FDIC v. Philadelphia Gear: A Standby Letter of Credit Backed by a Contingent Promissory Note is Not a Deposit-The Supreme Court Changes Gear

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CASENOTES

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I. INTRODUCTION

A buyer and a seller arrange for the sale of goods. In order to provide the seller security for the buyer's payment, the parties agree to use a letter of credit.[1] Upon the buyer's application, the buyer's

1. Letters of credit originated and developed in the realm of international trade. B. KOZOLCHYK, COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS 3-43 (1966); *see* Kozolchyk, *The Legal Nature of the Irrevocable Letter of Credit*, 14 AM. J. COMP. L. 395-400 (1965). Letters of credit were probably first used in 575 B.C. W. WARD & H. HARFIELD, BANK CREDITS AND ACCEPTANCES 145 (4th ed. 1958).

Traditionally, the letter of credit facilitated transactions between unfamiliar parties of distant countries. Foreign trade is naturally more risky than domestic trade because of variations in commercial standards, laws, customs or duties, governmental regulations, and currencies. Understandably, in the early years of international commerce, a seller may have been hesitant to rely on the credit of a buyer he did not know. Likewise, a buyer may have been unwilling to pay for goods sold by an unknown seller until they had been delivered. Despite all our modern transactional conveniences, similar fears still exist today. A letter of credit, issued by a bank with a readily discernable reputation, solves this common problem. Simply stated, a letter of credit authorizes the party to whom it is issued (the seller) to draw a draft up to a specified amount on the issuing bank. The bank agrees to pay the draft when it is bank issues a letter of credit for the benefit of the seller. The parties agree that if the buyer defaults on the required payments, the seller can collect on the letter of credit by presenting draft documents to the buyer's bank. To complete the financial arrangement, the buyer executes a promissory note in favor of the bank. This note, which equals the amount of the letter of credit and carries the same expiration date,

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presented. The effect is to substitute the bank's credit for that of the buyer, thereby assuring the seller of payment.

Henry Harfield, a leading scholar in letter of credit law, found it "virtually impossible to [define a letter of credit] in a manner that is both comprehensive and concise." H. HARFIELD, LETTERS OF CREDIT 1 (1979). The Uniform Commercial Code (UCC) provides:

> (a) "Credit" or "letter of credit" means an engagement by a bank or other person made at the request of a customer . . . that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit. A credit may be either revocable or irrevocable. The engagement may be either an agreement to honor or a statement that the bank or other person is authorized to honor.

U.C.C. § 5-103(1)(a) (1978). Florida and Louisiana have modified section 5-103(1)(a) slightly by changing the second sentence to read: "A credit shall clearly state whether it is revocable or irrevocable and in the absence of such statement shall be presumed to be irrevocable." FLA. STAT. § 675.103(1) (1985); LA. REV. STAT. ANN. § 10:5-103(1)(a) (West 1985).

The UCC definition provides a broad standard guide to letters of credit. For a small sampling of the extensive opinions construing the UCC definition of commercial letters of credit, see Data Gen. Corp. v. Citizens Nat'l Bank, 502 F. Supp. 776 (D. Conn. 1980); Baker v. National Blvd. Bank, 399 F. Supp. 1021 (N.D. Ill. 1975); Lewis State Bank v. Advance Mortgage Corp., 362 So. 2d 406 (Fla. 1st DCA 1978); Easton Tire Co. v. Farmers & Merchants Bank, 642 S.W.2d 396 (Mo. Ct. App. 1982); Richards Elec. Supply Co. v. First Nat'l Bank, 2 Ohio App. 3d 325, 441 N.E.2d 1130 (1981).

The Comptroller of the Currency's interpretation is less exact, but points to five elements generally attributable to letters of credit:

> (a) Each letter of credit should conspicuously state that it is a letter of credit or be conspicuously entitled as such; (b) the bank's undertaking should contain a specified expiration date or be for a definite term; (c) the bank's undertaking should be limited in amount; (d) the bank's obligation to pay should arise only upon the presentation of a draft or other documents as specified in the letter of credit, and the bank must not be called upon to determine questions of fact or law at issue between the account party and the beneficiary; (e) the bank's customer should have an unqualified obligation to reimburse the bank for payments made under the letter of credit.

12 C.F.R. § 7.7016 (1986); *see also* INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1974) (containing 50 articles defining letters of credit).

An instrument need not state that it is a letter of credit to qualify as one. *See* First Am. Nat'l Bank v. Alcorn, Inc., 361 So. 2d 481, 487 (Miss. 1978). In addition, an instrument may be construed as a letter of credit even though the parties labeled it otherwise. *See* Toyota Indust. Trucks v. Citizens Nat'l Bank, 611 F.2d 465 (3d Cir. 1979).

Some scholars track the language of the UCC in defining letters of credit. *See* Murray, *Letters of Credit in Nonsale of Goods Transactions,* 30 BUS. LAW. 1103 (1975). Those who do not, offer definitions that are substantively consistent with the Code. *See* Katskee, *The Standby Letter of Credit Debate—The Case for Congressional Resolution,* 92 BANKING L.J. 697 (1975); Megrah, *Risk Aspects of the Irrevocable Documentary Credit,* 24 ARIZ. L. REV. 255 (1982).

backs up the letter of credit. The letter of credit herein described is called a "standby" letter of credit because the bank stands by until the seller presents the proper documents or until the letter of credit expires on a predetermined date.

Simple enough. Now let's add some real world facts. Assume that the buyer defaults on his payments to the seller. The seller, having protected himself from precisely this possibility turns to the bank with documents in hand and requests payment on the letter of credit. But assume that the bank has gone insolvent. Does the seller lose the proceeds from his sale? In an effort to avoid the rough and tumble of bankruptcy proceedings, the seller seeks salvation in a federal statute. When read literally, the statute defines a standby letter of credit backed by a promissory note as a deposit, which is insured by the Federal Deposit Insurance Corporation (FDIC). The seller files a claim with the FDIC, which refuses payment. Question: What result?

The Supreme Court was faced with this fact pattern in *FDIC v. Philadelphia Gear.*[2] Although the FDIC had never recognized such a claim, two lower federal courts read the deposit statute literally and ruled in favor of Philadelphia Gear,[3] the seller in the above scenario. The lower court decisions caused considerable concern, even panic, among significant portions of the banking community, the industrial development bond market, the FDIC and those who utilized standby letters of credit in everyday business practice. Ultimately, the Supreme Court reversed.

The Supreme Court's decision was correct; but in an effort to avoid adverse effects on the banking industry and the industrial bond market, and yet align the deposit statute with both congressional intent and current commercial banking practice, the Court essentially eliminated a statutory term that it only intended to narrow in scope.

This note will critique and attempt to clarify the holding and rationale of the decision in *Philadelphia Gear.* The second section of the note introduces the factual dispute in *Philadelphia Gear.* The third section discusses the decisions of the lower courts. The next section outlines the Supreme Court's opinion. The fifth section describes the financial consequences that influenced, but were omitted from, the Supreme Court's decision. The sixth section introduces and

2. 106 S. Ct. 1931 (1986).

3. The Philadelphia Gear Corporation is extensively integrated, both horizontally and vertically. Its corporate parent is American Manufacturing Corporation. Its affiliates include American Insurance Corporation Services, Limitorque Corporation (Virginia), American Manufacturing Company, and Effector, Inc. Its nonwholly owned subsidiary is Philadelphia Gear de Mexico, S.A. Brief for Petitioners at 2 n.1, FDIC v. Philadelphia Gear Corp., 106 S. Ct. 1931 (1986) (No. 84-1972).

critically examines the Court's analysis in *Philadelphia Gear*. Part A of this section addresses the conflict between potentially applicable state and federal law. Part B critiques the Court's deference to the FDIC's interpretation of the deposit statute. Finally, part C, using letter of credit paradigms created by the authors, attempts to determine what types of financial instruments will trigger insurance protection. Section seven embodies the author's conclusion.

II. Statement of the Case

The Orion Manufacturing Corporation (Orion), a producer of oil pumping machinery, desired to purchase equipment used in the production of pumping jacks from the Philadelphia Gear Corporation (Philadelphia Gear), a trade supplier. In order to facilitate this transaction, Orion engaged the services of Penn Square Bank, N.A. (Penn Square), a national banking association doing business in Oklahoma City, Oklahoma. On April 23, 1981, upon Orion's application, Penn Square issued a standby[4] irrevocable letter of credit[5] for the benefit of

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4. A standby letter of credit may be defined as "[a]n instrument using the same mechanism as the [ordinary letter] of credit but issued as a guarantee against default by one party to the contract rather than a payment instrument—hence the expression standby. . . . The beneficiary is usually entitled to payment of the credit sum against presentation of a simple demand to be paid." M. Rowe, Letters of Credit 5 (1985). Standby letters should be contrasted with traditional (also known as commercial or documentary) letters of credit and guarantees:

> A letter of credit (whether of the commercial or standby variety) is an engagement by an issuer (almost always a bank) to a beneficiary (such as a seller of goods) . . . that binds the issuing bank to honor drafts up to the amount of the credit upon the beneficiary's presentment of the documents required by the terms of the letter.
>
> If a commercial letter is involved, the documents will normally include a bill of lading and invoice; if a standby letter is involved, the key document will probably be a certificate of default by the customer on the underlying obligation.

B. Clark, The Law of Bank Deposits, Collections and Credit Cards § 8.2, at 8-5 (rev. ed. 1981) (footnote omitted).

Essentially, this means that in the traditional letter of credit paradigm involving the sale of goods the parties have not yet executed the underlying sales contract. The bank's obligation will not arise until the contract is performed and the beneficiary presents the proper documents to the bank for payment. In contrast, the standby letter of credit is, to a large extent, an *existing obligation* which does not require performance until the proper documentation is presented. The standby letter of credit "represents [an] issuer's promise to pay on little more than the beneficiary's certification of default," regardless of whether such default actually occurred. Jarvis, *Standby Letters of Credit—Issuer's Subrogation and Assignment Rights Part II*, 10 U.C.C. L.J. 38, 45 (1977).

There has been some confusion as to the distinction between standby letters of credit and guarantees. Although both standby letters of credit and guarantees act as support mechanisms for the credit of one party, only a guarantor is able to assert the defenses of the party whose payment he backs. Kozolchyk, *The Emerging Law of Standby Letters of Credit and Bank Guarantees*, 24 Ariz L. Rev. 319, 319 (1982). In addition, in a letter of credit transaction the bank's obligation is independent of the buyer's obligation to pay for the goods. The bank must

Philadelphia Gear.[6]

In return, Orion issued an unsecured promissory note in favor of Penn Square. The promissory note was only intended to act as security for the letter of credit. Both Orion and Penn Square understood that Penn Square was not to demand, or expect, payment on the promissory note unless Philadelphia Gear called upon Penn Square to make payment under the letter of credit.[7] This understanding, however, was not mentioned anywhere on the face of the promissory note.

On July 5, 1982, the Comptroller of the Currency, declared Penn

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pay merely upon the presentation of documents. The bank therefore is not directly responsible to answer for the debt of another which is the traditional function of a guarantee. *See* L. SIMPSON, HANDBOOK ON THE LAW ON SURETYSHIP 10 (1950).

The conceptual differences between the two instruments, while once a more significant topic for legal discussion, have been basically settled and accepted in thought and practice. *See* Campbell, *Guarantees and the Suretyship Phases of Letters of Credit*, 85 U. PA. L. REV. 175, 261 (1937). Today there is little support for the contention that a standby letter of credit is nothing more than a guarantee. Verkuil, *Bank Solvency and Guarantee Letters of Credit*, 25 STAN. L. REV. 716, 725 (1973). Banks generally lack the statutory authority to guarantee the debt of other parties. 12 U.S.C. § 24 (1982); *see* Harfield, *The National Bank Act and Foreign Trade Practices*, 61 HARV. L. REV. 782, 788-89 (1948). An interpretive ruling by the Comptroller of the Currency, however, granted banks the authority to issue standby letters of credit. 12 C.F.R. § 7.7016 (1986); *see supra* note 1. For an examination of standby letters of credit and specific legal problems arising from their use, see Arnold & Bransilver, *The Standby Letter of Credit—The Controversy Continues*, 10 U.C.C. L.J. 272 (1978); Harfield, *The Standby Letter of Credit Debate*, 94 BANKING L.J. 293 (1977); Katsker, *The Standby Letter of Credit Debate—The Case for Congressional Resolution*, 92 BANKING L.J. 816 (1977); Verkuil, *Letters of Credit—Bank Solvency and Standby Letters of Credit: Lessons From the USNB Failure*, 53 TUL. L. REV. 314 (1979); *see also Regulation of Standby Letters of Credit: Hearings on S. 2347 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2nd Sess. (1976).

5. The letter of credit was in the amount of $145,200 and expired August 1, 1982. Philadelphia Gear Corp. v. FDIC, 751 F.2d 1131, 1133 (10th Cir. 1984), *rev'd*, 106 S. Ct. 1931 (1986). The letter of credit provided that Philadelphia Gear's "signed statement that [it had] invoiced Orion Manufacturing Corporation and that [the] invoices [had] remained unpaid for at least fifteen (15) days" and "cop[ies] of all invoices" must accompany drafts submitted to Penn Square for payment. *Id.* The agreement further provided that "all invoices [would] be *verified* for authenticity and *payment* with Orion Manufacturing Corporation," and that Penn Square "agree[d] with drawers, endorsers and bona-fide holders of all drafts, drawn under and in compliance with the terms of this credit, that such drafts [would] be duly honored upon presentation to the drawer." *Id.* (emphasis added).

Penn Square, at the request of Philadelphia Gear, amended the letter of credit by deleting the paragraph requiring that invoices be verified for authenticity, and added the following language: "This credit shall be automatically reinstated from time to time for any sum or sums up to $145,200 *upon presentation of described documents*. This credit and all reinstatements are irrevocable and shall expire on August 1, 1982." *Id.* (emphasis added).

6. *Id.*

7. "Both Orion and Penn Square understood that nothing would be considered due on this note nor would interest be charged unless and until Philadelphia Gear presented to Penn Square the requisite documents detailed in the letter of credit, which it had not done at the time of the bank's insolvency." *Id.* at 1134.

Square insolvent.[8] Orion had not yet paid Philadelphia Gear on the purchase of equipment. Two days later, on July 7, 1982, Philadelphia Gear, through its remitting bank, submitted three complying[9] documentary drafts to the FDIC as receiver, seeking payment on the standby letter of credit. On July 22, 1982, Philadelphia Gear presented five more drafts. In total, Philadelphia Gear presented eight drafts having a total value of $724,728.50. The FDIC refused to honor these drafts.[10] In a letter to Philadelphia Gear, the FDIC stated that it "disaffirmed 'any and all' terms, provisions, responsibilities or obligations that might otherwise exist" under the letter of credit.[11] The FDIC returned all drafts that Philadelphia Gear submitted under the letter of credit, and all drafts remained unpaid. Subsequently, Philadelphia Gear brought suit against the FDIC, both as receiver[12] and as insurer[13] of deposits,[14] claiming that the letter of credit was a "deposit" that was insured by the FDIC under 12 U.S.C. § 1813(l)(1).[15]

8. A bank is considered "insolvent either when its liquidity is so low that it cannot pay its debts; (i.e., a negative cash flow cannot be met) or when the market value of its assets reduced by the costs of bankruptcy is less than the value of liabilities to its customers, computed under the assumption that all such obligations will be met fully." S. MAISEL, RISK AND CAPITAL ADEQUACY IN COMMERCIAL BANKS 21 (1981).

9. The district court found that the documents complied with the requirements of the letter of credit. Philadelphia Gear, therefore, had satisfied the condition precedent for payment on the letter of credit. Although Orion had apparently refused to make payment due to insolvency, insolvency was not a prerequisite for presentation of the documentary drafts.

10. *Philadelphia Gear*, 751 F.2d at 1133-34.

11. *Id.* at 1134.

12. The pertinent text of 12 U.S.C § 1821(c) reads:

Corporation as receiver:

> (c) Notwithstanding any other provision of law, whenever the Comptroller of the Currency shall appoint a receiver other than a conservator of any insured national bank, insured Federal Branch of a foreign bank, or insured District bank, or of any noninsured National bank or District bank hereafter closed, he shall appoint the [FDIC] receiver for such closed bank.

12 U.S.C. § 1821(c) (1982).

13. *See* 12 U.S.C. § 1813(m) (1982).

14. Philadelphia Gear sought judgment against the FDIC in its capacity as insurer for $100,000 and for $624,728.50 in its capacity as receiver. *Philadelphia Gear*, 751 F.2d at 1133.

15. Section 1813(l)(1) provides in pertinent part:

The term deposit means:

> [T]he unpaid balance of money or its equivalent received or held by a bank in the usual course of business and . . . which is evidenced by . . . a letter of credit . . . on which the bank is primarily liable: Provided, that, without limiting the generality of the term "money or its equivalent", any such account or instrument must be regarded as evidencing the receipt of the equivalent of money when credited or issued in exchange for . . . a promissory note upon which the person obtaining any such credit or instrument is primarily or secondarily liable.

12 U.S.C. § 1813(l)(1) (1982).

III. The Decisions of the Lower Courts

The United States District Court for the Western District of Oklahoma[16] ruled in favor of Philadelphia Gear on all issues dealing with deposit insurance and in favor of the FDIC as receiver on the question of the total value of the letter of credit.[17] Both sides appealed to the United States Court of Appeals for the Tenth Circuit.

The Tenth Circuit addressed whether the standby letter of credit was a deposit within the meaning of 12 U.S.C. § 1813(l)(1).[18] The FDIC made two arguments to support a finding that it was not. First, the FDIC argued that Orion's promissory note was nonnegotiable and therefore of no value to the holder:[19] Orion had advanced no money on the promissory note to Penn Square; the promissory note did not represent an unconditional obligation to pay the face amount; and Penn Square could not obtain value from the note by offsetting it against Orion's other obligations, by selling it for approximately face value, or by accelerating it because the note was contingent.[20]

The Tenth Circuit disagreed. It held that negotiability, and ultimately value, "must be determined from the face of the instrument without regard to extraneous agreements."[21] Accordingly, the court tested for negotiability by looking at the face of the note only. The face of the promissory note contained merely "standard terms." Although the court acknowledged the understanding between Orion and Penn Square and recognized that no money had been advanced, it found that the note was negotiable on its face.

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16. 587 F. Supp. 294 (W.D. Okla. 1984), *aff'd in part, rev'd in part*, 751 F.2d 1131 (10th Cir. 1984), *rev'd*, 106 S. Ct. 1931 (1986).

17. Because the face of the letter of credit was ambiguous, the district court valued the letter at $145,200 rather than the larger sum (over $700,000) that Philadelphia Gear requested. *Id.* at 299.

18. The court of appeals decided two collateral issues. First, the court held that Philadelphia Gear could be considered the depositor entitled to receive deposit insurance proceeds. Second, it held that the district court erred in awarding Philadelphia Gear prejudgment interest from the FDIC in its capacity as insurer on the $100,000 deposit insurance proceeds and from the FDIC in its capacity as receiver on the delayed dividend for the excess. *Philadelphia Gear*, 751 F.2d at 1133.

19. The Uniform Commercial Code requires that "[a]ny writing to be a negotiable instrument within this Article must . . . contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article." U.C.C. § 3-104(1)(b) (1978). The FDIC argued that the note was nonnegotiable because payment on it was conditioned on Philadelphia Gear's presentation of the appropriate documents.

20. 751 F.2d at 1134.

21. *Id.* The court relied principally on a section of the Uniform Commercial Code which provides that "a promise or order is not unconditional if the instrument . . . states that it is subject to or governed by any other agreement." U.C.C. § 3-105(2)(a) (1978); OKLA. STAT. ANN. tit. 12a, § 3-105(2)(a) (1963).

Second, the FDIC asserted that the letter of credit was not one on which Penn Square was "primarily" liable. It believed that the "language in [section] 1813(l)(1) referring to letters of credit on which the bank is primarily liable was intended to refer only to commercial letters"[22] and highlighted the differences between commercial letters of credit and standby letters of credit.[23] The Tenth Circuit, however, was unpersuaded.[24] In an opinion by Judge Logan, the court of appeals held that "the transaction qualified as one in which 'money or its equivalent' was issued in exchange for a promissory note."[25] As a result, Philadelphia Gear was entitled to deposit insurance protection, pursuant to 12 U.S.C. § 1813(m), up to the $100,000 maximum limit generally insured by the FDIC for any single depositor at a given bank. The FDIC appealed.

IV. THE DECISION OF THE SUPREME COURT

The Supreme Court granted certiorari to decide whether the fed-

22. 751 F.2d at 1135.

23. The FDIC noted the similarity between a standby letter of credit and a guarantee of an account party's performance. In both situations a bank's obligation arises only if the account party defaults on the underlying contract. The FDIC argued that because banks are not empowered to act as a surety or guarantor of another party's debts, they should likewise be prevented from issuing standby letters of credit. *Id.* at 1136 (construing 12 U.S.C. § 24 (1982)). The court disagreed. It noted that the FDIC had argued in diametric opposition to this contention in previous litigation. In addition, a regulation promulgated by the Comptroller of the Currency expressly contradicted the FDIC's argument. *See* 12 C.F.R. § 7.7016 (1986). Finally, the court noted that a guarantor, unlike an issuer of a standby letter of credit, is able to assert "real defenses." *Id.*; *see supra* note 4.

The FDIC also contended that standby letters of credit are excluded from the scope of 12 U.S.C. § 1813. Its argument is as follows: Congress established an explicit assessment formula to determine the amount each member bank must contribute to the insurance fund; premiums are assessed relative to the amount of bank liabilities that would be absolutely due and owing upon the bank's failure, 12 U.S.C. § 1817 (1982); a bank's liability under a standby letter of credit is contingent on the account party's default on an underlying contract with the beneficiary of the letter of credit; and Congress did not intend the FDIC to evaluate the risk associated with such contingent obligations. The court, however, was unpersuaded. It noted that subsection 4 of section 1817 addresses the obligation of member banks to report their total liability in deposits, and explicitly refers to section 1813(l) for the definition of deposit. *See* 12 U.S.C. § 1817(4) (1982). Section 1813 (l)(1)'s definition of a deposit includes "a letter of credit . . . on which the bank is primarily liable." 12 U.S.C. § 1813(l)(1) (1982).

Finally, the FDIC claimed that its interpretation was entitled to substantial deference, absent compelling indications it was wrong, because it had been responsible for drafting significant portions of the statute and had been charged with administering it. 751 F.2d at 1135. The Tenth Circuit, however, found no evidence to indicate that Congress delegated authority to the FDIC to refine the definition of deposit. *Id.* Nor had the FDIC acted as if it possessed such authority. *Id.* The court held that the FDIC's interpretation did not represent the "thoroughness, validity and consistency" required for deference under Red Lion Broadcasting Co. v. F.C.C., 395 U.S. 367 (1969).

24. *Phildelphia Gear,* 751 F.2d at 1135.

25. *Id.*

eral deposit insurance program insured a standby letter of credit backed by a contingent promissory note as a "deposit." The Court reversed, holding that a standby letter of credit backed by a contingent promissory note did not constitute an insured deposit.[26]

The Court's opinion, authored by Justice O'Connor, presented a two-pronged rationale to support its decision. First, the Court deferred to the FDIC's longstanding federal interpretation of the terms "letter of credit" and "promissory note" as used in the deposit statute. Second, the Court relied on a theory best described as "entrustment theory."

A. *The FDIC's Interpretation*

The Supreme Court acknowledged the court of appeals' reliance on state law, specifically the Uniform Commercial Code, but opted for a federal interpretation of the statutory terms. The Court stated that "while the note here may have been labeled a promissory note on its face and may have been a promissory note under state law, it was not a promissory note for purposes of the federal law set forth in 12 U.S.C. § 1813(l)(1)."[27] In defining section 1813(l)(1), the Court deferred to the FDIC's "consistent interpretation" of the statute. The FDIC's view, that section 1813(l)(1) does not include standby letters of credit, is detailed below.

Pursuant to the Banking Act of 1935, the FDIC promulgated Regulation I, the precursor to secton 1813(l)(1).[28] In all relevant aspects, Regulation I was identical to section 1813(l)(1) as it exists today.[29] Although, like section 1813(l)(1), Regulation I did not "in terms" specifically exclude standby letters of credit, the FDIC contended that it has consistently, although informally, avoided treating standby letters backed by contingent notes as deposits.[30]

The FDIC, for example has never required the payment of insur-

26. 106 S. Ct. 1931 (1986).

27. *Id.* at 1934 (citing First Nat'l Bank v. Dickinson, 396 U.S. 122, 133-34 (1969) (federal law governs the definition of branch banking under the McFadden Act); D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447, 456 (1942) (liability on a promissory note acquired by the FDIC is a federal question)).

28. Banking Act of 1935, Pub. L. No. 74-305, ch. 614, 49 Stat. 684-87 (1935) (codified as amended in scattered sections of 12 U.S.C.).

29. 12 C.F.R. §§ 301, 301.1(d) (1939). The Banking Act of 1935 explicitly authorized the FDIC to supplement the statutory definition. In the same year, the FDIC enacted Regulation I and provided that a letter of credit could represent a deposit. *Id.* In 1960, Congress incorporated the language from Regulation I into section 1813. *See* Federal Deposit Insurance Act, amendment, Pub. L. No. 86-671, 74 Stat. 546 (1960) (codified at 12 U.S.C. § 1813(l) (1982)).

30. Brief for Petitioner at 24, FDIC v. Philadelphia Gear Corp., 106 S. Ct. 1931 (1986) (No. 84-1972).

ance premiums on these letters of credit.[31] In addition, the FDIC has never paid any insurance claims made on such letters.[32] Shortly after Regulation I was implemented, an FDIC official undertook to explain the meaning and effect of the provision. In a discussion directed to banking officials and auditors, the official stated:

> If your letter of credit is issued by a charge against a depositor's account or for cash and the letter of credit is reflected on your books as a liability, you do have a deposit liability. If, on the other hand, you merely extend a line of credit to your customer, you will only show a contingent liablility on your books. In that event no deposit liability has been created.[33]

Congress tacitly endorsed the FDIC's consistent treatment of standby letters of credit. In 1950, when Congress revamped the federal deposit insurance program, it left Regulation I intact.[34] And, in 1960, Congress lifted language from Regulation I involving letters of credit and promissory notes and placed it directly into what is now section 1813(l)(1). It seems that Congress was aware of the FDIC's general regulatory approach before enactment of the 1960 amendments,[35] and nothing in the legislative history of the 1960 amendments suggests Congressional dissatisfaction with, or an intent to depart from, the FDIC's approach.

Most recently, Congress enacted the Deficit Reduction Act of 1984 (DEFRA).[36] One of the provisions within the Act, 26 U.S.C. § 103(h)(1),(2),(3)(d) provides that "[a]n obligation [i.e. an industrial revenue bond] shall not be treated as [tax exempt] if such obligation is federally guaranteed,"[37] and that "an obligation . . . shall not be treated as federally guaranteed merely by reason of the fact that the proceeds of such issue are used in making loans to a financial institu-

31. *Id.*

32. *Id.* This may be due to the fact that the FDIC has never been presented with such claims.

33. FDIC v. Irving Trust Co., 137 F. Supp. 145, 161 (S.D.N.Y. 1955) (quoting Transcript of notes taken at a meeting of the New York Bank Auditors and Comptrollers Conference 25-26 (Sept. 27-28, 1935)).

34. *See* The Federal Deposit Insurance Act of 1950, Pub. L. No. 81-797, 64 Stat. 873 (codified as amended in scattered sections of 12 U.S.C.).

35. Brief for Petitioner at 25, FDIC v. Philadelphia Gear Corp., 106 S. Ct. 1931 (1986) (No. 84-1972) (citing *Federal Deposit Insurance Assessment: Hearings on H.R. 12465 Before the Senate Comm. on Banking and Currency*, 86th Cong., 2d Sess. 50 (1960) (statement of William G. Loeffler); *Federal Deposit Insurance Assessment: Hearings on H.R. 8916 and H.R. 8928 Before the Subcomm. of the House Comm. on Banking and Currency*, 86th Cong., 2d Sess. 112-13 (1960) (statement of Roy L. Coburn)).

36. The Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984) (codified as amended in scattered sections of 26 U.S.C.).

37. 26 U.S.C.A. § 103(h)(1), (2) (West 1984).

tion or there is a guarantee by a financial institution."[38] Both the House of Representatives[39] and the Joint Committee on Taxation[40] issued statements indicating their belief that a letter of credit exemplified a financial instrument issued by a financial intermediary that would not destroy an obligation's tax-exempt status. The implication is that a letter of credit is not federally guaranteed, i.e., not backed by federal deposit insurance protection. Consequently, DEFRA solidified the FDIC interpretation that a standby letter backed by a contingent note is not a "deposit." From this legislative history, the Court gleaned a distinction between contingent notes and noncontingent notes. This distinction formed the basis of the Court's second rationale in *Philadelphia Gear*, entrustment theory.

B. *Development of Entrustment Theory*

The FDIC and the deposit insurance protection program were created shortly after the great depression as a means to restore public confidence in the banking system.[41] The amount of bank failures during that period led to massive bank runs that culminated in President Roosevelt declaring a national bank holiday on March 6, 1933. As a result, Congress passed legislation creating deposit insurance. The insurance program set out to protect "hard earnings" that individuals and businesses entrusted to banks.[42] Congress sought to ensure that someone who placed tangible, valuable assets in a bank would not lose them if the bank became insolvent.[43] Accordingly, deposit insurance protection is triggered only when necessary to "prevent the destruction of deposits because of bank failure and to protect depositors against loss."[44] Protection is granted only to a "customer who [entrusts] his own funds to the bank and risks their total or partial

38. *Id.* The purpose of the change was to prevent obligations such as municipal bonds from receiving a double federal subsidy: deposit insurance protection and tax exemption. *See* H.R. REP. No. 432, 98th Cong., 2d Sess., pt. 2a, at 1684-85, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 697, 1306-07.

39. H.R. REP. No. 432, 98th Cong., 2d Sess., pt. 2a, at 1690, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 697, 1313.

40. JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D. SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 941 (Comm. Print 1984) (obligations are not treated as federally guaranteed merely because a financial institution guarantees repayment of the loans other than by means of federal deposit insurance (e.g., by a letter of credit)).

41. *See generally* S. REP. No. 77, 73d Cong., 1st Sess. 5-6, 12-13 (1933).

42. 77 Cong. Rec. 5862 (1933) (statement of Sen. Vandenberg).

43. *Philadelphia Gear*, 106 S. Ct. at 1936-37.

44. S. REP. No. 1821, 86th Cong., 2d Sess. 1, *reprinted in* 1960 U.S. CODE CONG. & ADMIN. NEWS 3234.

loss if the bank should suspend operations."[45]

In *Philadelphia Gear*, the Supreme Court found that Orion did not entrust any tangible and valuable assets to Penn Square. In reaching this conclusion, the Court stated:

> Orion [did not] surrender any assets unconditionally to the bank. The bank did not credit any account of Orion's in exchange for the promissory note, and did not treat its own assets as increased by its acceptance of the note. The bank could not have collected on the note from Orion unless Philadelphia Gear presented the unpaid invoices and a draft on the letter of credit. In the absence of a presentation by Philadephia Gear of the unpaid invoices, the promissory note was a wholly contingent promise and when Penn Square went into receivership, neither Orion nor Philadelphia Gear had lost anything except the ability to use Penn Square to reduce Philadelphia Gear's risk that [it] would go unpaid for a delivery of goods to Orion.[46]

The Court did not believe that granting deposit insurance protection to a contingent note would further the purpose of the deposit statute.[47]

The Court's language arguably implied, however, that a noncontingent note would satisfy the deposit statute.[48] The authors do not accept this implication unconditionally. A "commercial" letter of credit, where the account party unconditionally entrusts the bank with funds before the bank will issue the letter, would clearly justify this conclusion. But as will be discussed below, this implication—that a noncontingent note backing even a standby letter of credit creates the type of entrustment Congress sought to protect—is not clear cut.

V. THE EFFECT OF *Philadelphia Gear* ON THE MARKETPLACE

The Supreme Court's opinion made no reference to the tremendous effect a contrary decision would have had on both the banking industry and the industrial development bond market. This might be attributable to the fact that the Court decided to reverse and thus found such a discussion unnecessary. Blatantly omitting recognition of threatening consequences, however, causes speculation as to how much influence these consequences actually had on the decision. It

45. FDIC v. Irving Trust Co., 137 F. Supp. 145, 162 (S.D.N.Y. 1955).

46. *Philadelphia Gear*, 106 S. Ct. at 1936-37.

47. *Id.* at 1939.

48. The Supreme Court explicitly referred to the FDIC's concession that deposit insurance extends to a letter of credit backed by an uncontingent note. The Court quoted the remarks made by Mr. Charles Rothfeld, Assistant to the Solicitor General, at oral argument: "If this note were a fully uncontingent negotiable note that were not limited by any side agreements, it would be a note backing a letter of credit within the meaning of the statute." *Id.*

was widely recognized that a decision to affirm the Tenth Circuit's decision would cause the transmografication of a diverse set of economic interests. The authors contend that the Supreme Court's decision was somewhat tempered by the economic consequences involved and later draw support for this contention through an analysis of the Court's opinion.

A finding that deposit insurance protects standby letters of credit backed by contingent promissory notes would have had a strong impact on the banking industry. There are approximately 120 billion dollars in outstanding standby letters of credit backed by promissory notes.[49] Treating such letters as deposits would result in a significant increase in the total amount of domestic deposits held by FDIC member banks.[50] This places an immediate financial strain on banks. While these notes, would be treated technically as deposits—thereby requiring banks to pay additional premiums for FDIC insurance[51]—these contingent notes do not give the banks any additional cash on hand. So, the effect would be to increase the cost of issuing a standby letter of credit thereby putting domestic intermediaries at a competitive disadvantage with foreign or noninsured institutions. Alternatively, banks may not be able to meet these premium requirements. As a result, the ratio of the FDIC's insurance fund to total deposits outstanding would decrease beyond its already dangerously low level.[52] This possibility is particularly worrisome because the potential for widespread bank failure is already an uncomfortable reality.[53]

Industrial development bonds would also have been impaired. These bonds are exempt from federal taxation unless backed or guar-

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49. The FDIC provided this estimate to the Solicitor General prior to oral argument. The agency derived the estimate from its annual reports and published statistics on banking, and from reports that banking institutions submitted to the FDIC. Brief for Petitioner at 28 n.22, FDIC v. Philadelphia Gear Corp., 106 S. Ct. 1931 (1986) (No. 84-1972).

50. The increase would be approximately 8% of the current domestic deposits held by FDIC member banks. *Id.*

51. The FDIC requires each member bank to contribute a premium of 1/12 of 1% of its total deposits to the insurance fund. 12 U.S.C. § 1817(b) (1982). Moreover, carrying these additional standby letters of credit on the books as deposits will increase banks' assets. Accordingly, the FDIC will impose additional capital requirements. Brief for Petitioner at 29, FDIC v. Philadelphia Gear Corp., 106 S. Ct. 1931 (1986) (No. 84-1972).

52. Pursuant to 12 U.S.C. § 1817(g), the FDIC has the discretionary authority to collect assessments for the preceeding five year period. The FDIC suggested that this could make member banks liable for a one-time assessment of close to 400 million dollars. Brief for Petitioner at 28, FDIC v. Philadelphia Gear Corp, 106 S. Ct. 1931 (1986) (No. 84-1972) (citing 12 U.S.C. § 1817(g) (1982)).

53. The FDIC reports that from 1982 through November 1985 there were 287 bank failures. Brief for Petitioner at 28 n.23, FDIC v. Philadelphia Gear Corp, 106 S. Ct. 1931 (1986) (No. 84-1972).

anteed by the federal government.[54] Included in this category of bonds are various municipal bonds, issued by state, city or local governments to generate revenue for, among other things, public works projects.[55] Billions of dollars worth of these municipal bonds are backed by standby letters of credit. If standby letters of credit were federally insured, these municipal bonds would also be indirectly federally guaranteed. As a result, municipal bonds would lose their tax exempt status. The effect would be to destroy the economic expectation of both the investor and the issuer and to ignore the scheme Congress created by passing DEFRA.

In an attempt to temper a significant blow to the industrial development bond market and quiet fears of those employed in related areas, the Internal Revenue Service made clear that it would "grandfather" in all affected bond transactions completed within the first 120 days following an affirmance by the Supreme Court.[56] Notwithstanding action by the IRS, there would be a significant "chilling" effect on projects under development within the 120 day period. And subsequent projects dependent upon municipal bond offerings would have to be restructured or scrapped.

VI. Critical Examination of the Court's Analysis

A. *Conflict Between State and Federal Law*

As a threshold matter, the Supreme Court in *Philadelphia Gear* addressed whether state (i.e., the UCC) or federal law applied in determining the character of the promissory note at issue. The Court quickly dispensed with this issue. The Court cited *D'Oench, Duhme & Co. v. FDIC*[57] and *First National Bank v. Dickinson*[58] for the proposition that the term "promissory notes," as used in the federal

54. The Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of 26 U.S.C.).

55. Tax exempt municipal bonds are particularly attractive as an investment option to persons whose income places them in a high tax bracket. The interest income from these bonds is shielded from federal taxation. The interest payments, however, are commonly less than interest payments generated by other obligations of similar risk. Consequently, investors in these bonds accept a tradeoff: lower yield on investment for tax avoidance on interest income.

Issuers find municipal bonds equally atttractive because of the lower interest rate. The interest rate represents the issuer's cost of borrowing money from the investor. Therefore, a lower interest rate makes a particular project more affordable. Economically speaking, the only loser in a municipal bond transaction, assuming successful completion of the underlying project, is the federal government. It loses revenue that would otherwise be generated by taxing the interest income.

56. *See* I.R.S. News Release IR-85-113 (Nov. 7, 1985).

57. 315 U.S. 447 (1942) (holding that liability on a promissory note acquired by the FDIC is a federal question).

deposit statute, has a federal definition. In doing so, the Court completely ignored the application of the UCC, a source lower courts, including those in *Philadelphia Gear,* relied upon.[59] The Court's "choice of law" analysis, however, was incomplete. The Court itself has developed a two-prong analysis to determine the applicable law and the appropriate sources of law that give content to the applicable law. The Court's blanket assertion that federal law applies erroneously implies that the UCC would never have a bearing on questions of federal law. This implication is an erroneous and dangerous precedent.

The two-prong test of *United States v. Kimbell Foods, Inc.*[60] is instructive in determining what the proper source of law is in a particular case: "We must decide first whether federal or state law governs the controversies; and second, if federal law applies, whether this Court should fashion a uniform [federal] rule or incorporate state commercial law."[61]

Under the first prong, the Supreme Court "has consistently held that federal law governs questions involving the rights of the United States arising under nationwide federal programs."[62] In *Kimbell Foods,* the Court found that if the federal agencies under scrutiny "derived their authority to effectuate loan transactions from specific Acts of Congress passed in the exercise of a 'constitutional function or

58. 396 U.S. 122 (1969) (holding that federal law governs the definition of branch banking under the McFadden Act).

59. The court in Allen v. FDIC, 599 F. Supp. 104 (E.D. Tenn. 1984), addressed the same issue presented in *Philadelphia Gear*: Whether a contingent obligation could give rise to an insurable deposit. In *Allen,* the court held that although the promissory note was nonnegotiable within the meaning of article 3 of the UCC, it was nevertheless a promissory note, and therefore a "deposit" within section 1813(e)(1). *Allen,* 599 F. Supp. at 107 (citing Fejta v. Werner Enterprises, Inc., 412 So. 2d 155, 158 (La. App.), *cert. denied,* 415 So. 2d 953 (La. 1982); Leroux v. Donphan Retirement Home, Inc., 663 S.W.2d 791 (Mo. App. 1984); Reid v. Cramer, 24 Wash. App. 742, 744, 603 P.2d 851, 852-53 (1979)). The dissent in *Philadelphia Gear* argued, however, that because such a note is nonnegotiable, it is much more plausible to argue that Congress would not have considered it "money or its equivalent." *Philadelphia Gear,* 106 S. Ct. at 1941 (Marshall, J., dissenting). Regardless of the accuracy of the dissent's argument, it is clear that the Tenth Circuit in *Philadelphia Gear* and the court in *Allen* used the UCC in different ways—the note in *Philadelphia Gear* reflected no conditions, while the conditions on Allen's note were reflected on the face of the note—to achieve the same result. Although these conclusions bear unfavorably upon the use of the Code to achieve uniformity in commercial transactions, the courts' use of the UCC as guidance was proper and should not be abandoned in the future—a result that the Supreme Court may encourage because of its analysis in *Philadelphia Gear.*

60. 440 U.S. 715 (1979) (determining whether contractual liens arising from certain federal loan programs take precedence over private liens in the absence of a federal statute setting priorities).

61. *Id.* at 718.

62. *Id.* at 726.

power,' their rights, as well, should derive from a federal source."[63] In *Philadelphia Gear,* the FDIC—with its mandate to oversee the deposit insurance program—may be likened to the federal agencies in *Kimbell Foods* because the FDIC's activities "aris[e] from and bea[r] heavily upon a federal program."[64] In defining the deposit statute, therefore, the *Philadelphia Gear* Court properly turned to federal law for guidance,[65] but failed to engage the second prong of the *Kimbell Foods* test.

The Court's failure to address the second prong is significant because "[c]ontroversies directly affecting the operations of federal programs, although governed by federal law, do not inevitably require resort to uniform rules."[66] Rather, a court must engage in a balancing test to give content to a federal rule:

> Whether to adopt state law or to fashion a nationwide federal rule is a matter of judicial policy "depending 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."
>
> Undoubtedly, federal programs that "by their nature are and must be uniform in character throughout the nation" necessitate formulation of controlling federal rules. . . . Conversely, when there is little need for a nationally uniform body of law, state law may be incorporated as the federal rule of decision. Apart from considerations of uniformity, we must also determine whether application of state law would frustrate specific objectives of the federal programs. If so, we must fashion special rules solicitous of those federal interests. Finally, our choice of law inquiry must consider the extent to which application of a federal rule would disrupt commercial relationships predicated on state law.[67]

Although the Court in *Kimbell Foods* was not directly presented with the issue, federal courts have stated that the UCC is a recognized source of federal law.[68] As such, these courts have used the UCC in

63. *Id.* (quoting Clerfield Trust Co. v. United States, 318 U.S. 363 (1943)).

64. *Id.* (quoting United States v. Little Lake Misere Land Co., 412 U.S. 580, 592 (1973)).

65. The Court in *Philadelphia Gear* found support for applying federal law in D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447 (1942).

66. *Kimbell Foods,* 440 U.S. at 728-9.

67. *Id.* at 729 (footnotes and citations omitted).

68. *See* United States v. Conrad Pub. Co., 589 F.2d 949, 953 (8th Cir. 1978) ("The UCC has become the source of general commercial law . . . . [It] has become the source of federal common law in the area of commercial transactions."); United States v. Crittenden, 563 F.2d 678 (5th Cir. 1977); United States v. Hext, 444 F.2d 804 (5th Cir. 1971). By way of footnote, the *Hext* court stated that the UCC was on its way to becoming a "truly national law of commerce," *Hext,* 444 F.2d at 810 n.19 (quoting United States v. Wegematic, 360 F.2d 674, 676 (2d Cir. 1966) (Friendly, J.)), and is a "major influence on the development of common

adjudging commercial issues of law where its use would not frustrate the purpose of the federal program involved.[69]

The Court in *Philadelphia Gear* did not remain faithful to the mode of analysis set forth in *Kimbell Foods.* If the Court had explored the possible application of the UCC to the circumstances of *Philadelphia Gear,* it would have discovered that use of the UCC would frustrate the purpose of federal deposit insurance. Instead, the Court's blanket assertion in *Philadelphia Gear* that the deposit statute is defined by federal law may erroneously signal to the courts that the UCC should not be used in giving content to federal law.

B. *The Court's Basis for Deferring to the FDIC's Interpretation of the Deposit Statute*

The Supreme Court in *Philadelphia Gear* concluded that the

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law in the federal courts to govern cases involving government contracts and other *commercial transactions. Id.* at 810 n.17 (quoting Traynor, *Statutes Revolving in Common-Law Orbits,* 17 CATH. U.L. REV. 401, 420 (1968)); *see also* Allen v. FDIC, 599 F. Supp. 104, 107 (E.D. Tenn. 1984).

69. In United States v. Conrad Publishing Co., the United States brought suit to collect the balance due on a promissory note given by the Conrad Publishing Company and subsequently assigned to the Small Business Association. 589 F.2d 949 (8th Cir. 1978). In determining whether to use the UCC in giving content to the applicable federal rule, the court stated that the "applicable provisions of the UCC did not display any aberrational features that would defeat a legitimate federal interest and that would necessitate our resorting to federal common law." *Id.* at 953. In United States v. Crittenden, the court stated that:

> While the Code generally should be used to supply the content of the federal common law rules governing suits arising from FHA transactions, in fashioning a federal rule specific Code language and judicial interpretations need not be followed if the federal courts deem them contrary to the weight of authority, inconsistent with FHA operations, or undesirable as precedent.

563 F.2d 678, 690 n.19 (5th Cir. 1978). The *Crittenden* court adopted the test for using the UCC as a source of federal common law from United States v. Hext, 444 F.2d 804 (5th Cir. 1971).

The court also applied the *Hext* test in Allen v. FDIC, 599 F. Supp. 104 (E.D. Tenn. 1984), a case factually similar to *Philadelphia Gear.* While the *Allen* court may have satisfied the first prong of the *Hext* test in that the UCC interpretation was reflective of the weight of authority, it clearly did not meet the second prong because the UCC definition of promissory notes is not consistent with the purpose of federal deposit insurance—the protection of hard assets. The *Allen* court's opinion that the UCC definition is consistent with the federal statute because it instills confidence in the commercial banking system may be an unwarranted confidence—one that would allow the "depositor" to become risk-neutral in placing funds into commercial deals and not into the vaults of the bank. *See Allen,* 599 F. Supp. at 108. The FDIC was not created to insure commercial risks. Reduced to its essentials, Philadelphia Gear would have the courts insulate sellers from the evils of the marketplace by affording them deposit insurance protection. Viewed in this light, the holding in *Philadelphia Gear* is not unfair to sellers. Their after-the-fact remedy for commercial losses is a function of their success as creditors in bankruptcy proceedings; their before-the-fact remedy is a function of their success at adjusting the price of the goods sold to reflect the potential risks involved in the deal.

FDIC's position that unfunded letters of credit are not deposits was longstanding and consistent.[70] This finding was a critical step in the Court's ultimate conclusion because it allowed the Court to defer to the FDIC's interpretation of what constitutes a deposit. "When the statute giving rise to the longstanding interpretation has been reenacted without pertinent change, the Congressional failure to revise or repeal the agency's interpretation is pervasive evidence that the interpretation is the one intended by Congress.[71] Because the Court believed that the FDIC was the proper rulemaking authority in the instant matter, the Court felt it could judicially recognize the FDIC's view without impermissibly intruding into the congressional sphere of authority.

Characterization of the FDIC's interpretation of the deposit statute as longstanding and consistent, however, is tenuous. Moreover, even if one were to acknowledge that the FDIC interpretation is longstanding, deference in *Philadelphia Gear* was improper in light of standards that the Court previously enunciated to determine the propriety of deferring to an executive agency. It may be, however, that the Court created a new standard for deferring to an executive agency's views. Given the unique set of circumstances in *Philadelphia Gear*, it is difficult to predict what combination of facts will similarly persuade a Court to defer to an executive agency's statutory interpretation in the future.

The Court's own dicta appears to support the claim that the FDIC's interpretation of the deposit statute is not longstanding. The Court, in scrutinizing the legislative history of the deposit statute, concluded that no distinction between funded and unfunded letters of credit could be gleaned.[72] Because the issue of whether the FDIC's interpretation is longstanding is inextricably tied to the standards for determining deference, the Court's creation of a lower deference threshold clears up any perceived inconsistency in the Court's conclusion that the FDIC interpretation is longstanding. That is, the Court could support the FDIC's interpretation without regard to the legislative history of the deposit statute by scrutinizing the FDIC's *behavior* over the last fifty years.

The linchpin of the Court's decision to defer to the FDIC was *Chevron U.S.A. Inc. v. National Resources Defense Council Inc.*[73] The Court cited *Chevron U.S.A.* for the proposition that "*in the circum-*

70. *Philadelphia Gear*, 106 S. Ct. at 1937.
71. *Id.* (quoting NLRB v. Bell Aerospace, 416 U.S. 267, 275 (1974)).
72. *Id.* at 1936-37.
73. 467 U.S. 837 (1984).

stances of this case 'considerable weight . . . should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer.' "[74] Although we are not told what "circumstances in" *Philadelphia Gear* triggered the use of the *Chevron U.S.A.* test, it is clear that the facts in *Philadelphia Gear* should not have triggered such application. In *Chevron U.S.A.*, the Court stated that deference "is particularly justified if Congress has *explicitly* left a gap for the agency to fill as then 'there is an *express delegation* of authority to the agency to elucidate a specific provision of the statute by regulation.' "[75] With respect to the deposit statute at issue in *Philadelphia Gear*, Congress did not expressly delgate any authority to the FDIC.[76] Thus, the Court applied the *Chevron U.S.A.* test under a lower threshold then previously allowed. It was important for the Court to develop this new threshold because deference would not have been appropriate under previous Supreme Court standards.

Under *United States. v. Rutherford*,[77] "once an agency's statutory construction has been '*fully brought to the attention of the public and the Congress*,' and the latter has not sought to alter that interpretation although it has amended the statute in other respects, then presumably the legislative intent has been correctly discerned."[78] As noted above,[79] the FDIC has never distinguished between funded and unfunded letters of credit.[80] For this reason, the FDIC's statutory interpretation has not been fully brought to the attention of the public and Congress. The Court's decision to defer to the FDIC was, there-

74. *Philadelphia Gear*, 106 S. Ct. at 1938-39 (emphasis added).

75. *Chevron U.S.A.*, 467 U.S. at 843-44 (emphasis added).

76. In fact, the FDIC only cited 12 U.S.C § 1813(l)(5) for the proposition that Congress delegated a power of interpretation to the agency. Section 1813(l)(5) provides that the FDIC may define a deposit for "such *other* obligations of a bank as the Board of Directors, after consultation with the Comptroller of the Currency and the Board of Governors of the Federal Rerserve System, shall find and prescribe by regulation to be deposit liabilities by general usage." 12 U.S.C. § 1813(l)(5) (1982) (emphasis added).

This provision only grants power to the FDIC to define "other obligations" not enumerated in section 1813(l)(1)-(4). The provision is a catch-all provision. It does not, however, grant to the FDIC a power of interpretation for section 1813(l)(1). Indeed, because Congress expressly granted the FDIC such power under 1813(l)(5), Congress's silence with regard to section 1813(l)(1) indicates its desire not to grant the FDIC such power under that section. Against this backdrop of legislative history, the Supreme Court's creation of a lower deference threshold—one that focuses on an agency's behavior—is significant.

77. 442 U.S. 544 (1979).

78. *Id.* at 554 (emphasis added).

79. *See supra* note 1 and accompanying text.

80. *See Philadelphia Gear*, 106 S. Ct. at 1936 ("The reports on the 1935 amendments presented the definition of 'deposits' without any specific comment. . . . The legislative history of the 1950 amendments is similarly unhelpful. . . . The Committee Reports on the 1960 amendments likewise give no indication that the amendments' phrasing was meant to effect any fundamental changes in the definition of deposit. . . .").

fore, improper under *Rutherford*. The case of *Securities and Exchange Commission v. Sloan*[81] is also instructive on this point.

In *Sloan*, the SEC had issued a series of conservative ten-day orders suspending trading in the common stock of a corporation. As did the FDIC in *Philadelphia Gear*, the SEC claimed that its construction of the statute was entitled to deference, as it had administered the statute and made its views known to Congress. The Supreme Court rejected the SEC's claim, stating:

> Here the administrators, so far as we are advised, made no reference at all to their present construction of Section 12(k) to the Congress which drafted the "enabling legislation" here in question—the Securities Exchange Act of 1934. They made known to at least one committee their subsequent construction of that section 29 years later, at a time when the attention of the Committee and of the Congress was focused on issues not directly related to the one presently before the court. . . . We are extremely hesitant to presume general congressional awareness of the Commission's construction based only upon a few isolated statements in the thousands of pages of legislative documents. That language in a Committee Report, without additional indication of more widespread congressional awareness, is simply not sufficient to invoke the presumption in a case such as this.[82]

Because the legislative history more strongly supported the SEC's contentions in *Sloan*, the Court's rejection of the deference argument should have applied with equal force in *Philadelphia Gear*.

Moreover, the Court in *Skidmore v. Swift & Co.*[83] enunciated specific standards under which an agency's construction may be credited: The weight of such an agency judgment in a particular case will depend upon the *thoroughness* evident in its consideration, the *validity* of its reasoning, its *consistency* with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.[84] Under the *Skidmore* test, the *Philadelphia Gear* Court's deference to the FDIC was improper.[85]

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81. 436 U.S. 103 (1978).
82. *Id.* at 120-21.
83. 323 U.S. 134 (1934).
84. *Id.* at 140.
85. One of the prongs of the *Skidmore* standard requires that the agency *consistently* advance its statutory construction approach. On this point, the Court did not acknowledge Philadelphia Gear's argument that "the [FDIC's] position before the Court [was] at odds with its earlier affirmative statements on the issue, both in the instant case and in its posted regulations. Before the district court, the FDIC made no claim of any longstanding administrative interpretation; before the court of appeals, it maintained that it has consistently excluded *all* standby letters of credit from deposit insurance coverage, [and] not merely 'unfunded' standby letters as it now claims." Brief for Respondent at 29, FDIC v.

The Court in *Philadelphia Gear* was unable to find support in the legislative history of the deposit statute for the FDIC's statutory interpretation. Not surprisingly, the Court could not find support for its deference to the FDIC in previous cases either.[86] Yet, the Court still deferred to the FDIC. The Court claimed that although there was no "express regulation excluding a standby letter of credit backed by a contingent promissory note from the definition of 'deposit' in 12 U.S.C. § 1813(l)(1), that *exclusion* by the FDIC is nonetheless long-

Philadelphia Gear Corp., 106 S. Ct. 1931 (1986) (No. 84-1972) (citing Brief of FDIC in its Corporate Capacity Before the Court of Appeals for the Tenth Circuit at 6, FDIC v. Philadelphia Gear Corp., 751 F.2d 1131 (10th Cir. 1984) (Nos. 84-1901, 84-2007)).

Securities Industry Association v. Federal Reserve Board, 104 S. Ct. 2983 (1985), appears to support Philadelphia Gear's position that the FDIC's statement "strongly counsels against deferring to the FDIC." Brief for Respondent at 30, FDIC v. Philadelphia Gear Corp., 106 S. Ct. 1931 (1986) (No. 84-1972). In *Securities Industry Association*, the Federal Reserve Board changed the statutory construction argument that it had adopted during administrative hearings. The Court stated: "[t]o the extent that the Board has changed its position from that adopted at the administrative level, its interpretation is *entitled to less weight*." 104 S. Ct. at 2983-84 (emphasis added). Of course, the *Philadelphia Gear* Court could still have deferred to the FDIC under *Securities Industry Association* because inconsistent statutory construction arguments are only "entitled to *less* weight."

86. In addition to *Rutherford* and *Skidmore*, the FDIC cited to 12 U.S.C. §§ 1813 (l)(5), 1819 Tenth, and 12 C.F.R. § 330 to support its contention that Congress has "plainly indicated that the FDIC's interpretation of Section 1813 must be accorded great deference." Brief for Petitioner at 22, FDIC v. Philadelphia Gear Corp., 106 S. Ct. 1931 (1986) (No. 84-1972). The FDIC's reliance on these statutes and regulations, however, was misplaced. Section 1813 (l)(5) defines deposits as:

> such other obligations of a bank as the Board of Directors, after consultation with the Comptroller of the Currency and the Board of Governors of the Federal Reserve System shall find and prescribe by regulation to be deposit liabilities by general usage: *Provided further*, That any obligation of a bank which is payable only at an office of the bank located outside of the States of the United States, the District of Columbia, Puerto Rico, Guam, American Samoa, and the Virgin Islands, shall not be a deposit for any of the purposes of this chapter or be included as part of total deposits for any of the purposes of this chapter or be included as part of the total deposits or of an insured deposit.

12 U.S.C. § 1813(l)(5) (1982). This section merely grants the FDIC the power to *create* new definitions of deposits and does not grant the FDIC power to interpret the meaning of the existing definitions of deposits such as the section 1813 (l)(1) definition at issue in *Philadelphia Gear*.

Similarly, 12 U.S.C. § 1819 Tenth merely grants the FDIC the power to promulgate rules or regulations "as it may deem necessary to carry out the provisions of this chapter or any other law" that the FDIC administers. 12 U.S.C. § 1819 Tenth (1982). Section 1819 Tenth does not grant the FDIC the power to interpret *existing* rules. Moreover, in *Philadelphia Gear* the FDIC was not prescribing a rule or regulation, but was advancing an interpretation of section 1813 (l)(1). As such, the FDIC was not using the proper vehicle to refine the deposit statute.

Finally, 12 C.F.R. § 330 is entitled *Clarification and Definition of Deposit Insurance Coverage*. Although this title would appear to grant the FDIC the authority to clarify and define the deposit statute, nowhere in the section is there mention of any such authority. 12 C.F.R. § 330 (1985).

standing and consistent."[87] Furthermore, the Court went on to note that the FDIC's "contemporaneous understanding" that unfunded letters of credit are not deposits has been fortified by its behavior over the last few decades. Indeed, the FDIC has "never charged deposit insurance premiums on standby letters of credit backed by contingent promissory notes."[88]

As neither legislative history nor case law supported deference to the FDIC, the Court must have created a new standard to determine when to defer to executive agencies. That new standard is a function of all the circumstances of *Philadelphia Gear*. Although the new standard was neither clearly articulated nor expounded upon by the Court, the FDIC's informal, yet apparently consistent treatment of unfunded letters of credit—as evidenced as much through indirect examples as through direct proof—was enough to convince the Court to defer to the FDIC in the instant matter. Given the unique circumstances in *Philadelphia Gear*, courts will be hard-pressed to determine what combination of facts will trigger the use of the Supreme Court's new deference standard.

The Court could characterize the informal practices and beliefs of the FDIC and defer to that viewpoint because it knew that viewpoint was consistent with the legislative purpose of federal deposit insurance. The Court's failure to properly address the deference issue, however, does not mean that the *result* in *Philadelphia Gear* is incorrect. Indeed, the Court properly discerned the legislative purpose of federal deposit insurance and read qualifications into the deposit statute in order to allow modern-day banking practices to remain faithful to the spirit of the statute. The analysis in this Note challenges the Court's mode of analysis, and questions whether the Supreme Court was the proper institution to refine the deposit statute. Notwithstanding such good intentions on the part of the Court vis-a-vis the economic consequences involved, one has to question whether attaining the right result in the case may ultimately have adverse effects on the judicial system. Although the unique circumstances of *Philadelphia Gear* may never occur again, we should look for what creative minds might make of *Philadelphia Gear* in the future.

The *Phildelphia Gear* Court has allowed an executive agency to refine the meaning of a statute through its own informal, independent actions and behavior over a long period of time. By allowing executive agencies to change the thrust of statutes through their own institutional responses, the courts would be creating very powerful,

87. *Philadelphia Gear*, 106 S. Ct. at 1938.
88. *Id.*

decentralized pockets of power.[89]

It would appear, then, that a court's reliance on an agency's *reaction* to a statute—carried out informally and quietly—is not the proper inquiry, especially where the legislative purpose is not easily defined and is useless as a landmark in the deference analysis. In this light, the Supreme Court's *Rutherford* and *Skidmore* standards appear to be the appropriate vehicle for adjudging deference issues and for properly determining a shift in rulemaking authority. While the unusual factual circumstances in *Philadelphia Gear* may have warranted a departure from those standards, such a departure may in the future promote unusual, if not dangerous, results.

C. *Entrustment—Three Commercial Paradigms*

The Court has identified the congressional purpose in promulgating the deposit insurance protection fund as to protect those that entrust funds to a bank.[90] Although the Supreme Court spent considerable time addressing the importance of entrustment, the critical question is what kinds of financial instruments will create entrustment. Whether a letter of credit creates entrustment depends upon the type of entrustment backing the letter of credit.

It is clear from the Supreme Court's opinion that a contingent note does not constitute the entrustment of funds to the issuing bank.[91] But the inquiry into the function of deposit insurance protection is incomplete if analysis is limited to the posture of contingent notes. Unconditional notes must also be analyzed. Effective guidance to those engaging in future standby letter of credit transactions depends on such an analysis because these are the notes that may trigger deposit insurance protection. Because the Supreme Court's opinion did not explicitly address this issue, it is not clear whether an unconditional note automatically triggers deposit insurance protection.

The court of appeals and the FDIC took the same position on this issue. They maintain that execution of an unconditional note creates the requisite entrustment under the deposit statute. As noted, the court of appeals held that because Orion's promissory note was negotiable on its face, it was unconditional and deserved deposit insurance protection. The court's analysis indicated its belief that a finding of

89. *Cf.* I.N.S. v. Chadha, 462 U.S. 919 (1983) (holding unconstitutional a one-house veto of an executive agency's actions). If Congress disagreed with an executive agency's actions, its ability to control those actions might be more difficult in light of *Chadha*.

90. *See supra* notes 38-42 and accompanying text.

91. *Id.*

negotiability automatically triggered deposit insurance protection. It never discussed, or even acknowledged, the possibility that negotiability did not presuppose entrustment. The FDIC takes a corresponding position. While it did not agree that Orion's note was a negotiable instrument, it never disputed, and later conceded, that an unconditional note would have required it to pay Philadelphia Gear from the deposit insurance fund.[92]

It is the contention of the authors that, given the purpose of the deposit statute, entrustment does not exist simply because an unconditional note has been executed. Only "funded" unconditional notes will suffice. In other words, deposit insurance protection should attach only to unconditional notes upon which the bank has received payment. Although the Supreme Court opinion is silent with respect to this issue, the paradigms detailed below lead to the conclusion that the "unconditional" notes referred to in the Court's opinion are promissory notes that have been "funded."

1. THE CONDITIONAL PROMISSORY NOTE

a. Before Buyer's Payment

When a buyer executes a promissory note in favor of a bank, the buyer records the note as a liability on its books. The buyer probably has every intention of making payment on it. Accordingly, the seller has no reason to expect the buyer to default and will not present documents to the bank seeking payment until that time. Consequently, the bank has no reason to demand payment on the note. If the bank becomes insolvent at any time prior to payment on the letter of credit, no entrustment will have occurred. As the bank's payment is contingent on the buyer's default, the buyer therefore will not have entrusted funds to the bank prior to its default on the underlying agreement. No entrustment means no deposit insurance protection.

b. After Buyer's Nonpayment

The buyer may refuse to make payment for reasons other than insolvency. For example, the seller may send nonconforming goods or the buyer may allege that there was fraud in the transaction. When the buyer refuses to pay, the seller will turn to the bank for payment. If the bank is insolvent, it, through a trustee or receiver, will turn to the buyer for payment on the note. If the trustee collects the funds, the funds may or may not be earmarked for the seller. Only if the funds are earmarked for the seller will the seller not seek deposit

92. *See supra* note 45.

insurance. If the bank trustee does not earmark them for the seller, the seller will seek insurance. If the seller seeks deposit insurance the bank would be without funding on the letter of credit during the "gap" period—the period between the time it became insolvent and the time it collected the funds from the buyer. But when the seller initially presents documents to the bank, the buyer will not have entrusted anything of value to the bank. Deposit insurance protection should not be activated by a post-hoc decision by the buyer to complete his contractual obligation. If the buyer defaults because of insolvency, the bank will not collect the funds, and there will be no "gap" period. There will never have been an argument for entrustment. Therefore, the transaction will be beyond the ambit of deposit insurance protection.

2. CASH

Supporting a letter of credit by transferring cash or hard assets to the bank in the amount of the letter is the surest way to satisfy the deposit statute. The question is whether entrustment may occur in the standby letter of credit context when a promissory note backs the letter or whether entrustment is limited to cash transactions.

3. THE UNCONDITIONAL PROMISSORY NOTE

It is true, as the FDIC conceded, that an unconditional note is almost equivalent to having cash or hard assets in hand—the bank is free to transfer the note for value. In addition, the bank can: (1) offset the note against any deposit liabilities it owes the buyer; and (2) attempt to accelerate the note and realize the note's value in cash.

The authors contend that an unconditional note alone, without more, fails to create entrustment of assets within the meaning of the deposit statute. Although transferring the note to a third party for the approximate face value allows the bank to generate cash, it nonetheless fails to constitute an entrustment of funds because the account party has not put any of its assets at risk. If the bank shut its doors after it sold the conditional note, the account party would not lose anything: Nothing ventured, nothing lost, no entrustment.

On the other hand, if the unconditional note was actually accelerated or offset against another liability of the bank to the account party (e.g., a time-deposit), entrustment will have occurred. In these transactions the account party has put its own assets at risk, and putting assets at risk is what Congress intended to protect when it promulgated the deposit statute. An unconditional note, therefore, must be "funded" in some way to create the kind of entrustment identified by Congress in the early 1930's. The extra step—to actually fund—must be taken: The ability to take it, by offsetting or accelerating, is not enough.

VII. CONCLUSION

In *Philadelphia Gear*, the Supreme Court noted that a letter of credit backed by an unconditional promissory note would trigger insurance protection. The Supreme Court's use of the term "unconditional promissory notes" is synonymous with "funded promissory notes." Only in this way could the Court achieve its desire to insure only the hard assets of depositors and remain faithful to the federal deposit insurance statute. The Court's decision illustrates the erroneous assumptions underlying the court of appeals's analysis, namely that negotiability presupposes entrustment. Moreover, it appears that the FDIC got more than it bargained for in *Philadelphia Gear.* The FDIC would have been satisfied with the Supreme Court's explicit holding respecting contingent notes, but also got dicta addressing unconditional notes. In fact, this dicta, as interpreted by the authors, goes beyond the arguments posited by the FDIC.

The Supreme Court's decision staved off potential adverse consequences for various financial markets, but it is ironic that the Court did not clearly state its holding for the benefit of this same audience. The Supreme Court should have told the financial community which transactions are protected by the FDIC and which ones are not. Clearly, this knowledge would help businessmen shape the structure of their letter of credit transactions. As it stands, the Supreme Court's decision may cause needless confusion in the financial markets. Moreover, the *Philadelphia Gear* dissent is correct in recognizing that the decision will force businessmen to bear the difficult task of distinguising between different types of letters of credit when structuring their deals.[93]

What *is* certain is that the Court, in its struggle to narrow the definition of promissory notes, has essentially read this term out of the deposit statute. If one must "fund" the promissory note in order for it to be considered a deposit, there is no need for the promissory note in the first place. This is not to say that unfunded unconditional notes should not, or will, not be used in letter of credit transactions. A legal relationship will still be created between the buyer and the bank. The

93. *Philadelphia Gear*, 106 S. Ct. at 1941 n.2 (Marshall, J., dissenting).

ramification, however, is that the FDIC will not guarantee the commercial transaction through deposit insurance.

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