the Langleys defended on the grounds of fraud in the inducement.\(^{327}\) Unfortunately, while the suit was still pending, the bank became insolvent, and the FDIC was appointed receiver and became plaintiff in the suit.\(^{328}\) The district court granted summary judg-

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\(^{319}\) In Federal Sav. & Loan Ins. Corp. v. Hsi, 657 F. Supp. 1333 (E.D. La. 1986), section 1823(e) by its express terms was inapplicable because the FSLIC, and not the FDIC, was a party to the suit. *Id.* at 1338. In *Hsi*, defendants alleged that the S&L induced them to execute promissory notes by failing to disclose certain details concerning the weak financial condition of the company whose securities were purchased. *Id.* at 1335. The FSLIC subsequently took over the S&L and sought to enforce the notes, arguing that it was a HDC or, alternatively, that it was protected from such defenses under *D'Oench*. *Id.* The *Hsi* court held that under normal common law principles of commercial law the FSLIC was not a HDC because of its bulk acquisition. *Id.* at 1336-37. However, under *D'Oench* and based on the principles of section 1823 (which the court interpreted as codifying *D'Oench*), the court in essence conferred super HDC on the FSLIC by holding that it was immune to a fraud in the inducement defense. *Id.* at 1338.

\(^{320}\) See supra notes 193-319 and accompanying text.


\(^{322}\) *Id.* at 88.

\(^{323}\) *Id.*

\(^{324}\) *Id.* at 89.

\(^{325}\) *Id.*

\(^{326}\) *Id.* at 88.

\(^{327}\) *Id.* at 88-90.

\(^{328}\) *Id.* at 89.
ment in favor of the FDIC,\textsuperscript{329} and the United States Court of Appeals for the Fifth Circuit affirmed the lower court's judgment.\textsuperscript{330}

Before the Supreme Court, the Langleys argued that the lower court erred in concluding that their defense was barred under section 1823(e).\textsuperscript{331} They argued that since no "agreement" existed, section 1823(e) did not apply.\textsuperscript{332} The Court confronted the narrow issue of the interpretation of the word "agreement" contained in section 1823(e).\textsuperscript{333} Justice Scalia, writing for a unanimous Court, chose the most narrow fashion to decide the issue.\textsuperscript{334} The Court's opinion did not enunciate any rule of federal common law, nor did it examine the legislative history to interpret the statute.\textsuperscript{335} Instead, in line with Justice Scalia's judicial philosophy, the Court's opinion concentrated exclusively on the plain meaning of the words in section 1823(e) to resolve the issue.\textsuperscript{336} Justice Scalia's statutory interpretation was facile. Citing contract treatises, he noted that the word "agreement," in the normal contract sense, encompasses not only promises but conditions, and warranties regarding land are considered conditions to performance.\textsuperscript{337} Thus, "agreement" as used in section 1823(e) encompasses not only unrecorded promises but also unrecorded representations and warranties.\textsuperscript{338} Section 1823(e) therefore barred the Langleys' fraud in the inducement defense.\textsuperscript{339}

Justice Scalia's argument, of course, is syllogistic. Whether a term of an agreement, either a promise or condition,\textsuperscript{340} constitutes the agreement is a secondary question because it presupposes that an agreement in fact exists. The threshold question is whether there was an agreement in the

\begin{itemize}
\item \textsuperscript{330} FDIC v. Langley, 792 F.2d 541 (5th Cir.), aff'd, 484 U.S. 86 (1986).
\item \textsuperscript{331} Langley, 484 U.S. at 90.
\item \textsuperscript{332} Id.
\item \textsuperscript{333} Id.
\item \textsuperscript{334} See generally id. at 91-95.
\item \textsuperscript{335} Id.
\item \textsuperscript{336} Id. at 91. Justice Scalia noted that "[i]t seems to us that this common meaning of the word 'agreement' must be assigned to its usage in § 1823(e) if that section is to fulfill its intended purposes." Id.
\item \textsuperscript{337} Id.
\item \textsuperscript{338} Id.
\item \textsuperscript{339} Id. at 93.
\item \textsuperscript{340} Moreover, the condition of which Justice Scalia speaks is not considered a "true" or express condition of the contract. At most, the truth of a warranty is a constructive condition precedent (imposed by the court) to performance. See Calamari & Perillo, supra note 82, § 11-8, at 444-45; Farnsworth, supra note 82, § 8.9, at 576-82. Constructive conditions are more legal fiction than the subject matter of an actual agreement.
\end{itemize}
first place. If A and B agree that A will convey 100 acres to B, it is indisputable that 100 acres is part of the agreement since there is a mutuality of intention. If, however, A lies and tells B that he is conveying 100 acres which B readily accepts, but in fact only conveys 50 acres, it is difficult to see how the parties mutually "agreed" to the conveyance of 100 acres when A had no such intention.

In reaching his conclusion that section 1823(e) applied to representations as well as promises, Justice Scalia curiously relied on D'Oench. Justice Scalia believed that, if a condition in a note is unrecorded, it renders the note or part of the note a "secret agreement" (in the D'Oench sense of the term), and the borrower, by executing the note, is lending himself to a "scheme," whereby a banking authority might be misled. Justice Scalia's reasoning, like most of the post D'Oench jurisprudence, latches onto the language of D'Oench like a talisman, ignoring the actual facts of D'Oench. D'Oench involved an actual agreement between a bank officer and borrower that by its very nature was deceptive. In that case, the borrower knowingly agreed to sign a piece of paper in the form of an accommodation note that he knew did not mean what it said, as it was not intended to constitute a valid obligation. This is a far cry from the situation where a borrower is induced to sign a note based on a material misrepresentation concerning value.

341. Analytically, the question of contract formation and contract interpretation are separate issues, with the former preceding the latter. Contract formation is based on an offer, an acceptance and the recitation of valid mutual considerations (at least for bilateral contracts). In the absence of any of these requirements—which are based on the notion of mutual assent—no contract ordinarily exists. If there is no contract it obviously follows that one cannot reach the issue with regard to the terms of the contract (i.e., the promises and conditions).

342. See supra note 341.
343. See supra note 341.
345. Id. at 92-93. Justice Scalia concluded:

We can safely assume that Congress did not mean "agreement" in § 1823(e) to be interpreted so much more narrowly than its permissible meaning as to disserve the principle of [D'Oench] applying that term to FDIC-acquired notes. Certainly, one who signs a facially unqualified note subject to an unwritten and unrecorded condition upon its repayment has lent himself to a scheme or arrangement that is likely to mislead the banking authorities, whether the condition consists of performance of a counterpromise (as in D'Oench, Duhme) or of the truthfulness of a warranted fact.

346. Id. at 92.
348. Id.
Langley served to unshackle the more recent D’Oench authority from the constraints of a more common sense interpretation of section 1823(e) and from the constraints of the Gunter-created HDC analogy. Since section 1823(e) seemingly applies to any unrecorded statement tending to defeat or diminish the FDIC’s interest in any asset it acquires, the distinction between promises and misrepresentations is meaningless. Thus, any representation, so long as it is unrecorded as an official record of the institution, is a nullity.

Moreover, given the breadth of this interpretation of section 1823(e), the Gunter rule is superfluous. That is, Gunter and its progeny created a rule of federal common law because of a perceived void in section 1823(e): its inapplicability to non-promissory representations. Because of the Langley decision, it is unnecessary to resort to the new federal common law rule; the statute will do the trick. The federal common law rule, which sought to carve out a new HDC status for the FDIC, therefore becomes superfluous and under-inclusive. Because the HDC analogy may no longer be drawn and section 1823(e) on its face applies to any “asset” acquired by the FDIC, the distinction between negotiable and non-negotiable instruments becomes irrelevant. In effect, Langley produced a more expansive application of D’Oench.

d. Post-Langley Case Law

The case law since Langley continues the expansion of D’Oench. The FDIC and the FSLIC are now clothed in impenetrable armor shielding it from defenses not only based on lack of consideration and fraud in the inducement (promissory and non-promissory), but also estoppel, waiver, usury, and the like. The penumbra of D’Oench and its progeny encompasses negotiable and non-negotiable instruments. D’Oench applies in a context where there is no arguable agreement: in the context of an intentional misrepresentation. D’Oench bars not only defenses to obligations, but also affirmative claims: “The [D’Oench] doctrine has been expanded to encompass any claim against an insolvent institution that

349. Langley, 484 U.S. at 92-93.
350. Id. at 91-92. The court felt the rationale for such a requirement was “to allow federal and state bank examiners to rely on a bank’s records in evaluating the worth of the bank’s assets.” Id. at 91.
351. See supra notes 267-70 and accompanying text.
352. Langley, 484 U.S. at 95. The Court noted that “[t]he short of the matter is that Congress opted for the certainty of the requirements set forth in § 1823(e). An agreement that meets them prevails even if the FDIC did not know of it; and an agreement that does not meet them fails even if the FDIC knew.” Id.
353. See supra note 193.
354. See supra note 317 and accompanying text.
would either diminish the value of the assets held by the FSLIC [or FDIC] or increase the liabilities of the insolvent institution.

Courts routinely cite *D’Oench* and section 1823(e) in affirming judgments in favor of the FDIC, and have done so literally hundreds of times within the past several years. *D’Oench* has been described as a "once-little-used doctrine . . . applied to nearly every major S&L failure as myriad borrowers try to get out from under their debts." Mechanically, the further expansion of *D’Oench* has been accomplished by the merger of the *D’Oench* doctrine with section 1823(e) jurisprudence, including *Langley* and *Gunter*. Whereas before three connected but independent lines of authority existed, courts today treat analytically distinct factual scenarios in an identical manner. Even if a court differentiates a case based on its facts, the three lines of authority have broadened so significantly that the distinctions are meaningless as courts will employ one doctrine/rule as an alternative to another. If section 1823(e) does not apply, *D’Oench* will, and if *D’Oench* does not, *Gunter* will. *D’Oench* and its progeny have become a seamless web.

The merger of *D’Oench*, section 1823(e) and *Gunter* is reflected in numerous judicial decisions. In *FSLIC v. Gordy*, the United States Court of Appeals for the Eleventh Circuit affirmed a district court’s judgment in favor of the FSLIC based on *D’Oench*. S&L officers made statements misrepresenting the S&L’s financial condition to the borrowers, and because the FSLIC was a party, section 1823(e) did not expressly apply and *Langley* was therefore seemingly inapposite. Moreover, because the representations were nonpromissory, it would have been difficult to see where there existed any "secret agreement." The court nonethe-

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356. For example, between November 1992 and June 1993, *D’Oench* and/or section 1823 was cited in 147 reported federal and state decisions. Search of LEXIS, Genfed library, Mega file (July 1, 1993).
358. This has been largely accomplished on the strength of Justice Scalia’s opinion in *Langley* where he bizarrely cites *D’Oench* as supporting his strained interpretation of § 1823. *Langley* v. FDIC, 484 U.S. 86, 92-93 (1989). The post-*Langley* jurisprudence around the country has by and large interpreted *Langley* as indistinguishable from *D’Oench* for this reason. See, e.g., *FSLIC v. Gordy*, 928 F.2d 1558, 1562 (11th Cir. 1991) (noting the relationship between the *D’Oench* and *Langley* decisions).
359. 928 F.2d 1558 (11th Cir. 1991).
360. *Id.* at 1568.
361. *Id.* at 1560.
362. *Id.* at 1560-61.
363. *Id.* at 1561.
less held that Langley compelled the result that the defendant guarantee makers were estopped from asserting a fraud in the inducement defense. The court relied heavily on FDIC v. McCullough, which, although citing Langley, was actually a post-Gunter HDC case.

The Gordy court made no effort to distinguish section 1823 from D'Oench.

The importance of cases such as Gordy lies in the broadening of D'Oench so that the "secret agreement" element is no longer required for the application of the doctrine. Anything falling short of fraud in the factum is now barred under D'Oench. D'Oench applies as long as the borrower's defense or claim is based on something outside of the bank's records. Even where courts hold that section 1823(e) does not expressly apply, D'Oench and Gunter exist as fallback positions. Thus, in

364. Id. at 1563. The court stated "[b]ecause the alleged condition of repayment pursuant to the guaranties—the truth of [the bank]'s financial statement, an agreement under Langley—was unrecorded and thus not manifest as required by [FDIC v. McCullough, 911 F.2d 593 (11th Cir. 1990)], appellants 'lent [themselves] to a scheme or arrangement that is likely to mislead the banking authorities.' " Id. at 1564 (quoting Langley v. FDIC, 484 U.S. 93 (1987) (citations omitted)).


366. Id. at 600, 603. For another case in which Gunter and its progeny survive, see Campbell Leasing, Inc. v. FDIC, 901 F.2d 1244 (5th Cir. 1990) (relying heavily on another post-Gunter case, FDIC v. Wood, 758 F.2d 156 (6th Cir.), cert. denied, 474 U.S. 944 (1985)).

367. Some courts acknowledge that section 1823(e) literally does not apply to the FSLIC, although it can be used by analogy. See Firstsouth, F.A. v. Aqua Constr., Inc., 858 F.2d 441, 443 (8th Cir. 1988) (holding that section 1823(e) may apply to the FSLIC by analogy in order to prevent a party from escaping liability for a facially valid note by asserting an oral side agreement as a defense). Other courts are more direct in applying section 1823 even where it literally is inapposite. See In re Century Cntr. Partners Ltd. v. FDIC, No. 91-5549, 1992 U.S. App. LEXIS 28757, at *9 (9th Cir. Nov. 5, 1992) (holding that D'Oench applies to protect a federal insurer from the result of side agreements that were not reported to bank examiners); Weber v. New W. Fed. Sav. and Loan Ass'n, 12 Cal. Rptr. 2d 468, 472-73 (Cal. Ct. App. 1992) (finding that, while section 1823(e) only applies in situations involving the FDIC acting as a corporate entity, the D'Oench doctrine estops the enforcement of side agreement between failed financial institution and borrower where enforcement after agreement would diminish the value of the institution's assets or increase its liabilities).

368. See Kilpatrick v. Riddle, 907 F.2d 1523, 1527 (5th Cir. 1990) (relying on Langley as evidence that "[s]ince the initial statement of the doctrine in D'Oench, Duhme, the Court has expanded the preclusive effect well beyond the content of an oral 'secret agreement' between the bank and the borrower"), cert. denied, 498 U.S. 1083 (1991).


370. As one court stated:

In fact, however, D'Oench, Duhme is not limited only to "secret" agreements. It applies whenever there is an understanding "outside the bank's records." Neither is an actual "scheme" required, insofar as that word connotes something fraudulent and underhanded. "All that is relevant is that the agreements are not in the [bank's] files." . . . In short . . . "lack of bad faith, recklessness, or even negligence" is simply "not a defense in D'Oench cases."
Hall v. FDIC,\(^{371}\) even though section 1823(e) did not apply because the FDIC did not retain an interest in any asset, \(D'Oench\) applied to defeat the borrower's defenses.\(^{372}\) In \(FDIC v. McCullough\)^{373} and \(FSLIC v. Murray,\)^{374} although the statute applied in neither case because the FSLIC was a party, the FSLIC prevailed in both because of its status as an HDC.\(^{375}\)

The expansion of \(D'Oench\) has led to a number of egregiously inequitable results.\(^{376}\) In light of recent extension of \(D'Oench, Bartram v.\)


\(^{372}\) \textit{Id.} at 338-40.

\(^{373}\) 911 F.2d 593 (11th Cir. 1990), cert. denied, 500 U.S. 941 (1991).

\(^{374}\) 853 F.2d 1251 (5th Cir. 1988).

\(^{375}\) McCullough, 911 F.2d at 600; Murray, 853 F.2d at 1256. The \textit{Murray} court observed that "the sensitive federal interests implicated when FSLIC rescues an insolvent savings and loan lead us to conclude that FSLIC should enjoy at least holder in due course status as a matter of federal common law." \textit{Id.}

\(^{376}\) In FDIC v. Kasal, 913 F.2d 487 (9th Cir.), cert. denied, 498 U.S. 1119 (1990), a borrower was estopped from asserting payment as a defense to a note obligation where the payment was made to a bank employee who misappropriated the funds. \textit{Id.} at 488. The court conceded that the result was "harsh," but felt it had no choice given the evolution of case law under \(D'Oench\). \textit{Id.} at 490-91.

In Kilpatrick v. Riddle, 907 F.2d 1523 (5th Cir. 1990), cert. denied, 498 U.S. 1083 (1991), a borrower was estopped from asserting against the FDIC's purchaser of assets a claim under the federal securities laws of which the FDIC was aware at the time of acquisition. \textit{Id.} at 1525-26. Judge Brown in dissent posed the following semi-rhetorical question:

The question is whether the \(D'Oench, Duhme\) doctrine and it's [sic] so-called codified counterpart, 12 U.S.C. § 1823(e), estop all defenses to the repayment of loans of failed banks which the FDIC has assumed in receivership. Is the doctrine so powerful and all encompassing that nothing can stand in its way, including federal statutes protecting investors?

\textit{Id.} at 1529-30 (Brown, J., dissenting) (footnotes omitted).

In FDIC v. Texarkana Nat'l Bank, 874 F.2d 264 (5th Cir. 1989), cert. denied, 493 U.S. 1043 (1990), a bank that innocently participated in a document loan participation, but not the underlying deceptive transaction, could not claim a set-off based on \(D'Oench\) and \(Langley\). \textit{Id.} at 267-68. In essence, the court held that a completely innocent bank is responsible for the concealed fraud of another.

In FSLIC v. T.F. Stone-Liberty Land Assocs., 787 S.W.2d 475 (Tex. Ct. App. 1990), a judgment creditor's claim was defeated because \(D'Oench\) applies to claims already adjudicated, even where the FSLIC is aware of the judgment and merely is appointed receiver after the trial. \textit{Id.} at 481-85.

In McCullough v. FDIC, 987 F.2d 870 (1st Cir. 1993), borrowers who brought an action based on a bank's failure to disclose material facts, in violation of a statutory requirement, were estopped from asserting the claims against the FDIC based on \(Langley\). \textit{Id.} at 872-74. This holding represents \(Langley\) at its most illogical and absurd, as the \textit{McCullough} court essentially held that a non-disclosure constituted an "agreement."
FDIC,\textsuperscript{377} cited at the beginning of this Article, is neither extraordinary nor unusual. Bartram exemplifies the current application of the D'Oench doctrine. Because the FSLIC and not the FDIC was the original party to the dispute, section 1823(e) did not apply. Bartram presented a straightforward case of fraud in the inducement supported by fairly compelling evidence.\textsuperscript{378} Moreover, the plaintiffs in Bartram were not defending their liability on an outstanding note, but were suing in tort for fraud as general creditors.\textsuperscript{379}

Had Bartram been decided one day or a number of years after the D'Oench decision, it would be difficult to see how D'Oench would apply. Fifty years after D'Oench and its expansion, Bartram became an easy case, falling squarely within the jurisprudence of post-D'Oench case law.\textsuperscript{380} The Bartram court had no trouble concluding that plaintiffs' fraud cause of action was barred by D'Oench.\textsuperscript{381}

D. Deregulation

1. Portfolio Diversification: The Federal Response

a. Initial Responses

A funny thing happened on the way to the expansion of D'Oench: the S&L industry was deregulated. The S&L industry was originally designed to allow people in local communities to purchase their own homes.\textsuperscript{382} A S&L typically made a low rate mortgage loan available to a local resident in consideration of the acceptance of his savings held in a passbook account.\textsuperscript{383} The system of long-term mortgages financed by short-term deposits served the industry well for the first thirty years. During this period, roughly from the Great Depression to the mid-1960s, the industry prospered because interest rates were stable.\textsuperscript{384}


\textsuperscript{378} Almost immediately after the S&L promised to build on the land it was acquiring, it turned around and resold the property. \textit{Id.} at 615.

\textsuperscript{379} \textit{Id.} There was no outstanding note because the FSLIC fully obtained its recourse by foreclosing on the collateral. \textit{Id.}


\textsuperscript{381} \textit{Bartram}, 1 Cal. Rptr. 2d at 619.

\textsuperscript{382} \textit{JAMES R. BARTH, THE GREAT SAVINGS AND LOAN DEBACLE} 8-9 (1991). "The [savings and loan] institution economized on information and transactions costs by consolidating the savings of a group of local individuals and channelling the funds to the same individuals in the form of home mortgage loans." \textit{Id.} at 10.

\textsuperscript{383} \textit{Id.} at 9-10.

\textsuperscript{384} \textit{Id.} at 17-23.
Interest rates began to rise during the mid-1960s as the nation stepped up spending for the Vietnam War. Because S&L portfolios had been traditionally restricted to long-term, fixed-rate mortgages financed by short-term deposits, the industry was subject to a “maturity gap” as interest rates rose. Consequently, in 1966 Congress passed legislation which placed a ceiling on the interest rates that S&Ls could pay on deposits. The act solved interest rate squeeze problems during the remainder of the 1960s and most of the 1970s.

b. DIDMCA and Garn-St Germain

In the 1970s, interest rates began to soar dramatically. Unable to diversify their portfolios, S&Ls experienced a serious financial crunch as their cost of funds exceeded the rate of return from their long-term assets. The perceived portfolio diversification problem caused a regulatory reaction. If only S&Ls could be allowed to invest in shorter-term, higher-return investments, the “maturity gap” would theoretically disappear.

By the end of 1979, the S&L industry was suffering from heavy losses. Congress reacted to the financial troubles of the S&Ls with passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) and the Garn-St Germain Depository In-

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385. White, supra note 38, at 62. From 1964 to 1966 interest rates rose from approximately 3.5% to 5.0%. See id.
386. Id. The “maturity gap” is also known as the problem of “borrowing short and lending long.” An S&L derives its income from its investments in long-term, fixed-rate mortgages. Barth, supra note 382, at 10. These mortgages, because of their duration, only marginally respond to changes in the market rate of interest. An S&L’s liabilities (or its cost of funds) derive from the short-term passbook deposits it holds. Id. These short-term liabilities are exceedingly sensitive to the market rate of interest. White, supra note 38, at 61. As interest rates rise, this normally creates an imbalance between an S&L’s assets and liabilities: the assets (long-term mortgages) are locked into a lower rate while the costs (interest paid on passbook accounts) rise. Id. at 61-62. Therefore, an S&L is placed in a precarious position regardless of what it does. If it raises the interest payable on its short-term liabilities to compete with the market, it will operate at a loss, but if it does not increase its interest rates, it will lose depositors. Id.
389. White, supra note 38, at 67-68.
390. Id. at 72-73.
391. See supra note 385 and accompanying text.
392. White, supra note 38, at 72-73.
393. Id. at 70-71.
stitutions Act of 1982. The two acts were anti-regulatory measures that allowed S&Ls to make adjustable rate mortgages and diversify their portfolios. The legislation allowed the S&Ls to offer consumer loans up to a maximum of 30% of their assets, commercial real estate loans up to 40%, and unsecured commercial loans as high as 11%. In addition, the two acts permitted the S&Ls to take equity positions in ventures if done through a "service corporation." Given the regulatory changes that allowed portfolio diversity in high-risk ventures, coupled with changes in ownership restrictions for S&Ls and an overall decrease in oversight and net worth requirements, S&Ls became the perfect environment for high risk takers who could use low-cost, risk-free and, most importantly, federally insured funds for all kinds of ventures.


397. WHITE, supra note 38, at 73.

398. Id. Other regulatory changes in the early 1980s were of significance:

Regulatory Oversight. In the early 1980s, consistent with the Reagan administration's disdain for regulatory oversight, the number of field force regulatory personnel (examiners and supervisors) and examinations was reduced. Id. at 88.

Net Worth Requirements. Net worth requirements for S&Ls were lowered. Id. at 82-87. "A thrift that failed to maintain its net worth level above the minimum requirement would become subject, at least in principle, to tighter regulatory scrutiny and control. By lowering the net worth requirement the Bank Board was reducing its ability to restrain thrifts whose incentives for risk-taking were increasing." Id. at 82.

Ownership Restrictions. Traditionally, community interest, not personal interest, was the governing ethos for most S&Ls, with directorships comprised mainly by local business and community leaders. Fred E. Case, Deregulation: Invitation to Disaster in the S&L Industry, 59 FORDHAM L. REV. S93, S94-S95 (1991). Regulatory changes, however, allowed for a small number of individuals, and in some instances one individual, to become majority stockholders in S&Ls. Id. As a consequence, a smaller number of individuals could exert a dominating influence on an S&L's daily operations. Id. at S97. As one commentator observed:

Deregulation created a perfect environment for high-risk investors. Because one or only a few individuals could own an association (in contrast to the traditional, broad community-based S&L directorship) they could engage in all kinds of real estate lending and investing projects. Single-family lending could be and was abandoned for all practical purposes. The historical safeguards—i.e., regulations—that might have prevented such activities were no longer in place.

Id. (footnote omitted).

399. Congress contemporaneously raised the level of federal deposit insurance to $100,000 for individual savings account. 12 U.S.C. § 1821(a) (1980). Having an insured source of funds, of course, removes any market discipline on S&L investors.
c. **FIRREA**

The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)\(^400\) codified some of the expansion of the *D'Oench* decision. FIRREA extended the protection of section 1823(e) to the FDIC acting in its corporate capacity, the partial successor of the FSLIC, the Resolution Trust Corporation (RTC), and to affirmative claims against the FDIC and RTC.\(^401\)

2. **"Anything Goes": The State Response**

Following the lead of the federal government, state governments jumped into the deregulation frenzy. Multiple states, including Arkansas and Arizona, deregulated the assets side of S&Ls.\(^402\) In California, an “anything goes” policy allowed for investments in “just about everything.”\(^403\)

3. **The Fraud Epidemic**

The failure of the S&L industry during the 1980s is common knowledge. It is tempting and facile to ascribe such failure to rampant fraud among S&L insiders. A S&L in the 1980s presented an alluring target to


\(^{403}\) White, *supra* note 38, at 65. Originally California S&Ls were limited to investing only five percent of their total assets in real estate-owned investments (“REO”). 1971 Cal. Stat. 411. In 1983, the five-percent restriction was lifted. See Cal. Fin. Code § 7350 (West 1989). Later, following disastrous consequences, a ten-percent ceiling was imposed. See *id.* (West Supp. 1994).
any real estate developer with enough cash to buy it. After the deregulation the S&L industry allowed the developer to work on his own pet projects using other people's money. Tales of the Charles Keatings of the S&L world are legion. But most commentators agree that the S&L crash of the 1980s cannot be blamed on fraud alone. A myriad of problems, including mismanagement, careless underwriting standards, and a deteriorating real estate market ultimately led to the collapse of many thrifts.

At the time the S&L industry was being deregulated, however, the rate of fraud and self dealing rose dramatically. Prior to deregulation, fraud in the S&L industry existed only to a minor extent. The government estimated that at various times S&L failures caused by insider wrongdoing ranged from twenty-five percent to sixty percent to one hundred percent for large S&Ls. One commentator noted that a congressional committee reported that fraud occurred in seventy percent of the failed institutions. The fraud involved in many S&L failures concerned excessive valuations of property to justify larger loans to favored borrowers or to justify larger asset values on S&L balance sheets, which, in turn, increased an S&L's net worth and ability to declare dividends to its owners.

404. See White, supra note 38, at 115-17 (discussing the various sources of fraudulent activity); Bruce A. Green, After the Fall: The Criminal Law Enforcement Response to the S&L Crisis, 59 Fordham L. Rev. 155, 162-68 (1991) (postulating reasons why congressional blame on criminal activity for the S&L crisis is overstated).

405. White, supra note 38, at 99-119. "Rapid growth by any business enterprise is likely to involve management and organizational problems; thrifts are no exception. Compounding these usual problems was the fact that this growth often involved new categories of loans and investments. Thus, there were new opportunities to take risks—or just to make mistakes." Id. at 102.

406. Id. at 115-17.

407. Only seven to nine percent of all cases involving fraud and embezzlement referred to by the United States Department of Justice between 1978 and 1985 arose from S&Ls as compared to 85 to 89% from banks. See Case, supra note 398, at S100.

408. For the sources of the varying estimates, see Case, supra note 398, at S100 (estimating that 25% of industry losses are attributable to fraud); Green, supra note 404, at S162-63; see also Jane D. Goldstein, Langley v FDIC: FDIC Superpowers—A License to Commit Fraud, 8 Ann. Rev. Banking L. 559, 581 n.171 (1989) (stating that 58 bank failures were due in large part to insider abuse).

409. M. Danny Wall, The Tasks Ahead, 14 Proc. Fed. Home Loan Bank of San Francisco 231, 233 (1988) (commenting that the congressional committee footnoted the 70% figure with the caveat that fraudulent behaviors constituted 20% of the overall percentage).
E. Ramona Savings & Loan: Fraudulent Schemes

The case of Bartram v. FDIC\(^{410}\) is illustrative of the S&L debacle of the 1980s. In April 1984, John Molinaro and Donald Mangano acquired Ramona Savings and Loan Association, and during the following two years the two purchasers transformed the S&L into a real estate development corporation.\(^{411}\) Because of the deregulation of S&Ls in the 1980s, Mangano & Molinaro were able to act through Ramona to exchange its low-yield mortgages for Federal Home Loan Mortgage Corporation participation certificates, expand Ramona's lendable assets by acquiring high interest certificates of deposit, and to purchase a portfolio of real estate properties.\(^{412}\) A series of self-interested and illusory transactions that increased the S&L's net worth allowed Ramona's owners to be paid $3.5 million in dividends in one year.\(^{413}\) In truth, Molinaro and Mangano drained Ramona of its assets, and a later government audit revealed that the S&L's net worth dropped from $3 million to negative $19 million.\(^{414}\)

At the time Molinaro contacted the Bartrams in 1985, Molinaro was in the midst of a series of fraudulent paper transactions designed to inflate Ramona's net worth artificially. During 1984, Molinaro and Mangano had purchased through Ramona a number of real estate projects that caused great financial strain to the S&L.\(^{415}\) In an effort to stave off foreclosure by the FSLIC, the S&L owners sought to divest Ramona of its real estate holdings.\(^{416}\) The S&L owners swapped thirty-two condominium units from the West Hampton Cove project with the Bartrams in exchange for land held by the Bartams.\(^{417}\) Contrary to the oral representations made to the Bartrams, the S&L owners had no intention of developing the land, and immediately resold the parcels to another buyer, recording an artificial paper profit.\(^{418}\) The representations made by Molinaro to the Bartrams, while indisputable, were typical of practices by S&L owners during the 1980s. It was these misrepresentations asserted

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\(^{412}\) Id. at 7-8.

\(^{413}\) Id. at 8.

\(^{414}\) Id.

\(^{415}\) Id. at 8-10.

\(^{416}\) Id. at 19-21.


\(^{418}\) Id. at 3.
by the Bartrams that were eventually barred by the application of
D'Oench, Duhme & Co. v. FDIC.419

IV. THE IRONY OF D'OENCH

A. The Anti-Safety Net

The Supreme Court designed the D'Oench rule to restore public confidence in the financial institution system by allowing the public's representative, the government, to rely on the stated asset valuation of the institution.420 D'Oench was designed to deter and, in some respects, punish those who lent themselves to an arrangement whereby the public guardian could be misled.421 The D'Oench decision arose in the wake of the Great Depression at a time when the public's confidence was at an all-time low because of the systemic failure of savings institutions.

In the late 1970s and early 1980s, as S&L failures began to rise, the D'Oench doctrine, not coincidentally, began to expand. Prior to this expansion, bank/S&L borrowers confronted a number of legal hurdles in avoiding liability.422 To the extent the borrower alleged that a written obligation was subject to unrecorded oral terms, the parol evidence rule stood as a potential bar to the enforcement of those terms.423 To the extent the borrower executed a document she never meant to be enforced, the borrower's lack of consideration defense was subject to an equitable estoppel rule.424 To the extent the borrower entered into a transaction designed to deceive a regulator, she faced common law rules of illegality and conspiracy to breach fiduciary duty.425

421. See D'Oench, 315 U.S. at 457 (stating that federal banking law "reveal[s] a federal policy to 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").
422. Case, supra note 398, at S93.
423. See 3 Corbin, supra note 82, § 585, at 481 (stating that "[i]f testimony is offered to prove that a party to the written integration made extrinsic promises . . . by which would be increased, his duties, liabilities, or other kinds of burdens without any consideration other than that which is expressed in the writing, the testimony is ordinarily said to be excluded by the 'parol evidence rule'").
425. Id. Prior to the expansion of D'Oench, a borrower, absent the transfer of her obligations to a valid HDC, was not stripped of her ability to contend that true mutual assent was lacking because her assent was induced by a material misrepresentation. Id. at 1134-36.
The expansion of *D’Oench*, largely through the expansive interpretation of section 1823(e) and the intermingling of *D’Oench* and section 1823(e) jurisprudence, caught these borrowers in a net.\(^{426}\) Those individuals unlucky enough to have been defrauded by an oral representation now found themselves incapacitated in the ability to raise traditional contract defenses. Their ability to defend against liability on an obligation was severely limited because to the extent a defense was not subject to a common law restriction, it was now subject to a *D’Oench*/section 1823(e) restriction.\(^{427}\)

### B. Why *D’Oench* Is Too Broad

#### 1. The Fairness Critique

In *Langley v. FDIC*,\(^{428}\) the borrowers argued as a fallback position that an equitable exception for fraud in the inducement should be read into section 1823(e), at least where the FDIC has knowledge of the asserted defense at the time it acquires the asset.\(^{429}\) Justice Scalia rejected any argument based on the equities, finding that the equities favored the government.\(^{430}\) Justice Scalia made several points. First, he seemed to imply that the borrower is in a better position to protect herself because she can

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\(^{426}\) It should be noted that the “net” is not airtight. There are ways around *D’Oench*. See id. at 1136 (analyzing an equitable exception).

\(^{427}\) Id. “Since *Langley*, a growing number of courts of appeals . . . have directly held that there is no equitable estoppel principle underlying the *D’Oench*, Duhme doctrine or section 1823(e).” Id. (footnote omitted).


\(^{429}\) Id. at 93. The FDIC in *Langley* arguably was aware of the borrowers allegations of fraud at the time the FDIC acquired the note because the lawsuit was pending at the time of the FDIC’s takeover. *Id.* at 89.

\(^{430}\) Justice Scalia, commenting on the petitioners’ claims, wrote:

> Petitioners are really urging us to engraft an equitable exception upon the plain terms of the statute. Even if we had the power to do so, the equities petitioners invoke are not the equities the statute regards as predominant. While the borrower who has relied upon an erroneous or even fraudulent unrecorded representation has some claim to consideration, so do those who are harmed by his failure to protect himself by assuring that his agreement is approved and recorded in accordance with the statute. Harm to the FDIC (and those who rely upon the solvency of its fund) is not avoided by knowledge at the time of acquiring the note. The FDIC is an insurer of the bank, and is liable for the depositors’ insured losses whether or not it decides to acquire the note. The harm to the FDIC caused by the failure to record occurs no later than the time at which it conducts its first bank examination that is unable to detect the unrecorded agreement and to prompt the invocation of available protective measures . . . . Thus, insofar as the recording provision is concerned, the state of the FDIC’s knowledge at that time is what is crucial. But . . . § 1823(e) is meant to ensure more than just the FDIC’s ability to rely on bank records at the time of an examination or acquisition. The statutory requirements that an agreement be approved by the bank’s board or loan committee and filed contemporaneously in the bank’s records as-
insist that the representations be recorded.\textsuperscript{431} Second, even if the borrower is defrauded, so too is the public because the borrower's obligation is subject to an unrecorded ("secret") liability.\textsuperscript{432} Third, section 1823(e) is not meant only to allow the FDIC to rely on official bank records, but also insures that when a bank makes a loan, it is done in a deliberative and prudent manner.\textsuperscript{433} None of these arguments is terribly compelling.

First, it is axiomatic that one who participates in a transaction is in a better position to guard against its hazards than one outside the transaction. The ability to avoid risk is a justification for loss shifting rules in tort. But it is normally the justification where both parties are at least partially at fault, such as in cases involving negligence or assumption of the risk. Where both parties are blameless, the core inquiry is determining which party can better afford the loss. Where a bank official makes a non-promissory misrepresentation, such as a misstatement about value, it is difficult to perceive the defrauded person as the party at fault.\textsuperscript{434} The expansive D'Oench doctrine shifts the burden of loss from the public insurance fund to the individual.\textsuperscript{435} But what was the justification for the

\textsuperscript{431} Langley, 484 U.S. at 91-93. “Certainly, one who signs a facially unqualified note subject to an unwritten and unrecorded condition upon its repayment has lent himself to a scheme or arrangement that is likely to mislead the banking authorities . . . .” \textit{Id.} at 93.

\textsuperscript{432} \textit{Id.} at 91-92. Justice Scalia noted that section 1823(e) was “necessary when a bank is examined for fiscal soundness . . . and when the FDIC is deciding whether to liquidate a failed bank.” \textit{Id.} at 91 (citation omitted).

\textsuperscript{433} \textit{Id.} at 92. Justice Scalia stated that the execution of the written note implicitly signifies the bank's board or loan committee's approval, thus "ensur[ing] mature consideration of unusual loan transactions by senior bank officials." \textit{Id.}

\textsuperscript{434} If a promissory misrepresentation is made, i.e., the bank promises to fulfill some contractual duty in the future, it is probably easier to attribute fault to a borrower because presumably she should be wary enough to insist that the bank's obligation be spelled out in writing. \textit{See, e.g., id.} at 93; D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447, 461 (1942) (stating that "one who gives such a [fraudulent] note to a bank with a secret agreement . . . must be presumed to know that it will conceal the truth from the vigilant eyes of the bank examiners"), \textit{superseded as stated in} Gunter v. Hutcheson, 674 F.2d 862 (11th Cir.), \textit{cert. denied}, 459 U.S. 826 (1982).

\textsuperscript{435} It has been noted that this means that private business debtors are subsidizing the insurance fund and that such subsidization serves no market efficiency or safety purpose. Robert W. Norcross, Jr., \textit{The Bank Insolvency Game: FDIC Superpowers, The D'Oench Doctrine, and Federal Common Law}, 103 \textit{Banking L.J.} 316, 344-45 (1986); \textit{see also} FDIC v. Leach, 772 F.2d 1262, 1270 (6th Cir. 1985) (Merrit, J., dissenting) (arguing against extending HDC status to the FDIC because it redistributes "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"); W. Robert Gray, \textit{Limitations on the FDIC's D'Oench Doctrine of Federal Common-Law Estoppel: Congressional Pre-
creation of the FDIC and the FSLIC initially if not to assume the risk of institutional failure, thereby displacing the risk from the shoulders of individuals? Moreover, other writers have noted that the borrower has little or no control over satisfying the rigorous requirements of section 1823(e). Specifically, the borrower has no control over the content and maintenance of bank records and must, as an act of faith, assume that the bank official with whom she is dealing has authority and has received formal approval for the transaction. The borrower's reliance is especially misplaced where the bank official engages in intentional deception.

The second point made by Justice Scalia is that two parties have been defrauded—the individual and the public—and that implicitly the public's interest outweighs the interest of the individual. The whole justification for the creation of a governmental oversight and insurance system, however, was that individual losses in the aggregate had a tremendous demoralizing effect on the public. It appears difficult, therefore, to separate the public's interest from the interest of the individual. Is it not the case that the public's confidence is eroded each time an individual is defrauded and can find no shelter from her appointed protectorate?

Finally, when Justice Scalia opined that section 1823(e) was created at least in part to assure deliberative and thoughtful decision making as a part of the loan making process, he does so based on sheer speculation and inference. If that had been Congress' intent, why then restrict the enforceability of unrecorded agreements only in the context of a takeover by the FDIC? The more likely congressional intent was to codify more expressly and rigidly D'Oench by establishing a bright line rule. Prudence in the decision making process is already legally assured, at least to

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emption and Authoritative Statutory Construction, 31 S. TEX. L.J. 245, 276 (1990) (arguing that "the use of D'Oench and its statutory counterpart with their enormous power to quell a debtor's defenses ... to enhance the prospects of distribution to private claimants in liquidation, is a use of governmental power for private ends whose propriety and constitutionality might both be questioned").

436. See infra note 438 and text accompanying.

437. Kevin A. Palmer, The D'Oench Doctrine: A Proposal For Reform, 108 BANKING L.J. 565, 575 (1991) (describing that "the borrower has no control over the content or maintenance of bank records, can only assume that the bank officer has the authority to act, [and] has no idea whether the board of directors of the bank has approved the transaction").

438. Langley, 484 U.S. at 93-95. In denying the "equitable exception" to section 1823(e) argued by the petitioners in Langley, Justice Scalia noted that "[h]arm to the FDIC (and those who rely upon the solvency of its funds) is not avoided by knowledge at the time of acquiring the note." Id. at 94-95.

439. Id. at 95.

440. See supra notes 167, 175 and accompanying text.
some extent, by virtue of the existence of traditional common law rules, including the parol evidence rule and the statute of frauds.

The inclusion of a fraud in the inducement defense within the parameters of *D’Oench* is particularly inequitable due to the peculiar context in which *D’Oench* is applicable. *D’Oench* applies only to those situations where a bank has failed, and a statutory successor in interest (the FDIC) has been appointed. By definition the defrauded party can no longer look to the original miscreant (i.e., the bank) for recourse because it no longer exists. A public policy justification may exist for not permitting the defrauded party affirmative recovery against the successor. However, where the victim merely seeks to avoid her own liability, little justification exists for denying a shift in responsibility where the culpable party is judgment-proof.

Moreover, the expansion of *D’Oench* goes far beyond the mere conversion of the FDIC into a HDC. While a normal HDC is immune to a myriad of defenses to obligations owed to a payee under a negotiable instrument, *D’Oench* has been expanded to encompass non-negotiable instruments. It has been estimated, however, that in the typical FDIC takeover, eighty percent of the assets acquired are non-negotiable. Thus, *D’Oench* has exponentially changed the substantive commercial law by making HDC status applicable in the majority of cases to situa-

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441. It should be noted that federally insured banks and S&Ls cannot declare bankruptcy. The normal bankruptcy scheme has been displaced by the comprehensive depository insurance laws. In essence, when the FDIC is appointed receiver for an insolvent bank, it is in the same analogous position as a bankruptcy trustee in an ordinary bankruptcy. A bankruptcy trustee, however, is subject to any and all defenses the obligor could have asserted against the debtor. See, e.g., Bank of Marin v. England, 385 U.S. 99, 101 (1966) (determining that “[t]he trustee succeeds only to such rights as the bankrupt possessed; and the trustee is subject to all claims and defenses which might have been asserted against the bankrupt but for the filing of the petition”); In re Lapiana, 909 F.2d 221, 223 (7th Cir. 1990) (describing bankruptcy procedures regarding the enforcement of pre-bankruptcy entitlements); In re Giorgio, 862 F.2d 933, 936 (1st Cir. 1988) (explaining that “a bankruptcy trustee obtains rights of action belonging to the bankrupt subject to the same defenses or limitations that a defendant might have asserted against the bankrupt himself”). The justification is obviously two-fold: (1) the trustee is not a HDC, and (2) the original creditor/debtor, in essence, still exists in the form of the bankrupt estate and its trustee.

442. Bank officers and directors, to the extent they personally participated in the fraud, remain liable. But the problem of the ability to collect a judgment against an individual (and in some cases an incarcerated individual as in *Bartram*) remains paramount.

443. There may be a sound public policy reason for not allowing the FDIC to be liable on a money judgment in a action sounding in fraud. But, of course, in such a situation recovery would not be borne out of the insurance fund, but rather out of the estate of the insolvent institution.

444. See supra note 317 and accompanying text.

tions where it previously had no relevance.  

2. The Efficacy Critique

The case law beginning before Gunter and continuing through Langley is based not so much on an equities concern, but instead on an efficiency concern. Courts view the grant of "super" powers to the FDIC as an efficient way of allowing the FDIC to sell failed institutions without shutting them down. The D'Oench rule facilitates purchase and assumption transactions. However, the government can already accomplish this objective without sacrificing the equities of the individual. In a typical purchase and assumption transaction, the FDIC has the ability to indemnify the purchasing institution from losses. Allowing a defrauded borrower to assert fraud as a defense to an obligation on a note would simply present an indemnity claim by the purchasing institution against the FDIC. The loss would again be shifted to the party best able to bear it, the government.

C. Do We Need D'Oench?

1. Common Law Precedents

a. The Parol Evidence Rule

D'Oench is troublesome because it is too broad: it captures within its net persons whose equitable claims would ordinarily not be barred. If

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446. See cases cited supra note 445.
448. See id.
449. One author noted:

[T]he realities of a purchase and assumption transaction make the presence of "hidden" defenses irrelevant. Realistically, the FDIC cannot hope to evaluate its own ability to collect each asset of a failed bank on an overnight basis from the books and records of the bank. The bidding bank bases its bids on the failed bank's market position, total liabilities, and the asset mix and yield, subject to the loan classifications already completed during the bank examination process. The bidding bank does not need to make a more accurate assessment of the assets, because it is buying them with full recourse to the FDIC! If the loan turns out to be uncollectible, for any reason, the bank merely sells the loan back to the FDIC. Thus, the presence of hidden defenses to the payment of a failed bank's loans will not affect the FDIC's ability or desire to implement a purchase and assumption transaction. Indeed, these loans will, in all likelihood, already be in default and on the problem loan list.

D'Oench did not exist, however, a number of the common law doctrines would already provide adequate security for the FDIC.

A number of concerns are identifiable from the case law: (1) the desire to maintain the integrity of bank/S&L record keeping;\textsuperscript{450} (2) the desire to prevent collusive arrangements between bank officers and customers;\textsuperscript{451} (3) the desire to insure that agreements are not subject to secret conditions or terms;\textsuperscript{452} and (4) the need to restore and maintain public confidence in the nation's financial institutions.\textsuperscript{453} Most of these goals can be met in the absence of D'Oench because of current common law protections. The first such protection is the parol evidence rule.

The common law parol evidence rule specifies that if a written contract constitutes a total integration, meaning that it is the final and exclusive expression of the contracting parties' agreement, it may not be supplemented by prior contradictory or additional terms. Additionally, if the written contract constitutes a partial integration, that is it is not meant to be an exclusive expression, it may be supplemented by consistent additional terms.\textsuperscript{454} In the context of concerns under D'Oench, the parol evidence rule has the following effect. For large real estate transactions where the bank takes back paper (i.e., promissory notes), the paper itself is part of the larger transaction that, if the paperwork is adequate, in the aggregate probably constitutes a total integration.\textsuperscript{455} Thus, to the extent at the time the documents are executed the notes are subject to undisclosed terms concerning, for example, loan funding requirements, bank obligations, and the like, these undisclosed terms or agreements are unenforceable under the parol evidence rule.\textsuperscript{456}

To the extent that the documents for such transactions only constitute a partial integration, the terms of the agreement may be supplemented by

\textsuperscript{450} Langley v. FDIC, 484 U.S. 86, 91 (1987) (stating that one of the purposes behind section 1823(e) is "to allow federal and state bank examiners to rely on a bank's records in evaluating the worth of the bank's assets").

\textsuperscript{451} FSLIC v. Hsi, 657 F. Supp. 1333, 1337 (E.D. La. 1986) (stating that the D'Oench doctrine "prevents those who give notes to federally insured banks from raising defenses based on alleged secret agreements they had with the officers of failed banks").

\textsuperscript{452} FDIC v. MM&S Partners, 626 F. Supp. 681, 687 (N.D. Ill. 1985) (holding that "D'Oench and § 1823(e) demonstrate that there is a policy in federal banking law . . . that the FDIC should not be bound by anything outside a bank's loan documents").

\textsuperscript{453} Gunter v. Hutcheson, 674 F.2d 862, 870 (11th Cir.) (stating that the policies of the FDIC "promot[e] the stability of and confidence in the nation's banking system"), cert. denied, 459 U.S. 826 (1982).

\textsuperscript{454} See 1A CORBIN, supra note 57, §§ 209-217.

\textsuperscript{455} A total or complete integration is one in which, in view of its completeness and specificity, appears to be the parties' complete and exclusive statement of the terms of the agreement. See RESTATEMENT (SECOND) OF CONTRACTS §§ 209(3), 210(1) (1979).

\textsuperscript{456} See 1A CORBIN, supra note 82, § 213(1)-(2).
consistent additional terms. In the case of an accommodation note, the
term sought to be introduced (i.e., the agreement not to enforce the note)
is normally contradictory and thus unenforceable even if the transaction
is only partially integrated. One thing the parol evidence rule will not
exclude, however, is evidence that goes toward establishing that an agree-
ment is voidable because consent was induced by a misrepresentation. 457
To the extent a borrower seeks to deny liability based on a material mis-
representation, at least of a non-promissory nature, she is able to do so
under the parol evidence rule.

b. Equitable Estoppel

A second protection available to the FDIC under the common law is
the doctrine of equitable estoppel. For over fifty years before the
Supreme Court decided D'Oench, numerous states had developed a com-
mon law estoppel rule for collusive borrower/bank official transactions. 458
Specifically, these cases consistently held that where a borrower executes
a document she knows to be fallacious, she is estopped from denying its
unenforceability on the basis of, for example, lack of consideration. 459
The same result would hold where a bank fraudulently represents that it
will not call a note due. 460 The borrower, regardless of the bank’s inten-
tions, has knowingly executed what she believes to be a false document
and should thereby be equitably estopped.

The common law estoppel rule, which could also be viewed simply as a
narrow interpretation of D’Oench, has the effect of making accommoda-
tion (i.e., non-liability) agreements unenforceable. 461 An estoppel rule,
which is grounded in equitable considerations, however, would have no
application where a party did not knowingly participate in any deceptive
conduct. 462 Therefore, most fraud in the inducement defenses, with the
exception of the accommodation note context, will be preserved.

457. See Calamari & Perillo, supra note 82, § 3-7(c); Corbin, supra note 82.
458. See supra notes 77-113 and accompanying text.
459. See supra notes 77-113 and accompanying text.
460. See supra notes 77-113 and accompanying text.
461. This interpretation, moreover, would be consistent with Justice Jackson’s concur-
rence in D’Oench. See supra note 159.
462. One of the traditional elements of equitable estoppel is conduct by a party sought
to be estopped that would be inequitable and unconscionable not to estop. See Rody v.
Doyle, 29 A.2d 290, 293 (Md. 1942).
c. **Section 1823(e)**

The third protection that is available to the FDIC arises not out of the common law, but instead out of statutory law: section 1823(e).\(^{463}\) In many respects section 1823(e) is duplicative of the parol evidence rule and the common law estoppel rule.\(^{464}\) Matters that fall within both common law rules clearly also fall within the proscriptions of the statute. But section 1823(e) goes further. To the extent an oral agreement is consistent with the terms of a partially integrated contract, and to the extent the contract does not represent a deceptive arrangement, the oral agreement is not unenforceable under the parol evidence or common law estoppel rule. It is, however, unenforceable under section 1823(e).

Section 1823(e) can be viewed as a super parol evidence rule. Under section 1823(e) all transactions reduced by a bank to writing are conclusively presumed to be totally integrated.\(^{465}\) Any term not found in the transaction documents is therefore unenforceable. However, just as the parol evidence rule does not apply to matters that establish the voidability of a contract, section 1823(e) should be interpreted to apply only to matters upon which the parties actually reach an "agreement." Thus, even under section 1823(e), a fraud in the inducement defense would be preserved because there is no true "agreement" in that context.

d. **Illegality, Public Policy, and Conspiracy to Commit Breach of Fiduciary Duty**

To the extent that *D’Oench* originally concerned a situation in which a borrower was validly a party to a fraud, the doctrines of illegality\(^{466}\) and

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\(^{463}\) 12 U.S.C. § 1823(e) (1988 & Supp. II 1990). The existence of section 1823(e) raises an interesting question: should *D’Oench* and its progeny (including, importantly, *Gunter*) legally exist at all? In City of Milwaukee v. Illinois, 451 U.S. 304 (1981), the Supreme Court held that federal common law with regard to public nuisances in the context of polluted waters no longer exists because of Congress' passage of the Federal Water Pollution Control Act. *Id.* at 317-19. The Court reasoned that federal common law in an area of national concern is only applicable in the absence of an applicable act of Congress. *Id.* When Congress addresses a question directly, the need for the creation of federal common law disappears. The governing assumption is that it is up to the Congress, and not the federal courts, to define the appropriate standards of federal common law. *Id* at 312-17. Given the comprehensive expansion of section 1823(e) under FIRREA, an argument could be made that Congress has specifically defined the rights and liabilities of the government in bank/S&L takeovers, and thus there is no need for resort to the federal common law created by *D’Oench* and *Gunter.* See Gray, *supra* note 435.

\(^{464}\) See *supra* notes 455-63 and accompanying text.

\(^{465}\) See 12 U.S.C. § 1823(e). Moreover, viewed in this light, section 1823(e) extends the parol evidence rule to post-contract formation agreements, thus invalidating many waiver and estopped defenses.

\(^{466}\) For an excellent example of a recent application of the illegality doctrine against a bank borrower to preclude a claim against the FDIC, see Long v. South Bay Sav. & Loan...
conspiracy to breach a fiduciary duty\textsuperscript{467} arguably prevent the borrower from at least affirmative recovery, and probably prevent her from protective defensive shelter.

2. D'Oench, Langley and Bartram Revisited

How would the decisions in \textit{D'Oench}, Langley, and Bartram have resulted in the absence of the expansive \textit{D'Oench} doctrine? \textit{D'Oench}, itself, would be the least affected. The defendant in \textit{D'Oench} was a knowing accommodation note maker.\textsuperscript{468} Under the pre-\textit{D'Oench} common law estoppel rule, his lack of consideration defense is foreclosed. Under the parol evidence rule, the agreement not to enforce the note expressly contradicts the terms of the note itself and would therefore be inadmissible under the parol evidence rule. The agreement would also be a nullity under section 1823(e).

\textit{Langley}, however, constitutes another matter. In \textit{Langley}, the borrowers alleged that they signed documents based on misrepresentations by bank officials concerning material facts about the property purchased.\textsuperscript{469} Because the misrepresentations made the contract voidable and the borrowers could not have been held to have participated in any deceptive arrangement, neither the parol evidence rule nor the common law estoppel rule would apply. Section 1823(e) would also be inapplicable because the Langleys' defense was not based on an "agreement." In the absence of an expansive \textit{D'Oench} doctrine, the Langleys therefore would be able to resist enforcement of their obligations.

\textit{Bartram} presents the most problematic case. Since the Bartrams alleged a fraud in the inducement defense, the parol evidence rule,\textsuperscript{470} the doctrine of equitable estoppel, and section 1823(e) arguably should not

\textsuperscript{467} The Restatement of Torts provides that "[a] person who knowingly assists a fiduciary in committing a breach of trust is himself guilty of tortious conduct and is subject to liability for the harm thereby caused." RESTATEMENT (SECOND) OF TORTS § 874 cmt. c (1979); see also Jackson v. Smith, 254 U.S. 586, 589 (1921) (stating that an individual who "knowingly join[s]" a fraudulent scheme will be held liable with other parties to the scheme); RESTATEMENT (SECOND) OF TORTS § 876.


\textsuperscript{470} See supra notes 70-72 and accompanying text.
apply. However, the defense was based on an "agreement" in the sense that the S&L promised to do something in the future. Ordinarily, the mere fact that a promise is not carried out is not evidence of fraud and therefore the Bartrams' defense would ordinarily fail under the parol evidence rule and section 1823(e). But if the borrower could present clear and convincing evidence that the bank made a representation it never intended to carry out, the defense is established. Thus, whether the Bartrams should escape the proscriptions of section 1823(e) boils down to a matter of proof. Unless they can meet the rigorous scienter proof requirements of a promissory fraud theory, their claim should be barred under section 1823(e).\footnote{This, of course, assumes arguendo that section 1823(e) applies. In Bartram it did not because the FDIC was not an original party to the lawsuit.}

V. CONCLUSION

The principle upon which the D'Oench doctrine was originally based concerned confidence: the public's confidence in the banking system as guaranteed by their appointed guardian's confidence in the records of banks. D'Oench was originally meant to deter and preclude misleading financial arrangements between bank officials and bank customers. The D'Oench precedent, however, has embalmed this principle by expanding to apply to situations where public confidence is not served. Its application is ironic. In an era of widespread fraud, the victims of fraud are punished. Perhaps the only way to solve the inequities of D'Oench is for Congress to repeal, or at least amend, section 1823(e). Until such time, however, the doctrine of caveat emptor still endures.