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BankNews

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Depositor Offset in the Bank Failure Context

In 2008, the FDIC was appointed receiver for more than 20 depository institutions, the largest number since the savings and loan crisis. In the present economic climate, it is likely that 2009 will see additional bank failures. You should be aware of an important aspect of FDIC receivership that can affect your customers and your bank itself: the right of offset. A depositor has a common law right to utilize uninsured deposits to offset any loans the depositor has with a failed bank. You should understand the right of offset and how it affects uninsured deposits. Moreover, you need to be aware of how offset could adversely affect your bank in instances where you are a participant in a loan originated by a failed bank.

Depositors' Right of Offset

Even with the recent temporary increases in deposit insurance coverage, most banks have uninsured depositors. A guiding principle of FDIC receivership is protecting depositors from losses. In line with this goal, the FDIC allows depositors to offset the uninsured portion of a deposit against loan amounts owed to a failed bank. In the case of a depositor with large deposit balances and loans at the bank, you should know that if the bank closed, the depositor's amounts over the insurance limit could potentially be used to pay off any loans the depositor may have with the bank. An explanation of the right of offset may help prevent a nervous customer from unnecessarily pulling money out of your bank.

Whether the FDIC is acting as receiver for a federal or state institution, it will allow an offset only if it is permitted under state law. There are three common law elements that generally must be met before an offset is granted. First, mutuality must exist — the borrower and depositor must be the same person or entity acting in the same legal capacity and the loan and deposit must be with the same bank. Second, the deposited funds used to offset a loan must be a general deposit, not a deposit for a special purpose. Finally, the deposited funds must be the property of the depositor and no third party may have a right to such deposit. A customer's most prudent option is to meet

all of these requirements. But many states have loosened the common law elements or created exceptions, such as allowing joint obligations to be offset by deposits in the name of either party. Therefore, if a customer's deposits and loans do not squarely meet all three common law elements, the FDIC will allow an offset if it is persuaded that the customer's particular situation is covered under applicable state law. For clarification of the applicable requirements, your depositor or the bank should have legal counsel research state law interpreting the right of offset.

Offsets and Loan Participations

Despite the obvious benefit to depositors, the right of offset could have serious consequences for your bank due to the FDIC's treatment of offset in the participation loan context. As a general rule, a loan participant has a preferred interest in its share of payments made by a debtor when the payment is deemed to augment the receivership estate. Therefore, future payments on a participation loan will continue to flow to participants. But the FDIC and courts do not consider an offset to be a specific payment on a loan that augments the receivership estate. Instead, an offset is deemed a shifting of existing credit to debt rather than an actual payment. As such, there are no cash proceeds for the FDIC to pass on to the participant and the participant is left with a general unsecured claim against the receivership estate for the amount lost due to the offset. The effect of the FDIC's interpretation of the nature of offset is that the amount due on an offset loan is reduced by the amount of the offset, but the participants do not receive their share of the offset amount. Instead of receiving cash for its share of an offset, a participant is issued a receiver's certificate by the FDIC and will be paid on par with other general unsecured creditors, that is, after payments made for administrative expenses and payments to depositors. A participant will likely never recover its share of the offset amount.

The FDIC and courts have made a policy choice that a depositor's right of offset should not be diminished due

to a loan being participated and that participant banks should bear the risks of their participations. In the current banking environment, it is paramount to not only investigate the creditworthiness of the borrower, but also to ascertain the condition of the lead lender.

A depositor's right of offset in the bank failure context protects a depositor from losing any uninsured deposits by applying the uninsured deposit amount against debt owed to the failed bank. You must be mindful of the risk that the treatment of the amount allowed by an offset

under a participation loan could result in you, as a participant, receiving a receiver's certificate in the amount you would otherwise receive in cash had the originating bank not failed. Work with legal counsel to help protect yourself in the participation agreements you enter into. However, due to the uncertainty involved in the case-by-case nature of FDIC receivership, as well as the FDIC's broad powers as receiver, including the power to unilaterally rescind contracts, your best protection is to know the lead lender on loans in which you participate. **BN**