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Office of Continuing Legal Education at the University of Kentucky College of Law

Debra K. Stamper
Kentucky Bankers Association

Arthur L. Freeman
Kentucky Department of Financial Institutions

Phillip H. Schwartz
Federal Deposit Insurance Corporation

Martha Andes Ziskind
PNC Bank, N.A.

See next page for additional authors

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UNIVERSITY OF KENTUCKY
COLLEGE OF LAW

OFFICE OF CONTINUING LEGAL EDUCATION

Suite 260 Law Building
Lexington, Kentucky 40506-0048
(606) 257-2921 or
(606) 257-CLE1
Facsimile
(606) 323-9790

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Louisville, Kentucky

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Louisville, Kentucky

Martha A. Ziskind
PNC Bank, N.A.
Louisville, Kentucky

18th Annual Conference
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LEGAL ISSUES FOR FINANCIAL INSTITUTIONS

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1998 KENTUCKY LEGISLATIVE DEVELOPMENTS

AFFECTING FINANCIAL INSTITUTIONS

Debra K. Stamper
Kentucky Bankers Association
Louisville, Kentucky

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SECTION A
I. Introduction. The materials included in this topic were accumulated as of March 31, 1998, and based upon bills introduced in the Kentucky 1998 General Session. We will attempt to provide you with any changes made after March 31 at the conference. The bills summarized in this topic include issues of particular interest to financial institutions doing business in the Commonwealth of Kentucky and do not include bills that are not expected to pass. Most of the bills cited in this outline are provided as an attachment, in numerical order with Senate bills appearing first. If you need copies of those bills not attached, please contact Debra Stamper at 800-392-4045.

II. Chapter 287 (HB516)-Signed by the Governor on March 27, 1998. This is essentially a clean-up bill for the Department of Financial Institutions. It makes a number of changes that bring KRS Chapter 287 into conformance with Department practice and a few substantive changes. A few of the more notable, substantive changes are as follows:

- Includes savings and loan associations in the definition of “national bank.”
- Requires a multiple branch state or national bank to use the same name for all branches located in Kentucky.
- Deletes the requirement that a bank director own capital stock in the bank.
- Modifies capital minimums.
- Reduces the required meeting frequency of advisory boards of combined banks to quarterly from monthly.
- Allows the acquisition of single branches in another state, if allowed by that state.
- Allows banks to rely on the form and terms of an account in transferring or releasing joint account funds subsequent to the date of death of one or more named joint account holders, in response to Harris v. Rock, 799 S.W. 2d 10 (KY Supreme Court 1990).
- Establishes 5-year statute of limitations for actions for injury by certain trustees to the rights of a beneficiary.
- Establishes that no gain or loss shall be recognized for Kentucky income tax purposes for transfer of all assets by a common trust fund under certain circumstances, in accordance with Federal Tax Code.

III. Banks Selling Insurance (HB429)-Delivered to the Governor on March 25, 1998. Representatives of the banking and the insurance industry, as well as the Department of Financial Institutions and the Department of Insurance, ultimately agreed to the language contained in this bill. This bill is a restatement of compromise language adopted by regulation in late 1996 and results from years of litigation. The
requirements of this bill are addressed in detail at page I-87 of this volume. Highlights of the bill are as follows:

- Amends 287.030 to provide that state banks are expressly authorized to sell all general lines of insurance.
- Defines “financial institutions,” for purposes of the insurance regulations in this bill, as virtually any entity that makes loans and takes deposits in Kentucky.
- Requires licensure.
- Requires consumer disclosures which evidence compliance with KRS 304.12-150, and consumer disclosures similar to those required by the FFIEC for the sale of non-deposit products. The Department of Insurance has the authority to adopt model disclosure forms by regulation and has circulated recommended forms.
- Allows that a consumer signed, acknowledgment of release of insurance information is evidence that it is not to the detriment of the consumer.
- Makes a violation of Federal anti-tying laws a violation of insurance laws and requires notification of such violations.
- Prohibits the delay or impediment of other transactions for the purposes of influencing the selection of insurance.
- Allows for certain employee referral fees.

IV. **Tax Issues.** This is a general summary of changes effecting financial institutions. The text of House Bill 419 appears at page M-1 of this volume and will be discussed later in the conference.

A. **Federal Tax Code Update (HB170)**-Signed by the Governor on February 6, 1998. This bill amends KRS 141.010 to change the Internal Revenue Code reference date from December 31, 1995 to December 31, 1997 and applies to tax years beginning after December 31, 1996. Emergency status allows the bill to become effective immediately upon signature by the Governor.

B. **Bank Franchise Tax (HB419)**-Delivered to the Governor on March 27, 1998. This bill makes a number of substantive changes to KRS 136.500. They include:

- Allows for the deduction of Kentucky obligations from capital calculations.
- Allows for the averaging of quarters for de novo institutions in existence for less than a full year.
- Provides for the calculation methods applicable to combinations involving a savings and loan association and a bank.
- Provides for tax treatment of Subchapter S electing institutions.
V. Technology Issues.

A. **Electronic Transactions (HB708)**-Delivered to the Governor on March 27, 1998. Although several bills were introduced this session, regarding electronic transactions and the legal recognition of the same, it appears that this is the one most likely to pass. After concerns raised by governmental agencies and the business sector, it was determined that the method most likely to be accepted by business would be legislation that recognizes electronic commerce while placing some restrictions, but which does not approve of or specify certain types of acceptable systems. This bill provides for the following:

- Defines “electronic record,” “electronic signature” and “record” in the broadest possible way, in order to allow for technological development.
- Provides that the application of the provisions of the bill are voluntary in most instances, but do not apply to will/trust conveyances, real property transactions or the creation/transfer of negotiable instruments or title instruments.
- Parties agreeing to the application of the provisions of the bill may establish the conditions under which an electronic signature or electronic record will be accepted.
- Application of the provisions of the bill allows for electronic, duplicate or imaged information, signatures and records to not be denied legal effect on that ground alone. (This will be of particular interest to financial institutions that maintain records in imaged form.) The bill also allows for an electronic signature to satisfy any statutory requirements for a manual signature and for an electronic record to satisfy any statutory requirements for “in writing.”

B. **Telemarketing (SB199)**-As of March 30, 1998, this bill is still moving, but slowly. This bill was originated by the Attorney General Office Department of Consumer Protection and includes certain limitation on telephone or fax solicitations. Among other entities, institutions regulated by the Department of Financial Institutions are exempt from the provisions of the bill. If applicable, the bill requires more complete disclosures regarding the products or services marketed and prohibits activities including the following:

- Requests for a fee in advance to have derogatory credit information removed from a credit record.
- Requests for fees for obtaining an extension of credit when the extension of credit has been guaranteed or the high likelihood of obtaining the extension of credit has been represented by the company.
• Obtaining or submitting for payment a check, draft or other form of negotiable instrument drawn on a person’s account without that person’s express written authorization. (This will be of particular interest to those financial institutions that have had a problem with “pre-authorized drafts.”)
• Solicitation persons under the age of 18.
• Use of any method to block caller ID systems.
• Use of fictitious names in telephone solicitations.
• Allowing the telephone to ring for longer than 30 seconds.
• Use of annoying, harassing or abusive tactics.
• Calling other than between the hours of 10 a.m. and 9 p.m.
• Calling persons who have indicated that they do not wish to be contacted further or who have placed their names on the “no contact” list maintained at the AG’s office.

C. Central Search Mechanism (HB739)-Delivered to the Governor on March 31, 1998. Despite the industry’s lack of success in passing a central filing/central search system in Kentucky in the last eight years, the Secretary of State’s office was able to get introduced a bill which would create a separate system for central searches of some UCC filings, beginning January 4, 1999. This system will require a separate filing by the creditor to the Secretary of State’s office with a $1 filing fee. This filing is for purposes of notice only and does not impact perfection. House Bill 739 is discussed further at page F-2 of this volume.

VI. Competitive Industries.

A. Check Cashers (HB226)-As of March 30, 1998 this bill is still moving. Several bills have been introduced this Session that attempt to regulate check cashers. This bill is the most likely to pass. Although it does not directly impact financial institutions, these businesses do compete with them. The changes to KRS Chapter 368, which are in this bill, include increased licensure requirements and examination/penalty provisions; consumer protection provisions including a limitation on the aggregate value of outstanding deferred deposits allowed, the maximum length of deferral period and allowable fees; and, consumer disclosures.

B. Consumer Loan Companies (HB514)-Signed by the Governor on March 27, 1998. The changes to KRS 288.400 et. seq., which are included in this bill, allow consumer loan companies to lend up to $15,000 at the rates allowed for in KRS 360.010; allow for a fee to be charged for credit investigations; allow for the Department of Financial Institutions to charge a fee for examinations; and increase the amount of applications fees.
C. **Mortgage Brokers (HB515)**-Signed by the Governor on March 27, 1998. This is essentially a clean-up bill for the Department of Financial Institutions. It makes a number of changes that bring KRS Chapter 287 into conformance with Department practice and a few substantive changes. A few of the more notable, substantive changes are as follows:

- Allows for an exemption from its provisions, upon approval of the Department of Financial Institutions, for an independent contractor who works for only one mortgage loan company or licensed mortgage loan broker.
- Takes a number of previously exempt entities and makes the subject to the examination and investigation provisions of the Act. These entities include mortgage loan companies regulated by HUD, a natural person making a loan with his/her own funds with no intention of reselling, real estate professionals and persons making less than 5 loans a year.
- Requires a maintained funding source of at least $500,000 in order to obtain a license and requires continuing education and increases surety bond requirements to $100,000/$50,000.
- Increases application fees.
- Prohibits the use of “bank,” “trust,” “national” or “federal” in the name.
- Prohibits prepayment penalties after the fifth year of a mortgage and limits the penalty to 5% of the outstanding balance.
- Provides for confidentiality of certain records and reports of examination.

D. **Title Lenders (SB392)**-Delivered to the Governor on March 31, 1998. Just as with the check cashers, there have been a number of bills introduced which attempt to regulate this growing industry. Although this bill does not directly impact financial institutions, these businesses do compete with them. This bill creates a new section of KRS Chapter 368 and includes: definitions of “title pledge agreements” and limits that to unencumbered, titled personal property for a period of 30 days with limited roll-over periods; licensure requirements and examination/penalty provisions; limitation on allowable fees to those provided in KRS 288.530; repossession limitations; and consumer disclosures including TILA requirements.

VII. **Abandoned Property (SB339)**-Delivered to the Governor on March 31, 1998. This bill, regarding escheat, is discussed in detail at Section K of this volume, and the text is found at page K-39.
VIII. Data Match Requirements for Delinquent Child Support (HB161)-Passed both houses on March 31, 1998. This bill covers a number of areas of no interest to the financial services industries, most deal with the handling of delinquent child support payments. Due to the length of the bill, only a summary is attached. The portions of interest to financial institutions are those resulting from the Federal mandates of the Welfare Reform Act of 1996 and include:

- Creation and maintenance of a data match system by the Cabinet for Human Resources, which allows cross-referencing of account holders to delinquent, obligated parents. Financial institutions must report information to the Cabinet quarterly.
- Prohibition on disclosure by financial institutions to account holders that an account has been reported to the Cabinet, although financial institutions may disclose the general requirements of the law.
- System for encumbering matched account assets by the Cabinet.
- Provision for a "reasonable fee" to be paid to reporting financial institutions for the match process, not to exceed actual costs.
- Limitation of liability for compliance by financial institutions.
- Requirement that employers report new hires or rehires to the Cabinet within 20 days of start date by submitting the employee's W-4 or equivalent document.
- Establishes penalties for failure to comply.

IX. Miscellaneous.

A. Collateral for Public Deposits (SB208)-This bill passed both houses on March 31, 1998. It amends KRS 41.240 to include certain highly rated surety bonds as acceptable collateral on public deposits and to include in the definition of acceptable collateral letters of credit issued by certain governmental entities, such as the Federal Home Loan Bank.

B. UCC Cleanup (SB352)-Delivered to Governor on March 25, 1998. This bill repeals a number of UCC Article 3 sections inadvertently left in during the 1996 Session. It is discussed further at page F-1 of this volume.

C. Powers of Attorney (HB60)-Delivered to Governor on March 27, 1998. This bill amends KRS 386.093 to define "durable power of attorney" and offers language necessary to establish the same. Establishes effect of revocation, disability and death of principal.

D. Branching (HB491)-Dead. This bill amends KRS 287.180 to allows for contiguous county branching in up to four counties contiguous to the county where the principal office is located. The text is set out at page L-7 of this volume.
E. **Lien Releases (SB88 / HB121)**-SB88 delivered to Governor on March 25, 1998 and HB121 was passed by both houses on March 31, 1998. Both of these bills include amendments to KRS 382.365. SB88 makes minimal changes, allowing an action to be brought in District Court, in addition to Circuit Court, to enforce the statute. HB121 makes more significant changes including: allows an owner or person acquiring an interest in the real property to seek enforcement of the statute; allows the action to be brought in District or Circuit Court; allows for the recovery of costs and for daily penalties for failure to release a lien after the entry of judgment; increases existing penalties; and defines “date of satisfaction.”

F. **Elder Abuse (HB652)**-Delivered to Governor on March 27, 1998. This bill amends the current elder abuse laws. Most of the current and revised provisions are of little interest to financial institutions. There is, however, a growing trend and awareness of financial exploitation of the elderly. Because of that, this bill allows the Cabinet for Human Resources to access financial records during their investigations. The Cabinet will also be contacting financial institutions to set up awareness training for signs of financial exploitation.
AN ACT relating to the release of liens.
Amend KRS 382.365, relating to the release of liens, to provide that a district court as well as a circuit court may be utilized to secure the release of the lien and mandate that the court release the lien upon sufficient proof being shown.

SB 88 - AMENDMENTS

SCS - Delete provision of bill that had raised lienholders' liability from fifty dollars ($50) to five hundred dollars ($500); clarify that the court shall release the lien upon sufficient proof to the court.

Jan 7-introduced in Senate
Jan 8-to Judiciary (S)
Feb 25-reported favorably, 1st reading, to Consent Calendar with Committee Substitute
Feb 26-2nd reading, to Rules
Feb 27-posted for passage in the Consent Orders of the Day for March 2, 1998
Mar 2-3rd reading, passed 34-0 with Committee Substitute
Mar 3-received in House
Mar 4-to Judiciary (H)
Mar 10-posted in committee
Mar 17-reported favorably, 1st reading, to Calendar
Mar 18-2nd reading, to Rules
Mar 24-3rd reading, passed 89-2
Mar 25-received in Senate; enrolled, signed by each presiding officer, delivered to Governor
AN ACT relating to the release of liens.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 382.365 is amended to read as follows:

(1) A holder of a lien on real property, including a lien provided for in KRS 376.010, shall release the lien in the county clerk's office where the lien is recorded within thirty (30) days from the date of satisfaction.

(2) A proceeding may be filed in District Court or Circuit Court against a lienholder that violates subsection (1) of this section. A proceeding filed under this section shall be given precedence over other matters pending before the court.

(3) Upon proof to the court of satisfaction, the court shall enter a judgment releasing the lien. A lienholder that violates subsection (1) of this section shall also be liable to the owner of the real property for fifty dollars ($50) and any actual expense including a reasonable attorney's fee incurred by the owner in securing the release of real property by such violation. The judgment shall be with costs including reasonable attorneys' fees.

(4) The former holder of a lien on real property shall send by regular mail a copy of the lien release to the property owner at his last known address within seven (7) days of the release. A former lienholder that violates this subsection shall be liable to the owner of the real property for fifty dollars ($50) and any actual expense incurred by the owner in obtaining documentation of the lien release.
SENATE BILL 199

AN ACT relating to telephone solicitation.

Amend KRS 367.46953 to prohibit telephone solicitation to consumers in Kentucky; amend KRS 367.46951 and 367.46957 to conform; repeal KRS 367.46961, 367.46963, and 367.46987 to conform.

SB 199 - AMENDMENTS

SCS - Replace original provisions with provisions defining telemarketing; set forth organizations and activities which are exempt from provisions; specify prohibited telemarketing practices relating to fraud, threatening calls, permitted calling hours, and other practices; create a no-call list to be maintained by the Attorney General; provide misdemeanor and felony penalties for violating provisions of the Act.

SFA (1, J. Rose) - Restore the exemptions that are in existing law.

SFA (2, J. Rose) - Exempt previously exempted businesses and practices from all but fraud provisions of bill; apply no call list prohibitions to telemarketing companies only and not merchants.

SFA (3, T. Philpot) - Amend exclusions to delete calls made by real estate broker or sales associate properly licensed under KRS Chapter 324.

SFA (4, J. Rose) - Exempt previously exempted businesses and practices; apply fraud provisions to telemarketing companies only.

SFA (5, T. Philpot) - Permit telemarketers to make calls from Kentucky to other locations out-of-state without regulation.

HFA (1, M. Bowling) - Delete provision exempting telemarketers located in Kentucky who make calls to locations outside of Kentucky.

Jan 22-introduced in Senate
Jan 23-to Judiciary (S)
Mar 4-reported favorably, 1st reading, to Calendar with Committee Substitute; floor amendment (1) filed to Committee Substitute
Mar 5-2nd reading, to Rules
Mar 16-floor amendments (2) and (3) filed to Committee Substitute
Mar 17-floor amendments (4) and (5) filed to Committee Substitute
Mar 18-3rd reading; floor amendments (1) and (2) withdrawn; passed 32-2 with Committee Substitute and floor amendments (3) (4) and (5)
Mar 19-received in House
Mar 20-to Judiciary (H)
Mar 23-posted in committee
Mar 26-reported favorably, 1st reading, to Calendar
Mar 27-2nd reading, to Rules; floor amendment (1) filed; posted for passage in the Regular Orders of the Day for March 30, 1998
AN ACT relating to telephone solicitation.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 367.46951 is amended to read as follows:

As used in KRS 367.46951 to 367.46999, unless the context otherwise requires:

(1) "Telephone solicitation" means:

(a) A telephone call or message sent by a facsimile machine to a residential, mobile, or telephone paging device telephone number, including a call made by an automatic dialing or recorded message device, for the purpose of:

1. Soliciting a sale of consumer goods or services, offering an investment, business, or employment opportunity, or offering a consumer loan to the person called;

2. Obtaining information that will or may be used for the solicitation of a sale of consumer goods or services, the offering of an investment, business, or employment opportunity, or the offering of a consumer loan to the person called;

3. Offering the person called a prize, gift, or anything else of value, if payment of money or other consideration is required in order to receive the prize or gift, including the purchase of other merchandise or services or the payment of any processing fees, delivery charges, shipping and handling fees, or other fees or charges; or

4. Offering the person called a prize, gift, or other incentive to attend a sales presentation for consumer goods or services, an investment or business opportunity, or a consumer loan; or

(b) A solicitation or attempted solicitation which is made by telephone in response to inquiries generated by unrequested notifications sent by the merchant to persons who have not previously purchased goods or services from the merchant or telemarketer or who have not previously requested
credit from the merchant, to a prospective purchaser if the merchant or telemarketer represents or implies to the recipient of the notification that any of the following applies:

1. That the recipient has in any manner been specially selected to receive the notification or the offer contained in the notification;
2. That the recipient will receive a prize or gift if the recipient calls the merchant or telemarketer; or
3. That if the recipient buys one (1) or more items from the merchant or telemarketer, the recipient will also receive additional or other items of the same or a different type at no additional cost or for less than the regular price of the items;

(2) "Telephone solicitation" does not mean the following:

(a) A telephone call made in response to an express request of a person called, unless the request was made during a prior telephone solicitation;
(b) A telephone call made primarily in connection with the payment or performance of an existing debt or contract, the payment or performance of which has not been completed at the time of the call;
(c) A telephone call to any person with whom the telemarketer or merchant has a prior or existing business relationship, including but not limited to the solicitation of contracts for the maintenance or repair of items previously purchased from the person making the solicitation or on whose behalf the solicitation is made;
(d) A telephone call made by any of the following:

1. A college or university accredited by a national or regional accrediting organization;
2. An organization exempt from taxation under Section 501(c)(3) or Section 501(c)(6) of the Internal Revenue Code:
3. A school, or a person on behalf of a school, regulated by the Kentucky Department of Education;

[telephone call made by any of the following:]

4. A real estate broker or sales associate properly licensed under the provisions of KRS Chapter 324;

5. A broker-dealer, agent, or investment adviser properly registered under the provisions of KRS Chapter 292;

6. An insurance agent, solicitor, or consultant properly licensed under the provisions of Subtitle 9 of KRS Chapter 304;

7. An employment agency that has obtained a current permit from the Cabinet for Human Resources under the provisions of KRS Chapter 340;

8. A person soliciting the sale of a subscription to a newspaper, magazine, or periodical of general circulation, or a cable television service;

9. A merchant or telemarketer or the merchant's or telemarketer's affiliate or authorized agent, when the merchant or telemarketer is regulated by the Public Service Commission;

10. A merchant or telemarketer soliciting the sale of food costing less than one hundred dollars ($100) to each address;

11. A person who periodically issues and delivers catalogs to potential purchasers if the catalog includes a written description or illustration and the sales price of each item offered for sale, includes at least twenty-four (24) full pages of written material or illustrations, is distributed in more than one (1) state, and has an annual circulation of not less than two hundred fifty thousand (250,000) customers;
12. The solicitation of contracts for the maintenance or repair of items previously purchased from the person making the solicitation or on whose behalf the solicitation is made;

10.] Any corporation, partnership, or individual whose business or activities are regulated by the Commonwealth of Kentucky, Department for Financial Institutions;

13.] A nonprofit organization exempt from taxation under Section 501(c)(3) of the Internal Revenue Code of 1986;

14.] A merchant or telemarketer or the merchant's or telemarketer's affiliate or authorized agent when the merchant or telemarketer is subject to the control or licensure regulations of the Federal Communications Commission;

14. A book, video, or record club or contractual plan or arrangement in which the merchant or telemarketer provides the consumer with a form which the consumer may use to instruct the merchant or telemarketer not to ship the offered merchandise, or which is regulated by federal regulation concerning the use of negative option plans by sellers in commerce, or which otherwise provides for the sale of books, records, or videos. Examples of the latter plan include continuity plans, subscription arrangements, standing order arrangements, supplements, and series arrangements under which the seller periodically ships merchandise to a consumer who has consented in advance to receive the merchandise on a periodic basis;

15.] A merchant who solicits without intent to complete or obtain provisional acceptance of a sale during the telephone solicitation; does not make the major sales presentation during the solicitation but arranges for the major presentation to be made at a later,
face-to-face meeting between the sales person and the purchaser; and
does not go or cause another to collect payment for the purchase or
deliver any item purchased to the prospective purchaser directly
following the telephone solicitation;{or}

16. Any telephone marketing service company which provides
   telemarketing sales services under contract to merchants and has been
   operating continuously for at least five (5) years under the same business
   name and seventy-five percent (75%) of whose services are performed
   for merchants exempted under KRS 367.46951 to 367.46999, if the
   company files an annual certification with the Office of the Attorney
   General on a form prescribed by the Attorney General. The certification
   shall include the company's basis for claiming the exemption and shall
   indicate the company's agreement to comply with the provisions of KRS
   367.46951 to 367.46999, if applicable;

17. A telephone call made by a merchant or telemarketer located in
   Kentucky to a location outside the Commonwealth of Kentucky;

18. {(d)} A telephone call made by A merchant or his employee if the
   merchant has operated for at least two (2) years, under the same name as
   that used in connection with its telemarketing operations, a retail
   establishment in Kentucky where consumer goods are displayed and
   offered for sale on a continuing basis if a majority of the merchant's
   business involves the buyers obtaining services or products at the
   merchant's retail establishment; or

19. {(e)} A telephone call made by A merchant or telemarketer or the
   merchant's or telemarketer's affiliate or authorized agent, where the
   merchant or telemarketer is a publicly traded corporation;
Except for paragraph (d)16. (subsection (2)(e)15.) of this subsection, the exemptions provided under this subsection shall apply only to a merchant or telemarketer or the merchant's or telemarketer's affiliate or authorized agent engaging in a telephone solicitation on the merchant's or telemarketer's behalf;

(3) "Consumer goods or services" means goods, services, or interests in real property used by natural persons primarily for personal, family, or household purposes;

(4) "Consumer loan" means any extension of credit, including credit cards and other forms of revolving credit, to a natural person primarily for the purposes of purchasing consumer goods or services or for paying existing personal, family, or household debts;

(5) "Consumer" means a natural person who receives a telephone solicitation;

(6) "Legal name of the merchant" means the real name of the merchant, as defined in KRS 365.015(1), or the assumed name of the merchant for which all proper certificates have been filed pursuant to KRS 365.015;

(7) "Merchant" means the individual or business entity offering the consumer goods or services, an investment, business, or employment opportunity, or a consumer loan;

(8) "Caller" or "sales person" means the individual making the call or operating the automatic dialing or recorded message device and causing the call to be made;

(9) "Division" means the Consumer Protection Division of the Office of the Attorney General;

(10) "Automated calling equipment" means any device or combination of devices used to select or dial telephone numbers and to deliver recorded messages to those numbers without the use of a live operator; and

(11) "Telemarketer" means any person who under contract with a merchant or in connection with a telephone solicitation initiates or receives telephone calls to or from a consumer of goods and services. A telemarketer includes, but is not
limited to, any such person that is an owner, operator, officer, director, or partner to the management activities of a business.

(12) "Publicly-traded corporation" means an issuer or subsidiary of an issuer that has a class of securities which is:

(a) Subject to Section 12 of the Securities Exchange Act of 1934 (15 U.S.C. sec. 78l) and which is registered or exempt from registration under paragraph (A), (B), (C), (E), (F), (G), or (H) of subsection (g)(2) of that section;
(b) Listed on the New York Stock Exchange, the American Stock Exchange, or the NASDAQ National Market System; or
(c) A reported security within the meaning of subparagraph (4) of Regulation Section 240.11Aa3-1.(a) under the Securities Exchange Act of 1934. A subsidiary of an issuer that qualifies for exemption under this paragraph shall not itself be exempt unless at least sixty percent (60%) of the voting power of its shares is owned by the qualifying issuer.

(13) "Telemarketing company" means a company whose primary business is to engage in telephone solicitation.

Section 2. KRS 367.46977 is amended to read as follows:

(1) If the merchant or telemarketer represents or implies that the consumer will receive a prize, award, or similar item of value from a number of such prizes or awards, all sales presentations shall include the actual number of individuals who have received the item having the greatest value, a description of the item, the market value of the item, the number of prizes to be awarded, the conditions to receive the item, the odds of winning, the statement that no purchase is necessary to win the prize or to participate in the promotion, and the actual number of individuals who have received the item with the least value within the preceding twelve (12) months or since the merchant or telemarketer has been in business if less than twelve (12) months.
(2) If the merchant or telemarketer is offering real estate, an investment, business, or employment opportunity, the sales presentation shall include the following:
(a) The number of consumers or investors who have participated to date;
(b) The actual experience of the consumers or investors as measured by the standards used in the sales presentations; and
(c) The price of the real estate or investment;
(d) The location of the real estate or investment;
(e) Regarding an investment or business opportunity, the reasonable likelihood of success and a notice of the risk; and
(f) If the opportunity is so recent that no actual performance experience exists, that fact shall be disclosed in all sales presentations, and no other representation of performance shall be made in sales presentations.

(3) If the sales presentation includes representations of prices below those usually charged for items, the sales presentation shall include the name of the manufacturer, importer, or supplier of such items and the locations within the merchant's or telemarketer's calling state or this state at which the items are offered at usual prices. If the item has never been sold in the merchant's or telemarketer's calling state or this state no representation of usual selling price shall be made.

(4) If presenting information on merchandise or service, the total cost of the goods or services that are the subject of the call shall be given.

(5) If any restrictions, limitations, or conditions for the purchase or investment exist, these shall be disclosed during the telephone sales presentation.

(6) Terms for refunds, cancellation, exchange, or repurchase of the subject of the sales presentation shall be disclosed during the telephone sales presentation.

SECTION 3. A NEW SECTION OF KRS 367.46951 TO 367.46999 IS CREATED TO READ AS FOLLOWS:
It is a prohibited telephone solicitation act or practice and a violation of KRS 367.46951 to 367.46999 for any telemarketing company to engage in the following conduct:

(1) Advertising or representing that registration as a telemarketer equals an endorsement or approval by any government or governmental agency;

(2) Requesting a fee in advance to remove derogatory information from or improve a person's credit history or credit record;

(3) Requesting or receiving a payment in advance from a person to recover or otherwise aid in the return of money or any other item lost by the consumer in a prior telephone solicitation transaction;

(4) Requesting or receiving payment of any fee or consideration in advance of obtaining a loan or other extension of credit when the telemarketing company has guaranteed or represented a high likelihood of success in obtaining or arranging a loan or other extension of credit for a person;

(5) Obtaining or submitting for payment a check, draft, or other form of negotiable paper drawn on a person's checking, savings, or bond or other account without the consumer's express written authorization;

(6) Procuring the services of any professional delivery, courier, or other pickup service to obtain immediate receipt or possession of a consumer's payment, unless the goods are delivered with the opportunity to inspect before any payment is collected;

(7) Assisting, supporting, or providing substantial assistance to any telemarketer when the telemarketing company knew or should have known that the telemarketer was engaged in any act or practice prohibited under this section;

(8) Making a telephone solicitation to anyone under eighteen (18) years of age.

When making a telephone solicitation the telemarketer shall inquire as to
whether the person is eighteen (18) years of age or older and the answer shall be presumed to be correct;

(9) Utilizing any method to block or otherwise circumvent the use of a caller identification service when placing an unsolicited telephone solicitation call;

(10) Directing or permitting employees to use a fictitious name or not to use their name while making a telephone solicitation.

(11) Threatening, intimidating, or using profane or obscene language;

(12) Causing the telephone to ring more than thirty (30) seconds in an intended telephone solicitation;

(13) Engaging any person repeatedly or continuously with behavior a reasonable person would deem to be annoying, abusive, or harassing;

(14) Initiating a telephone solicitation call to a person, when that person has stated previously that he or she does not wish to receive solicitation calls from that seller;

(15) Making or causing to be made an unsolicited telephone solicitation call if the number for that telephone appears in the current publication of the "no telephone solicitation calls" list maintained by the Office of the Attorney General, Division of Consumer Protection. Any holder of a telephone number may notify the division and be placed on a "no telephone solicitation calls" list indicating the wish not to receive unsolicited telephone solicitation calls by notification to the division. The names of persons requesting to be on the "no telephone solicitation calls" list shall remain on the list until the person rescinds his or her name from the list. The list shall be published quarterly in hard copy and may be made available in other formats at the discretion of the division. After the publication of the list each month each telemarketing company shall be deemed to be on notice not to solicit any person whose name appears on the list. The division shall charge a fee calculated to defray costs of the no telephone
solicitation calls program to telemarketing companies for the provision of the list. Funds collected shall be deposited into the division's trust and agency account. The list shall be made available to requesters either on a statewide or county by county basis; or

(16) Engaging in telemarketing to a person's residence at any time other than between 10 a.m. - 9 p.m. local time, at the called person's location.

Section 4. KRS 367.46999 is amended to read as follows:

Any person, including, but not limited to, a merchant, a telemarketer, a salesperson, agent or representative of the merchant, or an independent contractor, who knowingly violates any provision of KRS 367.46951 to 367.46999 or engages in any act, practice, or course of business which operates or would operate as fraud or deceit upon any person in connection with a sale shall be guilty of a Class D felony, except that any person who violates subsections (7) to (16) of Section 3 of this Act shall be guilty of a Class B misdemeanor for the first offense and a Class A misdemeanor for any subsequent offense. The Office of the Attorney General shall have concurrent enforcement powers as to such felonies and misdemeanors.
GENERAL ASSEMBLY
COMMONWEALTH OF KENTUCKY
1998 REGULAR SESSION

SENATE BILL 208

AN ACT relating to deposit of public funds.

Amend KRS 41.240 to establish criteria to be met by banks to be state depositories; establish amount of collateral that must either be pledged or provided to State Treasurer; provide that surety bonds issued by sureties rated in one of the three highest categories by a nationally recognized rating agency may be used as collateral; amend KRS 56.520 to allow the Investment Commission to invest proceeds from the sale of its revenue or other authorized bonds in deposits in certificates of deposit or other interest bearing accounts of banks qualifying as state depositories; amend KRS 66.480 to allow a local government to invest in certificates of deposit which are collateralized by any obligations, including surety bonds; amend KRS 287.330 to allow banks to provide surety bonds as collateral security for government deposits.

SB 208 - AMENDMENTS

HFA (1, D. Butler) - Amend KRS 56.520 to provide that the State Investment Commission may invest proceeds from the sale of bonds, as provided in KRS 42.500, rather than to invest in a listing of permissible investments specified within KRS 56.520.

Jan 27-introduced in Senate
Jan 28-to Banking and Insurance (S)
Feb 11-reported favorably, 1st reading, to Consent Calendar
Feb 12-2nd reading, to Rules
Feb 17-posted for passage in the Consent Orders of the Day for February 18, 1998
Feb 18-3rd reading, passed 37-0
Feb 19-received in House
Feb 20-to State Government (H)
Mar 13-posted in committee
Mar 17-reported favorably, 1st reading, to Calendar
Mar 18-2nd reading, to Rules; floor amendment (1) filed
Mar 25-3rd reading, passed 93-1; reconsidered; passed 77-11 with floor amendment (1)
Mar 26-received in Senate
Mar 27-posted for passage for concurrence in House amendment on March 31, 1998
Mar 31-Senate concurred in House floor amendment (1); passed 31-0
AN ACT relating to deposit of public funds.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 41.240 is amended to read as follows:

(1) (a) Before any bank shall be named as a state depository to receive public funds, it shall either pledge or provide to the State Treasurer, as collateral, securities or other obligations having an aggregate current face value or a current quoted market value at least equal to the deposits or provide to the State Treasurer a surety bond or surety bonds in favor of the State Treasurer in an amount at least equal to the deposits, provided, however, that amounts insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation need not be so collateralized. The president or cashier of each depository bank shall submit to the Treasurer and the State Investment Commission a statement subscribed and sworn to by him showing:

1. The face value or current quoted market value of the securities or other obligations pledged or provided as of the time the securities or other obligations are offered as collateral; and

2. The value of surety bonds provided as of the time such surety bonds are provided as collateral.

The valuation of all pledged or provided collateral and the face amount of all surety bonds provided as collateral shall be reported to the State Treasurer and State Investment Commission upon receipt of deposit and within ten (10) days of the close of each quarter after the quarter beginning December 31. Such value with respect to pledged collateral other than surety bonds shall be as of the end of the quarter or the preceding business day and, as to market values, shall be obtained from a reputable bond pricing service. The State Treasurer and Governor
may from time to time call for additional collateral to adequately secure the deposits as aggregate face or current market values may require.

(b) No deposit of state collected demand and time funds shall collectively exceed at any time the depository's sum of capital, reserves, undivided profits and surplus or ten percent (10%) of the total deposits of any particular depository, whichever is less. Deposits will be valued at the end of each business day.

(2) (a) As an alternative to paragraph (1)(a) of this section, a Kentucky depository insured by the Federal Deposit Insurance Corporation may either pledge to the State Treasurer, as collateral, securities or other obligations having an aggregate face value or a current quoted market value or provide to the State Treasurer a surety bond or surety bonds in an amount equal to eighty percent (80%) of the value of the state deposit including demand and time accounts, if the depository is determined by the State Investment Commission to have very strong credit with little or no credit risk at any maturity level and the likelihood of short-term unexpected problems of significance is minimal or not of a serious or long-term nature. The value of the state deposit will be determined at the end of the business day of deposit and as of the end of business on the last day of each quarter that funds are so deposited.

(b) Valuation of all pledged or provided collateral and the face amount of surety bonds provided shall be reported to the State Treasurer and the State Investment Commission upon receipt of the state deposit and within ten (10) days of the close of each quarter after the quarter beginning December 31.

(c) Depositories designated as qualified for reduced pledging shall be so recorded in the executive journal.

(d) The State Investment Commission shall determine eligibility for the reduced pledging option based on totally objective and quantifiable measures of financial intermediary performance. The information for such eligibility shall
be obtained from publicly available documents. The State Investment Commission shall promulgate the particular criteria of eligibility by regulations issued pursuant to KRS Chapter 13A.

(3) Depositories which do not qualify or do not choose to qualify under subsection (1) or (2) of this section shall not receive state deposits in excess of amounts that are insured by an instrumentality of the United States.

(4) Only the following securities and other obligations may be accepted by the State Treasurer as collateral under this section:

(a) Bonds, notes, letters of credit or other obligations of or issued or guaranteed by the United States, or those for which the credit of the United States is pledged for the payment of the principal and interest thereof, and any bonds, notes, debentures, letters of credit, or any other obligations issued or guaranteed by any federal governmental agency or instrumentality, presently or in the future established by an Act of Congress, as amended or supplemented from time to time, including, without limitation, the United States government corporations listed in subsection (1)(c) of Section 3 of this Act;

(b) Obligations of the Commonwealth of Kentucky including revenue bonds issued by its statutory authorities, commissions or agencies;

(c) Revenue bonds issued by educational institutions of the Commonwealth of Kentucky as authorized by KRS 162.340 to 162.380;

(d) Obligations of any city of the first, second, and third classes of the Commonwealth of Kentucky, or any county, for the payment of principal and interest on which the full faith and credit of the issuing body is pledged;

(e) School improvement bonds issued in accordance with the authority granted under KRS 162.080 to 162.100;
(f) School building revenue bonds issued in accordance with the authority granted under KRS 162.120 to 162.300, provided that the issuance of such bonds is approved by the Kentucky Board of Education; and

(g) Surety bonds issued by sureties rated in one (1) of the three (3) highest categories by a nationally recognized rating agency.

Section 2. KRS 56.520 is amended to read as follows:

(1) The commission may issue and sell revenue or other authorized bonds, in carrying out the provisions of this chapter, in denominations and amounts, as is deemed to be for the best interest of the Commonwealth, for any of the following purposes:

(a) To acquire real estate for state governmental use;

(b) To pay all or any part of the expense or cost of or incidental to a building project for state governmental use;

(c) To defray the cost of plans, specifications, blueprints, architectural fees, and other expenses authorized to be incurred for state governmental use.

(2) The payment of bonds issued, together with the interest thereon, may be secured by a pledge and a first lien on all of the receipts and revenue derived, or to be derived, from the rental or operation of the property involved. Neither the payment of any bond, nor the interest thereon issued under the authority of KRS Chapter 56, shall constitute an indebtedness of the Commonwealth of Kentucky, nor shall any bond or interest thereon be payable out of any fund except funds derived from rentals or other revenues derived from the operation of the properties or from revenues as are available for the purpose by law.

(3) All competitive bids for the sale of revenue bonds shall be opened and read publicly by the secretary of the Finance and Administration Cabinet or his representative at a designated place, day, and hour, all of which shall be announced in the advertising made relative thereto.
(4) In the event the commission issues and sells bonds for a building project as authorized by KRS Chapter 56, insurance, including fire and windstorm, casualty, catastrophe, use and occupancy, and such other insurance as the commission may deem advisable, shall be carried in connection with the building project, and it may so obligate and bind itself in a trust indenture securing the payment of the bonds. Any insurance shall be paid for out of funds available for the project.

(5) As provided in KRS 42.500, the commission may invest proceeds from the sale of its revenue or other authorized bonds as follows:
   a) Obligations of the United States or obligations fully guaranteed both as to principal and interest by the United States;
   b) Obligations of the Federal Financing Bank, the Federal Farm Credit Bank, the Bank for Cooperatives, the Federal Intermediate Credit Bank, the Federal Land Banks, the Federal Home Banks, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Government National Mortgage Association, the Federal Housing Administration, the Farmers Home Administration, the United States Postal Services;
   c) Obligations for the Commonwealth of Kentucky;
   d) Bonds and notes of any state or local government or public authority;
   e) Savings certificates issued by any federal savings and loan association if any principal amount of the certificate in excess of the amount insured by the federal government, or any agency thereof, is fully collateralized;
   f) Prime quality commercial paper bearing the highest rating of at least one (1) nationally recognized rating service and not bearing a rating below the highest by any nationally recognized rating service which rates the particular obligation;
   g) Bills of exchange or time drafts drawn on and accepted by a commercial bank and eligible for use as collateral by member banks in borrowing from a federal
reserve bank, if the accepting bank or its holding company is either incorporated in the Commonwealth of Kentucky or has outstanding publicly held obligations bearing the highest rating of at least one (1) nationally recognized rating service and not bearing a rating below the highest by any nationally recognized rating service which rates the particular obligations;

(h) Participating share in a mutual fund for local government investment;

(i) A commingled investment pool established and administered under KRS 66.480;

(j) Evidences of ownership of or fractional undivided interests in future interest and principal payments on either direct obligations of the United States government or obligations the principal of and the interest on which are guaranteed by the United States, which obligations are held by a bank or trust company organized and existing under the laws of the United States or any state in the capacity of custodian;

(k) Repurchase agreements with respect to either direct obligations of the United States or obligations the principal of and the interest on which are guaranteed by the United States or entered into with a broker or dealer, as defined by the Securities Exchange Act of 1934, which is a dealer recognized as a primary dealer by a federal reserve bank, or any commercial bank, trust company, or national banking association, the deposits of which are insured by the Federal Deposit Insurance Corporation or any successor thereof if:

1. Such obligations that are subject to the repurchase agreement are delivered in physical or in book entry form to the local government or public authority, or any financial institution serving either as trustee for the local government or public authority or as fiscal agent for the local government or public authority or are supported by a safekeeping receipt issued by a depository satisfactory to the local government or public
authority. The repurchase agreement shall provide that the value of the underlying obligations shall be maintained at a current market value, calculated at least daily, of not less than one hundred percent (100%) of the repurchase price. The financial institution serving either as trustee or as fiscal agent for the local government or public authority holding the obligations subject to the repurchase agreement or the depository issuing the safekeeping receipt shall not be the provider of the repurchase agreement;

2. A valid and perfected first security interest in the obligations which are the subject of the repurchase agreement has been granted to the local government or public authority or its assignee or book entry procedure, conforming to the extent practicable with federal regulations and satisfactory to the local government or public authority, have been established for the benefit of the local government or public authority or its assignee;

3. The securities are free and clear of any adverse third party claims; and

4. The repurchase agreement is in a form satisfactory to the local government or public authority;

(l) Guaranteed investment contracts with a bank or insurance company, if the bank or insurance company bears one (1) of the two (2) highest ratings of at least one (1) nationally recognized rating service and does not bear a rating below one (1) of the two (2) highest ratings by any nationally recognized rating service; and

(m) Deposits in certificates of deposit or other interest bearing accounts of banks qualifying under Section 1 of this Act as state depositories to accept deposit of public funds.

Section 3. KRS 66.480 is amended to read as follows:
(1) The governing body of a city, county, urban-county, charter county, school district
(provided that its general procedure for action is approved by the Kentucky Board
of Education), or other local governmental unit or political subdivision, may invest
and reinvest money subject to its control and jurisdiction in:
(a) Obligations of the United States and of its agencies and instrumentalities,
including obligations subject to repurchase agreements, if delivery of these
obligations subject to repurchase agreements is taken either directly or
through an authorized custodian. These investments may be accomplished
through repurchase agreements reached with sources including, but not
limited to, national or state banks chartered in Kentucky;
(b) Obligations and contracts for future delivery or purchase of obligations
backed by the full faith and credit of the United States or a United States
government agency, including but not limited to:
1. United States Treasury;
2. Export-Import Bank of the United States;
3. Farmers Home Administration;
4. Government National Mortgage Corporation; and
5. Merchant Marine bonds;
(c) Obligations of any corporation of the United States government, including but
not limited to:
1. Federal Home Loan Mortgage Corporation;
2. Federal Farm Credit Banks;
3. Bank for Cooperatives;
4. Federal Intermediate Credit Banks;
5. Federal Land Banks;
6. Federal Home Loan Banks;
7. Federal National Mortgage Association; and
8. Tennessee Valley Authority;

d) Certificates of deposit issued by or other interest-bearing accounts of any bank or savings and loan institution which are insured by the Federal Deposit Insurance Corporation or similar entity or which are collateralized, to the extent uninsured, by any obligations, including surety bonds, permitted by KRS 41.240(4);

e) Uncollateralized certificates of deposit issued by any bank or savings and loan institution rated in one (1) of the three (3) highest categories by a nationally recognized rating agency;

f) Bankers' acceptances for banks rated in one (1) of the three (3) highest categories by a nationally recognized rating agency;

g) Commercial paper rated in the highest category by a nationally recognized rating agency;

h) Bonds or certificates of indebtedness of this state and of its agencies and instrumentalities;

i) Securities issued by a state or local government, or any instrumentality of agency thereof, in the United States, and rated in one (1) of the three (3) highest categories by a nationally recognized rating agency; and

j) Shares of mutual funds, each of which shall have the following characteristics:

1. The mutual fund shall be an open-end diversified investment company registered under the Federal Investment Company Act of 1940, as amended;

2. The management company of the investment company shall have been in operation for at least five (5) years; and

3. All of the securities in the mutual fund shall be eligible investments pursuant to this section.
(2) The investment authority provided by subsection (1) of this section shall be subject to the following limitations:

(a) The amount of money invested at any time by a local government or political subdivision in one (1) or more of the categories of investments authorized by subsections (1)(e), (f), (g), and (i) of this section shall not exceed twenty percent (20%) of the total amount of money invested by the local government; and

(b) No local government or political subdivision shall purchase any investment authorized by subsection (1) on a margin basis or through the use of any similar leveraging technique.

(3) The governing body of every local government or political subdivision that invests or reinvests money subject to its control or jurisdiction according to the provisions of subsection (1) of this section shall by January 1, 1995, adopt a written investment policy that shall govern the investment of funds by the local government or political subdivision. The written investment policy shall include, but shall not be limited to the following:

(a) A designation of the officer or officers of the local government or political subdivision who are authorized to invest and oversee the investment of funds;

(b) A list of the permitted types of investments;

(c) Procedures designed to secure the local government's or political subdivision's financial interest in the investments;

(d) Standards for written agreements pursuant to which investments are to be made;

(e) Procedures for monitoring, control, deposit, and retention of investments and collateral;
(f) Standards for the diversification of investments, including diversification with respect to the types of investments and firms with whom the local government or political subdivision transacts business;

(g) Standards for the qualification of investment agents which transact business with the local government, such as criteria covering creditworthiness, experience, capitalization, size, and any other factors that make a firm capable and qualified to transact business with the local government or political subdivision; and

(h) Requirements for periodic reporting to the governing body on the status of invested funds.

(4) Sheriffs, county clerks, and jailers, who for the purposes of this section shall be known as county officials, may, and at the direction of the fiscal court shall, invest and reinvest money subject to their control and jurisdiction, including tax dollars subject to the provisions of KRS 134.300, 134.320, and 160.510, as permitted by this section.

(5) The provisions of this section are not intended to impair the power of a county official, city, county, urban-county, charter county, school district, or other local governmental unit or political subdivision to hold funds in deposit accounts with banking institutions as otherwise authorized by law.

(6) The governing body or county official may delegate the investment authority provided by this section to the treasurer or other financial officer or officers charged with custody of the funds of the local government, and the officer or officers shall thereafter assume full responsibility for all investment transactions until the delegation of authority terminates or is revoked.

(7) All county officials shall report the earnings of any investments at the time of their annual reports and settlements with the fiscal courts for excess income of their offices.
The state local debt officer is authorized and directed to assist county officials and local governments (except school districts) in investing funds that are temporarily in excess of operating needs by:

(a) Explaining investment opportunities to county officials and local governments through publication and other appropriate means; and

(b) Providing technical assistance in investment of idle funds to county officials and local governments that request that assistance.

The state local debt officer may create an investment pool for local governments (except school districts) and county officials; and counties and county officials and cities may associate to create an investment pool. If counties and county officials and cities create a pool, each group may select a manager to administer their pool and invest the assets. Each county and each county official and each city may invest in a pool created pursuant to this subsection. Investments shall be limited to those investment instruments permitted by this section. The funds of each local government and county official shall be properly accounted for, and earnings and charges shall be assigned to each participant in a uniform manner according to the amount invested. Charges to any local government or county official shall not exceed one percent (1%) annually on the principal amount invested, and charges on investments of less than a year's duration shall be prorated. Any investment pool created pursuant to this subsection shall be audited each year by an independent certified public accountant, or by the Auditor of Public Accounts. A copy of the audit report shall be provided to each local government or county official participating in the pool. In the case of an audit by an independent certified public accountant, a copy of the audit report shall be provided to the Auditor of Public Accounts, and to the state local debt officer. The Auditor of Public Accounts may review the report of the independent
certified public accountant. After preliminary review, should discrepancies be found, the Auditor of Public Accounts may make his own investigative report or audit to verify the findings of the independent certified public accountant's report.

(b) If the state local debt officer creates an investment pool, he shall establish an account in the Treasury for the pool. He shall also establish a separate trust and agency account for the purpose of covering management costs, and he shall deposit management charges in this account. The state local debt officer may issue regulations, pursuant to KRS Chapter 13A, governing the operation of the investment pool, including but not limited to provisions on minimum allowable investments and investment periods, and method and timing of investments, withdrawals, payment of earnings, and assignment of charges.

(c) Before investing in an investment pool created pursuant to this subsection, a local government or county official shall allow any savings and loan association or bank in the county, as described in subsection (1)(d) of this section, to bid for the deposits, but the local government or county official shall not be required to seek bids more often than once in each six (6) month period.

(10) (a) With the approval of the Kentucky Board of Education, local boards of education, or any of them that desire to do so, may associate to create an investment pool. Each local school board which associates itself with other local school boards for the purpose of creating the investment pool may invest its funds in the pool so created and so managed. Investments shall be limited to those investment instruments permitted by this section. The funds of each local school board shall be properly accounted for, and earnings and charges shall be assigned to each participant in a uniform manner according to the amount invested. Charges to any local school board shall not exceed one
percent (1%) annually on the principal amount invested, and charges on investments of less than a year's duration shall be prorated. Any investment pool created pursuant to this subsection shall be audited each year by an independent certified public accountant, or by the Auditor of Public Accounts. A copy of the audit report shall be provided to each local school board participating in the pool. In the case of an audit by an independent certified public accountant, a copy of the audit report shall be provided to the Auditor of Public Accounts, and to the Kentucky Board of Education. The Auditor of Public Accounts may review the report of the independent certified public accountant. After preliminary review, should discrepancies be found, the Auditor of Public Accounts may make his own investigative report or audit to verify the findings of the independent certified public accountant’s report.

(b) The Kentucky Board of Education may issue administrative regulations governing the operation of the investment pool including, but not limited to, provisions on minimum allowable investments and investment periods, and methods and timing of investments, withdrawals, payment of earnings, and assignment of charges.

Section 4. KRS 287.330 is amended to read as follows:

(1) Banks, subject to statutory or charter limitations, may pledge such portion of their assets or provide surety bonds as may be required by law as collateral security for government deposits made with them, or any of them, by or under the authority of the United States, or for any other deposit required by law to be secured.

(2) Notwithstanding any law requiring security for deposits in the form of collateral, surety bond or in any other form, security for such deposits shall not be required to the extent said deposits are insured under the provisions of Section 12B of the Federal Reserve Act (38 Stat. 251) as amended.
(3) If a bank proposes to sell its assets and transfer its deposit liability to another bank and the purchasing bank is unwilling to accept a sufficient amount of the assets to cover the liability to depositors and other creditors, the selling bank may, with the consent of the commissioner, pledge all or a part of its remaining or unacceptable assets to secure a loan for an amount sufficient to cover the remaining liability to the depositors and other creditors.
AN ACT relating to Article 3 of the Uniform Commercial Code.
Repeal the following sections of the Uniform Commercial Code relating to negotiable instruments:
KRS 355.3-701, 355.3-801, 355.3-802, 355.3-803, 355.3-804, and 355.3-805; make Act retroactive to
January 1, 1996, the effective date of the repeal of the former Article 3.

Feb 25-introduced in Senate
Feb 26-to Judiciary (S)
Mar 4-reported favorably, 1st reading, to Consent Calendar
Mar 5-2nd reading, to Rules
Mar 6-posted for passage in the Consent Orders of the Day for March 10, 1998
Mar 10-3rd reading, passed 32-0; received in House
Mar 11-to Judiciary (H)
Mar 12-posted in committee
Mar 17-reported favorably, 1st reading, to Calendar
Mar 18-2nd reading, to Rules
Mar 24-3rd reading, passed 84-5
Mar 25-received in Senate; enrolled, signed by each presiding officer, delivered to Governor
AN ACT relating to Article 3 of the Uniform Commercial Code.

*Be it enacted by the General Assembly of the Commonwealth of Kentucky:*

Section 1. The following KRS sections are repealed:

- 355.3-701 Letter of advice of international sight draft.
- 355.3-801 Drafts in a set.
- 355.3-802 Effect of instrument on obligation for which it is given.
- 355.3-803 Notice to third party.
- 355.3-804 Lost, destroyed or stolen instruments.
- 355.3-805 Instruments not payable to order or to bearer.

Section 2. The General Assembly finds and declares that in enacting the Revised Article 3 of the Uniform Commercial Code in 1996 Ky. Acts Chapter 130, effective January 1, 1997, it was the intent of the General Assembly to repeal those sections of the former Article 3 that are now being repealed in Section 1 of this Act but that these sections were inadvertently omitted and further finds and declares that this situation has been properly described in the Legislative Research Commission Note that was appended to each of these statutes in the Kentucky Revised Statutes. For these reasons, this Act is retroactive to January 1, 1997, the effective date of the repeal of the former Article 3.
AN ACT relating to title pledge loans.

Create a new section of KRS Chapter 368 to define terms; to authorize a title pledge lender to make loans of money on pledges of titled personal property, to exempt title pledge lenders from KRS Chapter 360, and to establish a five (5) year statute of limitations for an action to be brought by a pledgor; create a new section of KRS Chapter 368 to require title pledge lenders to obtain a license; create a new section of KRS Chapter 368 to establish the requirements to qualify for a license; create a new section of KRS Chapter 368 to establish the information and manner of the application for a license; create a new section of KRS Chapter 368 to require a license; create a new section of KRS Chapter 368 to establish the requirements to qualify for a license; create a new section of KRS Chapter 368 to require an annual fee of five hundred dollars ($500); create a new section of KRS Chapter 368 to require an examination by the department of every title pledge lender at least once, and not more than twice, every twenty four (24) months; create a new section of KRS Chapter 368 to exempt the Commonwealth, the commissioner, and any examiner from liability regarding the examination of a title pledge lender; create a new section of KRS Chapter 368 to establish that reports and other information relating to the examination is confidential, with certain specific exceptions; create a new section of KRS Chapter 368 to require that a fee be collected by the department for any examination; create a new section of KRS Chapter 368 to require that a title pledge lender to keep records of agreements executed, to keep a copy of an agreement for a period of two (2) years, and to set forth the information that is required in each title pledge agreement; create a new section of KRS Chapter 368 to allow a title pledge lender to record the lender's security interest, and to allow the lender to require the pledgor to execute a power of attorney when signing the agreement; create a new section of KRS Chapter 368 to establish that a title pledge lender contract for an effective rate of interest not to exceed two percent (2%) per month, to allow the title pledge lender to charge a fee to defray the ordinary cost of operating a title pledge office, such as investigating the title, appraising the titled personal property, documenting and closing the title or property pledge transaction, making required reports, for all other services provided by the titled lender, advertising, for losses on titled pledge transactions, salaries, and for all other expenses incurred and specify that this fee will not be interest and that the fee may equal no more than one fifth of the original principal amount of the agreement or of the total unpaid principal balance due at the inception of any renewal of the agreement, to allow the lender to collect fees for repossession and storage, to require the title pledge lender to issue to the pledgor a disclosure form in compliance with the Federal Truth-in-Lending Act, and to set forth that by agreement the parties may renew the maturity date for additional thirty (30) day periods; create a new section of KRS Chapter 368 to set forth that the pledgor be entitled to a release of the interest and lien upon satisfaction of all outstanding obligations in accordance with the agreement, and that the power of attorney then be stamped "void"; create a new section of KRS Chapter 368 to establish that if the pledgor fails to pay all of the principal, interest, and fees owing to the lender, the lender has the right to possession of the property without judicial process; create a new section of KRS Chapter 368 to require that after the lender has taken possession of the property the lender must wait twenty (20) days before disposing of the property, to establish that all interest and fees other than storage fees cease to accrue, to establish that during the twenty (20) day period the pledgor has the sole
right to redeem the property by paying all principal, interest, and fees, and to require that after the twenty (20) day period the property be sold within sixty (60) days in a commercially reasonable manner after notice is sent to the pledgor and to other qualifying secured parties, and to require that proceeds of the sale be applied to the amount owed the lender, and that any surplus be remitted to the pledgor; create a new section of KRS Chapter 368 to prohibit the title pledge lender from certain specific actions, activities, and business transactions; and create a new section of KRS Chapter 368 to establish civil and criminal penalties.

SB 392 - AMENDMENTS

SFA (1, E. Scorsone) - Require a title lender to be subject to the fees and other charges provided in KRS 288.530; prohibit a title loan transaction from being renewed, rolled over or consolidated more than three times in succession, and require that each roll over period not be for less than 30 days.
HFA (1, R. Palumbo) - Limit loan amount to $2,500 rather than $4,000.
HFA (2, J. Gooch) - Amend KRS 226.080 to set forth that pawnbrokers be subject to the fees provided in KRS 288.530.
HFA (3, J. Gooch) - Make title amendment.
HFA (4, B. Yonts) - Allow interest of up to two percent per month; permit fees up to one-fifth of the original principal amount of the title pledge agreement; allow a repossession and storage charge.

Mar 2-introduced in Senate
Mar 3-to Banking and Insurance (S)
Mar 4-reported favorably, 1st reading, to Calendar
Mar 5-2nd reading, to Rules
Mar 6-posted for passage in the Regular Orders of the Day for March 10, 1998; floor amendment (1) filed
Mar 10-passed over and retained in the Orders of the Day
Mar 11-passed over and retained in the Orders of the Day
Mar 12-passed over and retained in the Orders of the Day
Mar 16-3rd reading, passed 32-3 with floor amendment (1)
Mar 17-received in House
Mar 19-to Licensing and Occupations (H)
Mar 20-posted in committee
Mar 24-reported favorably, 1st reading, to Calendar
Mar 27-floor amendment (4) filed
Mar 30-3rd reading, floor amendment (4) defeated; passed 67-29
Mar 31-received in Senate; enrolled, signed by each presiding officer, delivered to Governor

4/1/98 Signed by Governor
AN ACT relating to legal representatives.

Create a new section of KRS 311.621 to 311.643 to require a court appointed fiduciary, charged with the care and protection of a person, to be bound by the terms of the person's advance living will directive; amend KRS 386.093 to define "durable power of attorney"; establish the responsibilities of an attorney in fact and a fiduciary when a durable power of attorney is in effect; amend KRS 387.530 to require that a petition, for a determination of partial disability or disability and appointment of a guardian, shall state the name and address of the respondent's attorney in fact under a durable power of attorney and the respondent's health surrogate with authority to make decisions under a living will directive; amend KRS 387.600 to permit a court to name a person with power of attorney for an individual as that individual's limited guardian, guardian, limited conservator, or conservator; repeal KRS 387.605.

HB 60 - AMENDMENTS

HCS - Prohibit a fiduciary from revoking or amending a power of attorney which a principal has granted someone other than the fiduciary; delete the repeal of KRS 387.605; make technical amendments.

(Prefiled by the sponsor(s).)

Jan 6-introduced in House
Jan 7-to Judiciary (H)
Jan 16-posted in committee
Jan 22-reported favorably, 1st reading, to Calendar with Committee Substitute

Jan 26-3rd reading, passed 92-1 with Committee Substitute
Jan 27-received in Senate
Jan 28-to Judiciary (S)
Mar 18-reported favorably, 1st reading, to Calendar
Mar 19-2nd reading, to Rules
Mar 25-3rd reading, passed 31-0
Mar 26-received in House; enrolled, signed by each presiding officer
Mar 27-delivered to Governor
AN ACT relating to legal representatives.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

SECTION 1. A NEW SECTION OF KRS 311.621 TO 311.643 IS CREATED TO READ AS FOLLOWS:

If, following the execution of an advance directive under KRS 311.623, a court of the grantor's principal domicile appoints a fiduciary charged with the care and protection of the grantor's person, the fiduciary shall be bound by the terms of the grantor's advance directive. If the advance directive designates a surrogate to make health care decisions for the grantor, the surrogate may continue to act.

Section 2. KRS 386.093 is amended to read as follows:

(1) As used in this section, "durable power of attorney" means a power of attorney by which a principal designates another as the principal's attorney in fact in writing and the writing contains the words, "This power of attorney shall not be affected by subsequent disability or incapacity of the principal, or lapse of time", or "This power of attorney shall become effective upon the disability or incapacity of the principal", or similar words showing the intent of the principal that the authority conferred shall be exercisable notwithstanding the principal's subsequent disability or incapacity, and, unless it states a time of termination, notwithstanding the lapse of time since the execution of the instrument.

(2) All acts done by an attorney in fact under a durable power of attorney during any period of disability or incapacity of the principal have the same effect and inure to the benefit of and bind the principal and the principal's successors in interest as if the principal were competent and not disabled. Unless the instrument states a time of termination, the power is exercisable notwithstanding the lapse of time since the execution of the instrument.

(3) The death of a principal who has executed a written power of attorney, durable or otherwise, does not revoke or terminate the agency as to the attorney in fact or
other person, who, without actual knowledge of the death of the principal, acts in
good faith under the power. Any action so taken, unless otherwise invalid or
unenforceable, binds successors in interest of the principal.

(4) The disability or incapacity of the principal who has previously executed a written
power of attorney that is not a durable power does not revoke or terminate the
agency as to the attorney in fact or other person, who, without actual knowledge
of the disability or incapacity of the principal, acts in good faith under the power.
Any action so taken, unless otherwise invalid or unenforceable, binds the
principal and the principal's successors in interest.

(5) If the power of attorney is to become effective upon the disability or incapacity of
the principal, the principal may specify the conditions under which the power is
to become effective and may designate the person, persons, or institution
responsible for making the determination of disability or incapacity. If the
principal fails to so specify, the power shall become effective upon a written
determination by two (2) physicians that the principal is unable, by reason of
physical or mental disability, to prudently manage or care for the principal's
person or property, which written determination shall be conclusive proof of the
attorney in fact's power to act pursuant to the power of attorney. The two (2)
physicians making the determination shall be licensed to practice medicine[When
a principal designates another his attorney in fact or agent by a power of attorney in
writing and the writing contains the words "This power of attorney shall not be
affected by the disability of the principal," or "This power of attorney shall become
effective upon the disability of the principal," or similar words showing the intent of
the principal that the authority conferred shall be exercisable notwithstanding his
disability, then the authority of the attorney in fact or agent is exercisable by him as
provided in the power on behalf of the principal notwithstanding later disability or
incapacity of the principal at law or later uncertainty as to whether the principal is
dead or alive. All acts done by the attorney in fact or agent, pursuant to the power during any period of disability or incompetence or uncertainty as to whether the principal is dead or alive, have the same effect and inure to the benefit of and bind the principal or his heirs, devisees and personal representative as if the principal were alive, competent and not disabled. If a fiduciary is thereafter appointed by the court for the principal the power of the attorney in fact shall thereupon terminate and he shall account to the court's appointed fiduciary.

Section 3. KRS 387.530 is amended to read as follows:

(1) A petition for a determination of partial disability or disability and the appointment of a limited guardian, guardian, limited conservator, or conservator may be filed by any interested person or by an individual needing guardianship or conservatorship. The petition shall set forth the following:

(a) The name and address of the respondent;
(b) The date of birth of the respondent, if known;
(c) The nature and degree of the alleged disability of the respondent;
(d) The facts and reasons supporting the need for guardianship or conservatorship;
(e) A description and approximation of the value of the respondent's financial resources, including government benefits, insurance entitlements, and anticipated yearly income, if known;
(f) The names and addresses of the respondent's next of kin, if known;
(g) The name and address of the individual or facility, if any, having custody of the respondent;
(h) The name, address and interest of the petitioner;
(i) The name and address of the petitioner's attorney, if any; and
(j) The name and address of any person or entity appointed by the respondent as respondent's attorney in fact under a durable power of attorney, as
defined in subsection (1) of Section 2 of this Act, or as respondent's surrogate to make health care decisions under an advance directive.

(2) The petition shall be accompanied by a verified application of the person or entity desiring appointment as limited guardian, guardian, limited conservator, or conservator. The application shall state the name, address and qualifications of the applicant and his relationship to the respondent. If it is proposed that a standby limited guardian, guardian, limited conservator, or conservator be designated, the petition shall also be accompanied by the application of the person or entity desiring to be so designated. Additional petitions may be filed prior to the date of the hearing by other persons desiring appointment.
GENERAL ASSEMBLY
COMMONWEALTH OF KENTUCKY

1998 REGULAR SESSION

HOUSE BILL 121

AN ACT relating to the release of liens.
Amend KRS 382.365 to allow proceedings to be filed in District or Circuit Court; to increase the amount due the property owner to $100 for failure to release within 30 days, to require an additional $400 to be paid to the property owner if a satisfied lien is not released within 45 days, to require $100 per day to be paid to the property owner for each day a lien is not released after the issuance of a court order requiring the release; and to provide that payments are in addition to any other fees, charges, or damages owed pursuant to the provisions of any other section of KRS.

HB 121 - AMENDMENTS

HCS - Permit additional parties to secure release of lien, increase penalty for failure to release lien, provide definition of date of satisfaction of lien.

HFA (1, J. Barrows) - Exempt an estate from provisions of the bill until it is settled.

HFA (2, J. Barrows) - Provide an exemption from this act when lienholder is deceased and the estate of the lienholder has not been settled.

SFA (1, G. Neal) - Specify when the $100 payment for failure to release lien is to be made to owner of real property.

SFA (2, A. Robinson) - Require court to enter a judgment releasing a lien upon proof of satisfaction being submitted to the court.

Jan 6-introduced in House
Jan 7-to Judiciary (H)
Jan 16-posted in committee
Feb 10-reported favorably, 1st reading, to Calendar with Committee Substitute
Feb 11-2nd reading, to Rules
Feb 12-posted for passage in the Regular Orders of the Day for February 17, 1998
Feb 18-floor amendments (1) and (2) filed to Committee Substitute
Feb 25-3rd reading, passed 78-12 with Committee Substitute and Floor Amendment (2)
Feb 26-received in Senate
Feb 27-to Judiciary (S)
Mar 18-reported favorably, 1st reading, to Consent Calendar
Mar 19-2nd reading, to Rules
Mar 23-floor amendment (1) filed
Mar 24-taken from the Consent Orders of the Day, placed in the Regular Orders of the Day; passed over and retained in the Orders of the Day
Mar 25-floor amendment (2) filed
Mar 26-3rd reading, passed 31-0 with floor amendment (2)
Mar 27-received in House; posted for passage for concurrence in Senate amendment
Mar 31-House concurred in Senate floor amendment (2); passed 93-0

A - 49
AN ACT relating to the release of liens.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 382.365 is amended to read as follows:

(1) A holder of a lien on real property, including a lien provided for in KRS 376.010, shall release the lien in the county clerk's office where the lien is recorded within thirty (30) days from the date of satisfaction.

(2) A proceeding may be filed by any owner of real property or any party acquiring an interest in the real property in District or Circuit Court against a lienholder that violates subsection (1) of this section. A proceeding filed under this section shall be given precedence over other matters pending before the court.

(3) Upon proof of satisfaction of the lien being introduced, the court may enter a judgment releasing the lien. The judgment may be with costs including a reasonable attorney's fee. The lienholder may be liable to the owner of the real property in the amount of one hundred dollars ($100) per day, for each day that the lienholder fails to release a lien after the entry of a judgment by the court.

(4) A lienholder that violates subsection (1) of this section may[shall also] be liable to the owner of the real property for one hundred dollars ($100). A lienholder that fails to release a satisfied real estate lien within forty-five (45) days from the date of satisfaction may be liable to the owner of the real property for an additional four hundred dollars ($400), for a total of five hundred dollars ($500). The lienholder may also be liable for[50] any actual expense including a reasonable attorney's fee incurred by the owner in securing the release of real property by such violation.[The judgment shall be with costs including reasonable attorneys' fees.]

(5)[(4)] The former holder of a lien on real property shall send by regular mail a copy of the lien release to the property owner at his last known address within seven (7) days of the release. A former lienholder that violates this subsection shall be liable
to the owner of the real property for fifty dollars ($50) and any actual expense incurred by the owner in obtaining documentation of the lien release.

(6) For the purposes of this section, "date of satisfaction" means that date of receipt by a holder of a lien on real property of a sum of money in the form of a certified check, cashier's check, wired transferred funds, or other form of payment satisfactory to the lienholder that is sufficient to pay the principal, interest, and other costs owing on the obligation that is secured by the lien on the property.

(7) The provisions of this section shall not apply when a lienholder is deceased and the estate of the lienholder has not been settled.
AN ACT relating to child support.

Amend KRS 186.570 to require the Transportation Cabinet to deny a motor vehicle license after failure to comply with a subpoena or warrant relating to paternity or child support proceedings; amend KRS 205.175 to direct the information received or transmitted by the Cabinet for Human Resources not be published, including instances in which the agency determines reasonable cause to believe evidence of domestic violence or child abuse and that disclosure could be harmful to the custodial parent or the child; amend KRS 205.595 to provide for employer acceptance of a notice of transfer of health insurance enrollment; amend various provisions of KRS Chapter 205 to redefine the term "duty of support" to include the duty to pay spousal support that applies to spouses with a child even if the child support is not part of the order; redefine "income" to additionally include bonuses, worker's compensation, retirement and pensions, and interest and disability; delete references to "aid to families with dependent children" and replace them with "public assistance" under Title IV-A of the Social Security Act; expand the duties of the Division of Child Support Enforcement; provide for enforcement of a cumulative child support lien or levy; provide penalty for failure of a bank, savings and loan association, credit union, investment company, savings institution or other specified financial institution to comply with a subpoena; amend various provisions of KRS Chapter 213 to provide for voluntary acknowledgment of paternity services; direct hospitals to provide oral, audio, or video materials about paternity when a birth occurs in a hospital to a woman who is unmarried; allow for changing of Vital Statistics records involving paternity when acknowledgment of paternity is rescinded; amend KRS 237.110 to direct the Department of State Police to deny, suspend, or revoke a license to carry a concealed deadly weapon upon written notice from the Cabinet for Human Resources that the person has a child support arrearage that equals or exceeds the cumulative amount that would be owed after one year of nonpayment, or for failure, after receiving appropriate notice to comply with a subpoena or warrant relating to paternity or child support proceedings. amend KRS 403.150 to require marriage dissolution petitions to include social security numbers of each party, including living infant children of the marriage; amend KRS 403.160 to require in proceedings for dissolution of marriage or legal separation, or for maintenance or support, the court to determine whether disclosure to any other person of information of domestic violence or child abuse would be harmful to the parent or child; provide for Cabinet for Human Resources protection of information of evidence of domestic violence or child abuse in actions to establish or enforce child support; amend KRS 403.212, relating to the definition of terms for the child support table, to redefine the term "gross income" to include retirement and pension funds; amend various provisions of KRS Chapter 405 to require the cabinet to pay, when administratively ordered, the cost of genetic testing to establish paternity, when a parent presents himself for the voluntary establishment of paternity; allow the cabinet to review and adjust a parent's child support obligation upon a request of the cabinet under specified circumstances; require obligated parents of a child receiving public assistance to participate in work activities; set forth conditions under which transfer of property or income to avoid payment to a child
support creditor indicates fraud; provide for employer forwarding of a portion of current and due salary of wages of a parent to the cabinet; amend various provisions of KRS Chapter 406 to provide that either party in an action to establish paternity not be entitled to a jury trial; require an unchallenged acknowledgment of paternity to be ratified without the requirement for judicial or administrative proceedings; provide for payment of the cost of administratively ordered genetic testing to establish paternity; amend KRS 427.120 to allow seizure of a police or firefighters' pension fund for payment of court or administratively ordered current child support, or child support owed, or to be owed; amend KRS 427.125 to allow for seizure of a pension fund created under KRS 95.761 to 95.785 for purposes of court or administratively ordered child support, or owed or to be owed child support; amend KRS 67A.620 to allow for seizure of a retirement annuity for purpose of court or administratively ordered child support; amend KRS 161.700 to allow the garnishment or attachment of teacher retirement allowance for purposes of court or administratively ordered child support; create various new sections of KRS Chapter 205 to allow the Cabinet for Human Resources to have authority to issue an administrative subpoena commanding information and records relating to the establishment, enforcement, and collection of child support; require all public and private entities including financial institutions to comply with a subpoena within a reasonable time period; allow financial institutions to deduct $20 from the account on which the subpoenaed information has been issued; direct the cabinet to request information from a certified consumer reporting agency only when a full credit report is needed for the purpose of establishing an individual's capacity to make child support payments, or to determine the obligation amount, and paternity has been established or acknowledged; provide for advance notice to the obligor of the requested report; provide for confidentiality if the report and limits on the use for the report; require financial institutions to enter into cooperative agreement with the cabinet to operate a data match system providing identifying information each calendar quarter for each obligated parent maintaining an account at the institution and who owes an arrearage and is so identified by the cabinet; set forth the conditions included in the cooperative agreement; create a new section of KRS Chapter 335B to require licensure or certification denial or suspension if the person has a child support arrearage equal to or exceeding the amount which would be owed after one year of nonpayment or fails to comply with subpoenas or warrants relating to paternity or child support proceedings; create a new section of KRS Chapter 403 to require District or Circuit Court notice of arrearage or failure to comply with subpoenas or warrants to any professional, occupational, sporting license, or recreational licensing board or agency that has issued or is considering issuing a license or certification to the party with a child support arrearage equal to or exceeding one year of nonpayment; create a new section of KRS 405.405 to 405.520 to require an employer or labor organization to provide information to the Cabinet for Human Resources when that employer or labor organization hires or rehires an employee who has been laid off, furloughed, separated, granted a leave without pay, or terminated, unless the reporting could endanger the safety of the employee or compromise an ongoing investigation or intelligence mission; require the reporting within specified time intervals and under certain procedures; provide reporting exemptions; create a new section of KRS Chapter 205 to require the Revenue Cabinet and Cabinet for Human Resources to design, develop, implement, and operate a wage reporting and financial institution match system for the purpose of identifying the financial assets of individuals as identified by cabinet agencies, for the purpose of administering the tax laws, and the child support enforcement programs; provide for entrance into agreements to develop and operate a match system to facilitate identification of financial assets of individuals; direct the Revenue Cabinet to request from financial institutions specified data about each person listed; provide for child support liens; amend KRS 405.991 to conform; EMERGENCY.

HB 161 - AMENDMENTS

HCS/FN - Retain original provisions, except clarify enforcement of liens for foreclosure on homesteads for minor child of the obligor and minor child of the custodial parent; make provision for an obligor to contest the accuracy of the information obtained from the Cabinet for Human Resources from a
certified consumer reporting agency, for the purpose of establishing an individual's capacity to make child support payments; direct that financial institutions have no obligation to match an account based only on a name or other identifying information

HCA (1, B. Heleringer) - Allow the basis for child support dispute hearings to also include reasonableness of a payment schedule; require child support liens of the Cabinet for Human Resources to be on a parity with state, county, and municipal ad valorem tax liens; require motions for temporary support orders, pending an administrative or judicial determination of parentage, to be served upon the adverse party at the last known address; delete reference to conformance with federal law related to the prohibition of entitled to a jury in a paternity action.

HFA (1, T. Burch) - Delete the minimum requirement for the cabinet to report child support arrearages to consumer reporting agencies.

HFA (2, J. Barrows) - Provide for license reinstatement upon proof of elimination of child support arrearage from a court where the action is pending; provide that income from worker's compensation be from awards attributable to lost wages; provide that the clerk be entitled to fees pursuant to KRS Chapter 64; provide genetic testing exception for good cause, taking into account the best interests of the child; delete the provisions for the Revenue Cabinet to design, develop, implement, and operate a financial match system to identify financial assets.

HCA (2, T. Burch) - Make technical corrections.

HCA (3, M. Marzian) - Delete requirement that courts order denial, suspension, or revocation of a professional, occupational, sporting, or recreational license or certification when an individual has a child support arrearage equal to or exceeding the amount that would be owed after one year of nonpayment.

HCA (4, J. Barrows) - Provide that the proof of the elimination of child support arrearage or proof of the compliance with the subpoena or warrant relating to paternity or child support proceedings can come from the court where the action is pending; provide that "income" can include awards attributable to lost wages; make technical corrections.

HCA (5/Title, M. Marzian) - Make title amendment.

SCS/FN - Retain the original provisions but delete the requirement that courts order denial, suspension, or revocation of a professional, occupational, sporting, or recreational license or certification when an individual has a child support arrearage equal to or exceeding the amount that would be owed after one year of nonpayment.

(Prefiled by the sponsor(s).)

Jan 6-introduced in House
Jan 7-to Health and Welfare (H)
Jan 12-posted in committee
Jan 27-reported favorably, 1st reading, to Calendar with Committee Substitute and Committee Amendments (1) and (2)

Jan 28-2nd reading, to Rules
Jan 29-recommitted to Appropriations and Revenue (H)
Feb 12-posted in committee
Feb 25-reported favorably, to Rules with Committee Amendments (3) (4) and (5-title)
Mar 3-floor amendments (1) and (2) filed to Committee Substitute
Mar 9-3rd reading, passed 80-15 with Committee Substitute, floor amendments (1) and (2), and committee amendment (5-title)
Mar 10-received in Senate
Mar 11-to Appropriations and Revenue (S)
Mar 17-reported favorably, 1st reading, to Consent Calendar with Committee Substitute
Mar 18-2nd reading, to Rules
Mar 23-3rd reading, passed 35-3 with Committee Substitute
Mar 24-received in House; posted for passage for concurrence in Senate amendment
Mar 31-House concurred in Senate Committee Substitute; passed 82-14
AN ACT relating to revenue and taxation and declaring an emergency.
Amend KRS 141.010 to change the Internal Revenue Code reference date from December 31, 1995 to December 31, 1997; the Act applies to tax years beginning after December 31, 1996; EMERGENCY.

Jan 7-introduced in House
Jan 8-to Appropriations and Revenue (H)
Jan 9-posted in committee
Jan 13-reported favorably, 1st reading, to Calendar

Jan 15-3rd reading, passed 98-0
Jan 16-received in Senate
Jan 20-to Appropriations and Revenue (S)
Jan 27-reported favorably, 1st reading, to Consent Calendar
Jan 28-2nd reading, to Rules
Jan 29-posted for passage in the Consent Orders of the Day for February 2, 1998
Feb 2-3rd reading, passed 35-0
Feb 3-received in House; enrolled, signed by Speaker of the House
Feb 4-enrolled, signed by President of the Senate; delivered to Governor
Feb 6-signed by Governor
AN ACT relating to revenue and taxation and declaring an emergency.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 141.010 is amended to read as follows:

As used in this chapter, unless the context requires otherwise:

1. "Secretary" means the secretary of revenue;
2. "Cabinet" means the Revenue Cabinet;
3. "Internal Revenue Code" means the Internal Revenue Code in effect on December 31, 1997, exclusive of any amendments made subsequent to that date, other than amendments that extend provisions in effect on December 31, 1997, that would otherwise terminate, and as modified by KRS 141.0101;
4. "Dependent" means those persons defined as dependents in the Internal Revenue Code;
5. "Fiduciary" means "fiduciary" as defined in Section 7701(a)(6) of the Internal Revenue Code;
6. "Fiscal year" means "fiscal year" as defined in Section 7701(a)(24) of the Internal Revenue Code;
7. "Individual" means a natural person;
8. For taxable years beginning on or after January 1, 1974, "federal income tax" means the amount of federal income tax actually paid or accrued for the taxable year on taxable income as defined in Section 63 of the Internal Revenue under the provisions of this chapter, minus any by the taxpayer;
9. "Gross income"

...excerpt of 9 page bill showing principal amendment to statute
AN ACT relating to check cashing and deferred deposit transactions and declaring an emergency.

Amend KRS 368.010 to include definitions for “deferred deposit transaction" and deferred "deposit service business"; amend KRS 368.020 to require a separate license for each business location; amend KRS 368.040 to require a net worth minimum for each location; amend KRS 368.070 to require a licensee to notify the department 15 business days before changing location or name; amend KRS 368.100 to require payment of fees when checks are cashed, cap any fee at 5% of face amount, deferred deposit consideration viewed as interest subject to KRS Chapter 360, prohibit a service fee as consideration for an agreement not to present a check to the payor for a specified period of time or for any other purpose, cap licensee transactions from any one customer at any one time to a set face amount of $250, list certain requirements to be met in writing by customer, limit amount of time check can be held by licensee to 31 days, prohibit prosecution under KRS 514.040 of individuals who enter into a deferred deposit transaction with a licensee; amend KRS 368.110 to allow the commissioner to revoke or suspend all licensees issued to a licensee if revocation or suspension at any one location is of general application to all locations; create a new section of KRS Chapter 368.010 to 368.120 to allow written complaints to be filed with and investigated by the commissioner, assign certain investigative powers to the commissioner; create a new section of KRS Chapter 368.010 to 368.120 to establish that an annual report be filed with the commissioner by the licensee; and create a new section of KRS Chapter 368.010 to 368.120 to mandate that each licensee comply with the Consumer Credit Protection Act and display certain information.

HB 226 - AMENDMENTS

HCS - Retain original text, with the following exceptions: amend KRS 368.030 to remove mortgage loan companies, mortgage loan brokers and pawn brokers from the Chapter 368 exemption list; amend KRS 368.060 to require an investigation fee of $500 to accompany each application for a license for each location; amend KRS 368.080 to require a license fee of $500 for each renewal for the first location and $500 for each additional location; amend KRS 368.090 to allow the department to charge an examination fee sufficient to cover the cost of the examination; amend KRS 368.100 to establish that the fee charged can not exceed $15 per $100 and that the fee is for a period of 14 days, to prohibit a licensee from accepting more than one deferred deposit transaction from any one customer with a face value greater then $500, to require a customer to represent in writing that he has no more than one deferred deposit transaction and the face value of the deferred deposit transaction does not exceed $500, to establish that a deferred deposit transaction can not be held for more than 60 days and must be made in accordance with a dated and signed written agreement, and to limit the deferred deposit transaction to 3 rollovers; amend KRS 368.120 to establish that no license can be suspended without an opportunity for a hearing; and create a new section of KRS Chapter 368 to mandate that each licensee comply with the disclosure requirements of the Consumer Credit Protection Act, to require that every licensee display a schedule of fees in the office and in every branch office of the licensee, and to allow a licensee to charge, collect and receive check collection charges for each check returned or dishonored from a financial institution.
HFA (1, J. Adams) - Make title amendment.

HCA (1, J. Adams) - Amend KRS 368.010 to define a "licensee" as a person duly licensed for one or more locations; amend KRS 368.020 to change time frame for application process to begin; amend KRS 368.040 to require a licensee to maintain a specific net worth; and amend to drop the requirement of a net worth for each location.

HFA (2, J. Coleman) - Amend to prohibit a licensee from prosecuting or threatening to prosecute an individual under the provisions of KRS 514.040; amend to require a licensee to post a notice that an individual who enters into a deferred deposit transaction will not be prosecuted under the provisions of KRS 514.040; EMERGENCY.

HCA (2, J. Adams) - Make title amendment.

HFA (3, J. Coleman) - Make title amendment; and declare an EMERGENCY.

HFA (4, S. Riggs) - Amend to replace a net worth requirement of $100,000 with a requirement that an applicant post a letter of credit with the commissioner in specified amounts that increase with the number of business locations.

HFA (5, M. Long) - Amend to replace a net worth requirement of $100,000 with a requirement that an applicant deposit with the commissioner a letter of credit, evidence of an account payable to the commissioner or a savings certificate in specified amounts that increase with the number of business locations.

HFA (6, R. Crimm) - Amend to retain the exclusion for mortgage loan brokers and for pawn brokers.

SFA (1, C. Borders) - Amend to decrease from fifteen dollars ($15) to ten dollars ($10) per hundred dollars ($100) regarding allowable fees of deferred deposit transactions; and amend to decrease the number of rollovers from three (3) to two (2).

CCR - The committee could not agree and asks for a free conference committee.

FCCR (Majority Report) - Eliminate renewal and rollovers for deferred deposit transactions.
AN ACT relating to check cashing and deferred deposit transactions and declaring an emergency.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 368.010 is amended to read as follows:

As used in KRS 368.010 to 368.120 and 368.990, unless the context requires otherwise:

(1) "Check" means any check, draft, money order, personal money order, travelers' check, or other demand instrument for the transmission or payment of money.

(2) "Commissioner" means the commissioner of the Department of Financial Institutions, or his duly designated representative.

(3) "Consideration" includes any premium charged for the sale of goods or services in excess of the cash price of the goods or services.

(4) "Deferred deposit transaction" means, for consideration, accepting a check and holding the check for a period of time prior to deposit or presentment in accordance to an agreement with or any representation made to the maker of the check, whether express or implied.

(5) "Deferred deposit service business" means a person who engages in deferred deposit transactions.

(6) "Department" means the Department of Financial Institutions.

(7) "Licensee" means a person duly licensed by the commissioner under KRS 368.010 to 368.120.

(8) "Person" means any individual, partnership, association, joint stock association, trust, corporation, or other entity, but shall not include the United States government or the government of this Commonwealth.

Section 2. KRS 368.020 is amended to read as follows:

Except as provided in KRS 368.030, no person shall engage in the business of cashing checks or accepting deferred deposit transactions for a fee or other consideration without having first obtained a license. A separate license shall be required for each
location from which the business of cashing checks or accepting deferred deposit transactions is conducted. Any person engaged in that business on the effective date of this section may continue to engage in the business without a license until the commissioner shall have acted upon his application for a license if the application is filed within sixty (60) days after the effective date of this Act (July 14, 1992).

Section 3. KRS 368.030 is amended to read as follows:

The provisions of KRS 368.010 to 368.120 shall not apply to:

(1) Any bank, trust company, savings and loan association, savings bank, credit union, consumer loan company, or industrial loan corporation, mortgage loan company, mortgage loan broker, or pawn broker which is chartered, licensed, or organized under the laws of this Commonwealth or under federal law and authorized to do business in this Commonwealth;

(2) Any person who cashes checks without receiving, directly or indirectly, any consideration or fee therefor; and

(3) Any person principally engaged in the retail sale of goods or services who, either as an incident to or independently of a retail sale, may from time to time cash checks for a fee or other consideration.

Section 4. KRS 368.040 is amended to read as follows:

To qualify for a license, an applicant shall satisfy the following requirements:

(1) The applicant shall deposit with the commissioner one (1) of the following:

(a) An irrevocable letter of credit in the following amounts:

1. If an applicant has only one (1) business location, the amount shall be fifty thousand dollars ($50,000);

2. If an applicant has two (2) to five (5) business locations, the amount shall be one hundred thousand dollars ($100,000);

3. If an applicant has six (6) to ten (10) business locations, the amount shall be one hundred fifty thousand dollars ($150,000); and
4. If an applicant has more than ten (10) business locations, the amount shall be two hundred thousand dollars ($200,000);

(b) Evidence that the applicant has established an account payable to the commissioner in a federally insured financial institution in this state and deposit money of the United States in an amount equal to the amount of the required letter of credit; or

(c) A savings certificate of a federally insured financial institution in this state for an amount payable that is equal to the amount of the required letter of credit and that is not available for withdrawal except by direct order of the commissioner. Interest earned on the certificate accrues to the applicant [have a net worth of at least one hundred thousand dollars ($100,000), computed according to generally accepted accounting principles].

(2) The financial responsibility, financial condition, business experience, character, and general fitness of the applicant shall reasonably warrant the belief that the applicant's business will be conducted honestly, carefully, and efficiently. In determining whether this qualification has been met, the commissioner may review and approve:

(a) The business record and the capital adequacy of the applicant;

(b) The competence, experience, integrity, and financial ability of any person who:

   1. Is a director, officer, supervisory employee, or five percent (5%) or more shareholder of the applicant; or

   2. Owns or controls the applicant; and

(c) Any record, on the part of the applicant or any person referred to in subparagraph (b)1. and 2. of:

   1. Any criminal activity;

   2. Any fraud or other act of personal dishonesty;
3. Any act, omission, or practice which constitutes a breach of a fiduciary duty; or
4. Any suspension or removal, by any agency or department of the United States or any state, from participation in the conduct of any business.

Section 5. KRS 368.060 is amended to read as follows:

Each application for a license shall be accompanied by:

(1) An investigation fee of five hundred dollars ($500) for Kentucky residents and five hundred dollars ($500) for nonresidents of Kentucky for each location which shall not be subject to refund but which, if the license is granted, shall constitute the license fee for the first license year or part thereof;
(2) Audited financial statements prescribed by the commissioner; and
(3) Evidence that the applicant has complied or will comply with all workers', and unemployment compensation laws of Kentucky.

Section 6. KRS 368.070 is amended to read as follows:

(1) Upon the filing of an application in a form prescribed by the commissioner, accompanied by the fee and documents required in KRS 368.060, the department shall investigate to ascertain whether the qualifications prescribed by KRS 368.040 have been satisfied. If the commissioner finds that the qualifications have been satisfied, and if he approves the documents, he shall issue to the applicant a license to engage in the business of cashing checks or deferred deposit transactions in this Commonwealth.
(2) The license shall be kept conspicuously posted in the place of business of the licensee and shall not be transferable or assignable.
(3) A license issued under this section shall remain in force and effect through the remainder of the fiscal year ended June 30 following its date of issuance, unless earlier surrendered, suspended, or revoked under KRS 368.010 to 368.120.
A licensee shall notify the department fifteen (15) business days before any change in the licensee's business location or name.

Section 7. KRS 368.080 is amended to read as follows:

Each licensee may be renewed for the ensuing twelve (12) months period upon the payment to the department annually on or before July 1 of each year a license fee of five hundred dollars ($500) for the first location and five hundred dollars ($500) for each additional location.

Section 8. KRS 368.090 is amended to read as follows:

(1) The department may adopt reasonable administrative regulations, not inconsistent with law, for the enforcement of KRS 368.010 to 368.120.

(2) To assure compliance with the provisions of KRS 368.010 to 368.120, the department may examine the business, books, and records of any licensee, and each licensee shall pay an examination fee sufficient as established by administrative regulations of the department to cover the cost of the examination based upon fair compensation for time and actual expense as established by administrative regulations of the department.

Section 9. KRS 368.100 is amended to read as follows:

(1) Each licensee shall keep and use in its business any books, accounts, and records the department may require to carry into effect the provisions of KRS 368.010 to 368.120 and the administrative regulations issued under those sections hereunder. Every licensee shall preserve the books, accounts, and records for at least two (2) years.

(2) Any fee charged by a licensee for cashing a check shall be disclosed in writing to the bearer of the check prior to cashing the check, and the fee shall be deemed a service fee and not interest. A licensee shall not charge a service fee in excess of fifteen dollars ($15) per one hundred dollars ($100) on the face amount of the deferred deposit check. A licensee shall prorate any fee, based upon the
maximum fee of fifteen dollars ($15). This service fee shall be for a period of fourteen (14) days.

(3) Before a licensee shall deposit with any bank or other depository institution a check cashed by the licensee, the check shall be endorsed with the actual name under which the licensee is doing business.

(4) No licensee shall cash a check payable to a payee other than a natural person unless the licensee has previously obtained appropriate documentation from the board of directors or similar governing body of the payee clearly indicating the authority of the natural person or persons cashing the check, draft, or money order on behalf of the payee.

(5) No licensee shall indicate through advertising, signs, billhead, or otherwise that checks may be cashed without identification of the bearer of the check; and any person seeking to cash a check shall be required to submit reasonable identification as prescribed by the department. The provisions of this subsection shall not prohibit a licensee from cashing a check simultaneously with the verification and establishment of the identity of the presenter by means other than the presentation of identification.

(6) Within five (5) business days after being advised by the payor financial institution that a check, draft, or money order has been altered, forged, stolen, obtained through fraudulent or illegal means, negotiated without proper legal authority, or represents the proceeds of illegal activity, the licensee shall notify the department and the Commonwealth's attorney for the judicial circuit in which the check was received. If a check, draft, or money order is returned to the licensee by the payor financial institution for any of these reasons, the licensee shall not release the check, draft, or money order without the consent of the Commonwealth's attorney or other investigating law enforcement authority.

(7) No licensee shall alter or delete the date on any check accepted by the licensee.
(8) No licensee shall engage in unfair or deceptive acts, practices or advertising in the conduct of the licensed business.

(9) No licensee shall require a customer to provide security for the transaction or require the customer to provide a guaranty from another person.

(10) A licensee shall not have more than one deferred deposit transaction from any one (1) customer at any one time, with a face value greater than five hundred dollars ($500).

(11) Each licensee shall inquire of any person seeking to present a deferred deposit transaction, whether the person has any outstanding deferred deposit transactions from any licensees. If the customer represents in writing that the customer has no more than one (1) deferred deposit transaction outstanding to any licensee and that the face value of the outstanding deferred deposit transaction issued by the customer does not equal or exceed five hundred dollars ($500), a licensee may accept a deferred deposit transaction in an amount that, when combined with the customer's other outstanding deferred deposit transaction, does not exceed five hundred dollars ($500). If the customer represents in writing that the customer has more than one (1) deferred deposit transaction outstanding to any licensee or if the face value of the deferred deposit transaction issued by the customer equals or exceeds five hundred dollars ($500), a licensee shall not accept another deferred deposit transaction from that customer until the customer represents to the licensee in writing that the customer qualifies to issue a new deferred deposit transaction under the requirements set forth in this section.

(12) A licensee shall not use any device or agreement, including agreements with affiliated licensees, with the intent to obtain greater charges than are authorized in this section.
(13) No licensee shall agree to hold a deferred deposit transaction for more than sixty (60) days.

(14) Each deferred deposit transaction shall be made according to a written agreement that shall be dated and signed by the customer and the licensee or an authorized agent of the licensee, and made available to the department upon request. The customer shall receive a copy of this agreement.

(15) A licensee or its affiliate shall not for a fee renew, roll over, or otherwise consolidate a deferred deposit transaction for a customer more than three (3) times in succession. Each roll over or renewal period shall not be less than the original period. The fee for a renewal, roll over, or consolidation shall be paid in cash or cash equivalent and shall be in an amount not to exceed the rate set forth in subsection (2) of this section.

(16) No individual who enters into a deferred deposit transaction with a licensee shall be convicted under the provisions of KRS 514.040.

(17) No licensee who enters into a deferred deposit transaction with an individual shall prosecute or threaten to prosecute an individual under the provisions of KRS 514.040.

(18) Each licensee shall conspicuously display in every deferred deposit business location a sign that gives the following notice: "No person who enters into a post-dated check or deferred deposit check transaction with this business establishment will be prosecuted or convicted of writing cold checks or of theft by deception under the provisions of KRS 514.040.

Section 10. KRS 368.110 is amended to read as follows:

(1) The commissioner may suspend or revoke a license on any ground on which he may refuse to grant a license or for violation of any provision of KRS 368.010 to 368.120 or if the licensee:
(a) Has committed any fraud, engaged in any dishonest activities, or made any misrepresentation;

(b) Has violated any provisions of KRS 368.010 to 368.120 or any administrative regulation issued pursuant thereto or has violated any other law in the course of its or his dealings as a licensee;

(c) Has made a false statement in the application for the license or failed to give a true reply to a question in the application; or

(d) Has demonstrated his or its incompetency or untrustworthiness to act as a licensee.

(2) If the reason for revocation or suspension of a licensee's license at any one location is of general application to all locations operated by a licensee, the commissioner may revoke or suspend all licenses issued to a licensee.

Section 11. KRS 368.120 is amended to read as follows:

No license shall be denied, suspended, or revoked unless the applicant or licensee is afforded the opportunity for a hearing to be conducted in accordance with KRS Chapter 13B.

SECTION 12. A NEW SECTION OF KRS 368.010 TO 368.120 IS CREATED TO READ AS FOLLOWS:

(1) Any person aggrieved by the conduct of a licensee under KRS 368.010 to 368.120 in connection with the licensee's regulated activities may file a written complaint with the commissioner who may investigate the complaint.

(2) In the course of the investigation initiated by a complaint or by the commissioner, the commissioner may:

(a) Subpoena witnesses;

(b) Administer oaths;

(c) Examine any individual under oath; and
(d) Compel the production of records, books, papers, contracts or other documents relevant to the investigation.

(3) If any person fails to testify or to comply with a subpoena from the commissioner under this section, the commissioner may petition any court of competent jurisdiction for enforcement.

(4) The license of any licensee under KRS 368.010 to 368.120 who fails to comply with a subpoena of the commissioner may be suspended pending compliance with the subpoena.

(5) The commissioner shall have administrative power to investigate all complaints filed by any person if the complaints are not criminal in nature and if they relate to the check cashing or the deferred deposit service business.

SECTION 13. A NEW SECTION OF KRS 368.010 TO 368.120 IS CREATED TO READ AS FOLLOWS:

(1) Each licensee shall file an annual report with the commissioner by September 1 of each year, containing the following information:

(a) The names and addresses of each person owning a controlling interest in each license;

(b) The location of all places of business operated by the licensee and the nature of the business conducted at each location;

(c) The names and addresses of all affiliated entities regulated under KRS 368.010 to 368.120 and doing business in this state;

(d) Balance sheets, statement of income and expenses, and other statistical information as may be reasonably required by the commissioner, consistent with generally accepted accounting practices, for the purpose of determining the general results of operations under this chapter; and

(e) If the licensee is a corporation, the names and addressees of its principle officers and directors, or if the licensee is a partnership, the names and
addresses of the partners, or if the licensee is a limited liability company, the names and addresses of the board of directors of the limited liability company.

(2) If the licensee holds two (2) or more licenses or is affiliated with other licensees, a composite report may be filed.

(3) All reports shall be filed in a form as may reasonably be required by the commissioner and shall be sworn to by a responsible officer of the licensee.

(4) The information submitted by licensees under this section shall be held in confidence by the department and the commissioner.

SECTION 14. A NEW SECTION OF KRS 368.010 TO 368.120 IS CREATED TO READ AS FOLLOWS:

(1) Each licensee who engages in deferred deposit transactions shall give the customer the disclosures required by the Consumer Credit Protection Act (15 U.S.C. sec. 1601). Proof of this disclosure shall be made available to the department upon request.

(2) Each licensee shall conspicuously display a schedule of all fees, and charges for all services provided by the licensee that are authorized by KRS 368.010 to 368.120. The notice shall be posted at the office and every branch office of the licensee.

(3) A licensee may charge, collect, and receive check collection charges made by a financial institution for each check returned or dishonored for any reason, provided that the terms and conditions upon which check collection charges will be charged to the customer are set forth in the written disclosure.

(4) Any personal check accepted from a customer must be payable to the licensee.

(5) Before a licensee shall present for payment or deposit a check accepted by the licensee, the check shall be endorsed with the actual name under which the licensee is doing business.
Section 15. Whereas it is increasingly difficult to prevent the working people of
the Commonwealth from being charged outrageous fees when they enter into deferred
deposit transactions which has lead many to economic ruin, an emergency is declared to
exist, and this Act takes effect upon its passage and approval by the Governor or upon its
otherwise becoming a law.
GENERAL ASSEMBLY
COMMONWEALTH OF KENTUCKY

1998 REGULAR SESSION

HOUSE BILL 514

AN ACT relating to consumer loan companies.

Amend KRS 288.430 to require the application for a consumer loan company to include the names and addresses the principal officers and directors; amend KRS 288.450 to delete requirement that the commissioner must find that the applicant will promote the convenience and advantage of the community; amend KRS 288.470 to allow consumer loan companies to operate in other businesses that engage in purchases of retail and installment sales contracts and motor club memberships; amend KRS 288.533 to permit consumer loan companies to charge a credit investigation fee of $1 for every $50 of the loan on the first $2000 of the loan; amend KRS 288.610 to require consumer loan companies to pay a fee to cover annual examinations; amend KRS 288.615 to make technical changes; amend KRS 288.620 to delete provision that prohibits a person from charging any interest, discount, or consideration greater than six percent per annum upon any loan in the amount of $15,000; repeal KRS 288.510, financial condition of licensee, and KRS 288.515, advertising statement required where institution not fully insured.

HB 514 - AMENDMENTS

HCS - Amend KRS 288.440 to increase application fee.

Feb 5-introduced in House
Feb 6-to Banking and Insurance (H)
Feb 9-posted in committee
Feb 12-reported favorably, 1st reading, to Calendar with Committee Substitute
Feb 23-3rd reading, passed 89-2 with Committee Substitute
Feb 24-received in Senate
Feb 25-to Banking and Insurance (S)
Mar 11-reported favorably, 1st reading, to Consent Calendar
Mar 12-2nd reading, to Rules
Mar 13-posted for passage in the Consent Orders of the Day for March 17, 1998
Mar 17-3rd reading, passed 27-9
Mar 18-received in House
Mar 19-enrolled, signed by each presiding officer, delivered to Governor
Mar 27-signed by Governor
AN ACT relating to consumer loan companies.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 288.430 is amended to read as follows:

(1) Each application for a license under this chapter shall be made in writing, under oath or affirmation, in such form as the commissioner prescribes.

(2) The application shall contain:

(a) In the case of an individual, his name and the address of his residence and place of business;

(b) In the case of a partnership or association, the name and address of every member thereof and the address of the place where the business is to be conducted;

(c) In the case of a corporation, the names and addresses of the principal officers and directors thereof and the address of the place where the business is to be conducted; and

(d) Such additional information as the commissioner prescribes.

Section 2. KRS 288.450 is amended to read as follows:

(1) The commissioner shall, after investigation, issue to the applicant a license to make loans in accordance with this chapter, if the commissioner:

(a) Approves the form of the application;

(b) Finds that the financial responsibility, experience, character, and general fitness of the applicant, and of the members thereof if the applicant is a partnership or association, and of the officers and directors thereof if the applicant is a corporation, are such as to command the confidence of the community and to warrant the belief that the business of the applicant will be operated honestly, fairly, and efficiently in accordance with the purposes of this chapter; and
(c) Finds that permitting such applicant to engage in such business will promote the convenience and advantage of the community; and

(d) Finds that the applicant has complied with KRS 288.440.

(2) If the commissioner does not so find, he shall not issue a license and shall notify the applicant of the denial and return the sum paid by the applicant as a license fee, retaining the fifty dollars ($50) investigation fee to cover the cost of investigating the application.

(3) The commissioner shall approve or deny every application for license within sixty (60) days from the filing thereof with the fees unless the time is extended by a written agreement between the applicant and the commissioner. If the commissioner denies a license, the applicant may appeal, and upon appeal an administrative hearing shall be conducted in accordance with KRS Chapter 13B.

(4) The official record of the hearing shall be filed in the office of the commissioner as public records, open to public inspection.

Section 3. KRS 288.470 is amended to read as follows:

(1) No licensee shall conduct the business authorized by this chapter in any office, room, or place of business in which any other business, except purchase of retail and installment sales contracts and motor club memberships, is solicited or engaged in, or in association or conjunction therewith, except upon a written authorization from the commissioner.

(2) Nothing in this chapter shall be construed to limit the loans of any licensee to residents of the community in which the licensed place of business is situated, nor to prohibit the making and collecting of loans by mail.

(3) Nothing in this chapter shall be construed to limit the ability of any licensee to make a loan or loans in the principal amount greater than fifteen thousand dollars ($15,000) at the licensed location at the same rates as provided in KRS 360.010.
Section 4. KRS 288.533 is amended to read as follows:

Notwithstanding the provisions of KRS 288.530(10) or of any other law, in any extension of credit pursuant to KRS Chapter 288, the licensee may charge and collect the following:

(1) A fee, or premium for insurance, in lieu of perfecting a security interest to the extent that the fee or premium does not exceed the fee payable to public officials for perfecting the security interest; and

(2) A bad check charge of fifteen dollars ($15), or the amount passed on from other financial institutions, whichever is greater, for any check, draft, negotiable order of withdrawal, or like instrument returned or dishonored for any reason by a depository institution, which charge licensee may charge and collect, through regular billing procedures, or otherwise from the borrower; and

(3) A reasonable attorney's fee, in connection with the collection of a loan, actually incurred by the licensee and paid to an attorney who is not an employee of the licensee; and

(4) A charge for credit investigations of one dollar ($1) for each fifty dollars ($50) or fraction thereof of the principal amount of the loan. This charge shall be permitted only on the first two thousand dollars ($2,000) of the principal amount of the loan. No charge shall be collected unless a loan has been made as a result of the investigation.

Section 5. KRS 288.600 is amended to read as follows:

Each licensee shall keep and use in his business and shall preserve for at least two (2) years after making the final entry therein, such books, accounts, records, or card systems in accordance with sound accounting principles and practices to enable the commissioner to determine whether the licensee is complying with the provisions of this chapter, and with the regulations made pursuant thereto, and for at least three (3) years on loans secured by residential property.

Section 6. KRS 288.610 is amended to read as follows:
(1) The provisions of this chapter shall be enforced by the commissioner, who may, after notice to licensees and a hearing, promulgate regulations, referenced to the section or sections which set forth the legislative standards they interpret or apply, for the proper conduct application shall state the date of promulgation and the effective date. A copy of every such regulation shall be sent to all licensees before the effective date thereof and a copy shall be kept in an indexed permanent book in the office of the commissioner as a public record.

(2) The commissioner shall make an annual examination of the affairs, business, office, and records of every licensee, and such further examinations or investigations as he deems necessary for the purpose of discovering violations of this chapter or of securing information necessary for its proper enforcement. *Every licensee shall pay a fee sufficient to cover the cost of each examination based upon fair compensation for time and actual expenses.*

(3) For the purpose of making such examinations or investigations the commissioner and his representatives may require the attendance of and examine under oath all persons whose testimony he may require, relative to the loans or business of any such licensee, and shall have free access to the accounts, papers, records, files, safes, vaults, offices, and places of business used in connection with any business conducted under any license issued in accordance with this chapter.

Section 7. KRS 288.615 is amended to read as follows:

In undertaking the examination of a *consumer* loan company neither the Commonwealth of Kentucky, the commissioner of the department of financial institutions, nor any examiner employed by the Commonwealth shall become liable to any depositor, investor, or other obligor of said *consumer* loan company by reason of said examination or omission of said examination to fully and effectively disclose the financial condition of said *consumer* loan company, it being the policy of the Commonwealth of Kentucky that such examinations as are required by KRS 288.610 are
Section 8. KRS 288.620 is amended to read as follows:

(1) No person, except as authorized by statute, shall directly or indirectly by any device, subterfuge or pretense whatsoever, charge, contract for or receive or participate as agent, broker or in any other capacity in charging, contracting for or receiving any interest, discount or consideration greater than six percent (6%) per annum upon any loan in the amount of or the value of fifteen thousand dollars ($15,000).

(2) Any loan in the amount of fifteen thousand dollars ($15,000) or less for which there has been charged, contracted for or received a greater rate of interest, discount or consideration, except as provided for by statute, is against the public policy of this state.

(2)(3) No such loan made outside this state shall be enforced in the state and every person participating therein in this state shall be subject to the provisions of this chapter, but this section does not apply to loans legally made in any state, country, commonwealth, territory or district.

Section 9. KRS 288.440 is amended to read as follows:

(1) Each applicant at the time of making application shall pay two hundred fifty dollars ($250) to the commissioner as a fee for investigating the application for the initial location in Kentucky, or a fee of one hundred fifty dollars ($150) for additional locations, and the additional sum of three hundred seventy-five dollars ($375) as an annual license fee for each location for the period terminating on the last day of the current calendar year. If the application is filed after June 30 in any year, the payment shall be one hundred eighty-seven dollars ($187) as a
license fee in addition to the fee for investigation. In addition to the annual license fee every licensee hereunder shall pay the same fees for each examination as are allowed by statute for the examination of banks.

(2) If any person regulated by the department desires to purchase an existing licensed location or locations, the person shall submit an application to the commissioner containing the information as the commissioner may prescribe. The fee for this application shall be one hundred dollars ($100) per location not to exceed one thousand dollars ($1,000).

Section 10. The following KRS sections are repealed:

288.510 Financial condition of licensee.

288.515 Advertising statement required where institution not fully insured.
HOUSE BILL 515

AN ACT relating to the mortgage loan business.

Amend various statutes in KRS Chapter 294 pertaining to the mortgage loan company business to clarify the definition of mortgage loan company; exempt mortgage loan companies and brokers regulated by the Department of Housing and Urban Development; require an application for a mortgage loan broker license to contain a financial statement of the applicant; require a mortgage loan company to maintain a funding source of $500,000; require certain information to be filed with the commissioner if a licensee desires to establish a branch office; require applicants for broker's license to complete an educational training course; require a mortgage loan company or broker to notify the commissioner of an office or branch closing; increase the amount of surety bond filed by mortgage loan companies from $25,000 to $100,000 and for brokers from $25,000 to $50,000; require transfer of voting stock of a mortgage loan broker to be approved by the commissioner; require filing of a registration statement to establish or maintain a branch office; prohibit a prepayment penalty being assessed against a borrower after the fifth anniversary date of the mortgage; delete requirement that mortgage loan company provide applicant with a written explanation of all fees, expenses, and other costs; delete requirement that a mortgage loan company furnish a loan settlement statement to each borrower upon request; allow the commissioner to accept examinations of the Government National Mortgage Association and the Federal Home Loan Mortgage Corporation in whole or in part in lieu of an examination by the commissioner; make it unlawful upon receipt of a customer's written request to delay beyond 2 business days the issuance of a written loan payoff amount or to delay beyond 10 business days the issuance of a payment history; permit the commissioner to impose fines of $1,000 to $5,000 against mortgage loan companies and brokers; create a new section of KRS Chapter 294 to provide that examinations of mortgage loan companies and brokers are confidential; allow the department to exchange information with officials and examiners of other properly authorized state or federal regulatory authorities.

HB 515 - AMENDMENTS

HCS - Retain provisions of the bill and prohibit mortgage loan companies and brokers from using certain terms as part of its name; increase investigation and license fees.

HFA (1, S. Cave) - Amend to allow an exemption from the licensing requirement for independent contractors if certain specific requirements are met by the licensed mortgage loan company or licensed mortgage loan broker.

HFA (2, S. Cave) - Exempt independent contractors that solicit loans for only one mortgage loan company or broker.

SFA (1, R. Roeding) - Amend to exempt mortgage loan companies and mortgage loan brokers from a prohibition regarding the use of the words "bank", "trust", national", or "federal" in their names.
Feb 5-introduced in House
Feb 6-to Banking and Insurance (H)
Feb 9-posted in committee
Feb 19-reported favorably, 1st reading, to Calendar with Committee Substitute
Feb 26-floor amendment (1) filed
Feb 27-floor amendment (2) filed to Committee Substitute
Mar 2-3rd reading, passed 92-1 with Committee Substitute and Floor Amendment (2)
Mar 3-received in Senate
Mar 4-to Banking and Insurance (S)
Mar 11-reported favorably, 1st reading, to Consent Calendar
Mar 12-2nd reading, to Rules
Mar 13-posted for passage in the Consent Orders of the Day for March 17, 1998
Mar 16-floor amendment (1) filed
Mar 17-taken from the Consent Orders of the Day, placed in the Regular Orders of the Day
Mar 18-3rd reading; floor amendment (1) defeated; passed 36-0
Mar 19-received in House
Mar 20-enrolled, signed by each presiding officer, delivered to Governor
Mar 27-signed by Governor
AN ACT relating to the mortgage loan business.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 294.010 is amended to read as follows:

Unless the context otherwise requires:

(1) "Affiliate" means any person who directly or indirectly through one (1) or more intermediaries, controls, or is controlled by, or is under common control with another person;

(2) "Department" means the Department of Financial Institutions;

(3) "Commissioner" means the commissioner of financial institutions;

(4) "Mortgage loan" means any loan secured by a mortgage on residential real property or any loan secured by collateral which has a mortgage lien interest in residential real property;

(5) "Residential real property" means any single family residence or multiple dwelling structure containing four (4) or less single dwelling units for four (4) or less family units, living independently of each other, or any single family condominium unit;

(6) "Person" means an individual, a corporation, a partnership, an association, a joint-stock company, a trust where the interest of the beneficiaries is evidenced by a security, an unincorporated organization, a government, a political subdivision of a government, or any other group however organized;

(7) "Mortgage loan company" means any person who directly or indirectly:

(a) Holds himself out as being able to make or purchase loans secured by mortgages on residential real property;

(b) Holds himself out as being able to service loans secured by mortgages on residential real property; and

(c) Holds himself out as being able to buy or sell notes secured by mortgages on residential real property;
(8) "Mortgage loan broker" means any person who for compensation or gain, or in the expectation of compensation or gain, directly or indirectly:

(a) Holds himself out as being able to serve as an agent for any person in an attempt to obtain a loan which will be secured by a mortgage on residential real property; or

(b) Holds himself out as being able to serve as an agent for any person who has money to loan, which loan is or will be secured by a mortgage on residential real property.

Section 2. KRS 294.020 is amended to read as follows:

(1) The following shall be exempt from this chapter:

(a) Any person doing business under the laws of this state or any other state or the United States relating to banks, bank holding companies, trust companies, credit unions, savings and loan associations, service corporation subsidiaries of savings and loan associations, consumer finance companies, industrial loan companies, insurance companies, or real estate investment trusts as defined in 26 U.S.C. sec. 856 and the affiliates of such companies, or an institution of the farm credit system organized under the Farm Credit Act of 1971 as amended;

(b) An attorney-at-law licensed to practice law in Kentucky who is not principally engaged in the business of negotiating mortgage loans, when the person renders services in the course of his practice as an attorney-at-law;

(c) Any person doing any act under order of any court;

(d) Any natural person making a mortgage loan with his own funds for his own investment without intent to resell the mortgage loan;
(e) Any person doing business under the laws of this state or the United States relating to any broker-dealer, agent, or investment adviser duly registered with the Department of Financial Institutions;

(f) The United States of America, the Commonwealth of Kentucky, or any other state, and any Kentucky city, county, or other political subdivision, and any agency, division, or corporate instrumentality of any of the foregoing;

(g) The Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Government National Mortgage Association (GNMA);

(f) With the approval of the commissioner, an independent contractor that solicits mortgage loans for only one (1) licensed mortgage loan company or licensed mortgage loan broker may be exempted from obtaining a license under this chapter if:

1. The licensed mortgage loan company or licensed mortgage loan broker notifies the department that it will assume legal responsibility for the actions of the independent contractor in complying with the provisions of KRS Chapter 294; and

2. The licensed mortgage loan company or licensed mortgage loan broker provides the department with proof that its bond will cover the independent contractor.

(h) Any person licensed in this state as a real estate broker or real estate sales associate, not actively engaged in the business of negotiating loans secured by real property, when the person renders services in the course of his practice as a real estate broker or real estate associate;

(i) Any person making less than five (5) mortgage loans per year.

(2) The following shall be exempt from all the provisions of KRS Chapter 294 except that they shall be subject to the examination or investigation provisions of
subsections (4), (5), and (6) of Section 14 of this Act, KRS 294.180, and KRS 294.190 if it appears on grounds satisfactory to the commissioner, on written complaint, that an examination or investigation is necessary, and they shall be subject to the prohibited acts provisions of Section 15 of this Act:

(a) Mortgage loan companies or mortgage loan brokers regulated by the Department of Housing and Urban Development;

(b) Any natural person making a mortgage loan with his or her own funds for the person's own investment without intent to resell the mortgage loan;

(c) Any person doing business under the laws of this state or the United States relating to any broker-dealer, agent, or investment adviser duly registered with the Department of Financial Institutions;

(d) Any person licensed in this state as a real estate broker or real estate sales associate, not actively engaged in the business of negotiating loans secured by real property, when the person renders the services in the course of his or her practice as a real estate broker or real estate associate; and

(e) Any person making less than five (5) mortgage loans per year.

(3) Any person relying upon an exemption under subsection (2)(c) or (d) of this section shall file with the commissioner a claim of exemption. The commissioner shall thereafter determine the availability of the claimed exemption and he shall not disallow an exemption that is validly claimed.

Section 3. KRS 294.032 is amended to read as follows:

(1) A license as a mortgage loan company or a mortgage loan broker may be obtained by filing a written application with the commissioner.

(2) The application shall:

(a) Be sworn to;

(b) State the name of the applicant and each of the applicant's affiliates engaged in business as a mortgage loan company or a mortgage loan broker;
(c) State the name under which the applicant will conduct business in Kentucky;
(d) State the location of the applicant's principal office and branch offices in Kentucky;
(e) List the name, residence, and business address of each person having an interest in the business as principal, partner, officer, trustee and director, specifying the capacity and title of each;
(f) Indicate the general plan and character of the business;
(g) Contain a corporate surety bond or other instrument as prescribed by KRS 294.060;
(h) If applying for a mortgage loan broker license, contain a compiled financial statement of the applicant; or, if applying for a mortgage loan company license, contain a reviewed or audited financial statement of the applicant prepared by a licensed or certified public accountant; or contain a verified financial statement of the applicant prepared by a certified public accountant or by a public accountant registered in this state;
(i) Require payment of the appropriate registration fees; and
(j) Require such other information as the commissioner determines necessary.

(3) No mortgage loan company license may be granted unless the applicant has and maintains, so long as the license is in effect, a minimum, documented funding source of five hundred thousand dollars ($500,000). If a mortgage loan company has a net worth in excess of five hundred thousand dollars ($500,000), an additional funding source is not required. A mortgage loan broker's license may be granted to a person unless he is a bona fide resident of this state for a period of at least six (6) months immediately preceding the date of licensing.

(4)—No mortgage loan broker's license may be granted unless the applicant has and maintains a principal place of business in this state for the transaction of business.
(5) If a licensee is a person other than a natural person, the license issued to it shall entitle all officers and employees of the person, if a corporation, and all members, partners, trustees, and employees, if an association, partnership, or trust, to engage in the mortgage loan business licensed pursuant to this chapter.

(5) **If a licensee desires to establish a branch office in Kentucky not already approved, the licensee shall file a registration statement with the commissioner that includes the address and telephone number of the branch office, the name of the prospective manager, the anticipated opening date, and any other information prescribed by the commissioner.**

(6) **All applicants for a mortgage loan broker license shall have successfully completed an educational training course, approved by the department, of not less than thirty (30) hours' duration. Mortgage loan brokers who have held a license for at least one (1) year shall be exempt from this requirement. This section shall not become effective until the department has approved at least one (1) educational training course. This section shall not apply to renewals of existing licenses.**

Section 4. KRS 294.034 is amended to read as follows:

(1) An applicant for a license under this chapter shall provide the commissioner with separate checks payable to the Kentucky State Treasurer for:

(a) An investigation fee of **three hundred ($300) for the principal office and one hundred fifty ($150) for each branch office**; and

(b) A license fee of **four hundred fifty ($450) for the principal office and two hundred fifty ($250) for each branch** in Kentucky if the applicant applies for a license on or between July 1 and December 31 or of one hundred fifty dollars ($150) for the principal office
and one hundred dollars ($100) for each branch if the applicant applies for a license on or between January 1 and June 30.

(2) A license under this chapter shall expire June 30 next after the date of issuance if it is not renewed.

(3) A license may be renewed by paying the annual fee for renewing a license which is three hundred fifty dollars ($350) for the main office and two hundred fifty dollars ($250) for each branch office in Kentucky, and submitting an annual report of activity as prescribed by the commissioner, and any financial statement, and submitting other information required by the commissioner.

(4) The information and payment shall be received by the commissioner on or before June 20 prior to July 15 following the June 30 expiration date. If the information and payment are not received by July 15, the license shall be cancelled. The commissioner may reinstate the license if the licensee pays the filing fee and a reinstatement fee of one hundred dollars ($100).

(5) The department shall provide a licensee with a duplicate copy of any license upon a satisfactory showing of its loss and payment of a ten dollar ($10) replacement fee.

Section 5. KRS 294.036 is amended to read as follows:

(1) Each license issued under this chapter shall state the address or addresses at which business is to be conducted, the name of the licensee, and the date and place of its incorporation, if applicable.

(2) A licensee shall post a copy of such license in a conspicuous place in the office to which it pertains.

(3) A license may not be transferred or assigned without the prior written approval of the commissioner.

(4) No licensee shall transact the business provided for by this chapter under any other name or maintain an office at any location other than that designated in the license.
(5) Every licensed mortgage loan company or mortgage loan broker shall notify the commissioner, in writing, within ten (10) days of the closing of any licensed office or registered Kentucky branch.

Section 6. KRS 294.060 is amended to read as follows:

(1) Except as otherwise provided in this section, at the time of filing an application for registration as a mortgage loan company or mortgage loan broker, the applicant shall post corporate surety bonds in an amount that the commissioner determines by administrative regulation to be necessary and appropriate under the circumstances but not less than **one hundred thousand dollars ($100,000)** for mortgage loan companies and not less than **fifty thousand dollars ($50,000)** for mortgage loan brokers. Every bond shall provide for suit thereon by any person who has a cause of action under this chapter. The total liability of the surety, to all persons, cumulative or otherwise, shall not exceed the amount specified in the bond. Every bond shall provide that no suit shall be maintained to enforce any liability on the bond unless brought within three (3) years after the act upon which it is based.

(2) In lieu of posting corporate surety bonds, the applicant may:

(a) Deposit with the commissioner an irrevocable letter of credit for an amount equal to the required bond upon which the applicant is the obligor, issued by a bank approved by the commissioner, whose deposits are insured by the Federal Deposit Insurance Corporation;

(b) Establish an account payable to the commissioner in a federally insured financial institution in this state and deposit money of the United States in an amount equal to the amount of the required bond; or

(c) Deposit with the commissioner an escrow agreement for a savings certificate of a federally insured financial institution in this state for an amount payable which is equal to the amount of the required bond and which is not available
for withdrawal except by direct order of the commissioner. Interest earned on the certificate accrues to the applicant.

(3) If the commissioner or the commissioner's representative shall at any time reasonably determine that the bond or securities aforesaid are insecure, deficient in amount, or exhausted in whole or part, he may by written order require the filing of a new or supplemental bond or the deposit of new or additional securities in order to secure compliance with this chapter, the order to be complied with within thirty (30) days following service thereof upon the registrant.

Section 7. KRS 294.070 is amended to read as follows:

(1) The use of the words "certified" or "licensed" or any form thereof separately or in any combination thereof with other words or syllables, is prohibited as part of the name of a mortgage loan company or a mortgage loan broker. No license of a proposed mortgage loan company or a mortgage loan broker having the same name as a corporation authorized to do business under the laws of this state or a name so nearly resembling it as to be calculated to deceive shall be issued by the commissioner.

(2) No person, unless lawfully authorized to do business in this state under the provisions of this chapter, and actually engaged in carrying on a mortgage loan or loan broker business, shall do business under any name or title which contains the terms "mortgage company," "mortgage loan company," "mortgage loan broker," "loan broker," "financial broker," or any combination employing the words "mortgage," "loan," or "broker," with one (1) or more of the words "association," "institution," "society," "company," "corporation," or words of similar import, or use any name or represent in any manner which indicates or reasonably implies that his or its business is that of a mortgage loan company or mortgage loan broker as defined by KRS 294.010.
A mortgage loan company or mortgage loan broker required to have a license under this chapter shall not use the words "bank," "trust," "national," or "federal," or any form thereof separately or in combination thereof with other words or syllables as a part of its name or to otherwise identify itself.

Section 8. KRS 294.075 is amended to read as follows:

(1) As used in this section, "change of control" means:

(a) A transfer of voting stock which results in giving a person, directly or indirectly, the power to direct the management and policy of a mortgage loan company or mortgage loan broker; or

(b) A transfer of at least ten percent (10%) of the outstanding voting stock of a mortgage loan company or a mortgage loan broker.

(2) A transfer of voting stock of a mortgage loan company or mortgage loan broker which constitutes a change of control shall be approved in writing by the commissioner, prior to the transfer.

(3) The owner, president, chief executive officer or a partner shall apply to the commissioner for approval of a transfer of voting stock in his mortgage loan company or a mortgage loan broker which constitutes a change of control. The application must contain information which shows that the requirements of this chapter for obtaining a license will be satisfied after the change of control.

Section 9. KRS 294.090 is amended to read as follows:

The commissioner may deny, suspend, or revoke any license when the applicant or licensee:

(1) Does not meet or has failed to comply with the requirements of this chapter;

(2) Is unfit through lack of financial responsibility or experience to conduct the business of a mortgage loan company or mortgage loan broker, as the case may be;
(3) Does not conduct his business in accordance with law or the method of business includes or would include activities which are illegal where performed, or has willfully violated any provision of this chapter or any regulation hereunder;

(4) Collects interest at a usurious rate;

(5) Is in such financial condition that he cannot continue in business with safety to his customers;

(6) Has been guilty of fraud in connection with any transaction governed by this chapter, or is the subject of an administrative cease and desist order or similar order, or a permanent or temporary injunction of any court of competent jurisdiction entered under any other federal or state act applicable to the registrant; but the commissioner may not institute a proceeding under this subsection more than one (1) year from the date of the order or injunction relied on, and he may not enter an order under this subsection on the basis of an injunction entered under any other state act unless that order or injunction was based on facts which would currently constitute a ground for an order under this section;

(7) Has made any misrepresentations or false statements to, or concealed any essential or material fact from, any person in the course of acting as a mortgage loan company or mortgage loan broker, or has engaged in a course of business which has worked or tended to work a fraud upon any person or would so operate;

(8) Has knowingly made or caused to be made to the commissioner any false representation of material fact or has suppressed or withheld from the commissioner any information which the applicant or licensee possesses, and which if submitted by him would have rendered the applicant or licensee ineligible to be licensed under this chapter;

(9) Has failed to account to persons interest for all funds received for the escrow account required under KRS 294.130;
(10) Has refused to permit an examination by the commissioner of his books and affairs or has refused or failed, within a reasonable time, to furnish any information or make any report that may be required by the commissioner under the provisions of this chapter;

(11) Has been convicted of any misdemeanor of which an essential element is fraud, or any felony, or has pending against him any felony charge; or

(12) Has had any license related to the financial services industry denied, suspended, or revoked under the laws of this state or any other state or the United States.

Section 10. KRS 294.100 is amended to read as follows:

(1) No mortgage loan company or mortgage loan broker may establish or maintain a branch office in Kentucky without filing the registration statement as described in subsection (5) of Section 3 of this Act and the receipt of prior written approval of the commissioner.

(2) Each registration statement[application] for approval of the establishment and maintenance of a branch office shall state the proposed location, the functions to be performed, and other information which the commissioner may require if different from that contained in the original application for a license[registration].

(3) Each registration statement[application] under this section shall be sworn to[verified] and accompanied by the appropriate fee as set out in KRS 294.034(1)(b).

(4) Upon the receipt by the commissioner of a registration statement[an application] and the required fee, if he finds that the applicant is otherwise in compliance with the provisions of this chapter, he shall approve the registration statement[application].

Section 11. KRS 294.110 is amended to read as follows:
(1) Mortgage loan companies are prohibited from making loans and mortgage loan brokers are prohibited from brokering loans at a rate or rates in excess of those provided by KRS 360.010 and 360.025 or other applicable usury statutes.

(2) Every loan shall be evidenced by a note for the amount of the loan. Every note evidencing a loan under this subsection shall contain the following information and provisions: The original principal amount of the loan, excluding any charge for the loan; a statement of the total charge for the loan; the terms of repayment, including the amount and date of installments and penalty or charge for late payment; the date of final maturity; and may contain all other terms of the loan contract. The borrower shall be given a copy of the note, at the time the loan is made and shall thereafter be given a receipt for each cash payment.

(3) Every real estate loan shall be secured by a mortgage or other instrument constituting a lien upon the real estate securing the loan, according to any lawful or well-recognized practice which is best suited to the transaction. Any such instrument, constituting a lien, is herein termed a "mortgage." All such mortgages shall be recorded in accordance with the law of this Commonwealth.

(4) Delinquency charges may be made for each installment more than ten (10) days in arrears, and only one (1) delinquency charge shall be made on any one (1) installment. No delinquency charge shall be made unless disclosed as required under subsection (2) of this section. In addition to such delinquency charges, attorneys' fees not exceeding fifteen percent (15%) of the unpaid balance shall be taxed as costs and court costs may be collected, provided that the note is referred to an attorney not a salaried employee of the holder for collection.

(5) Any charges to be assessed against the borrower, in the event a loan is paid prior to maturity shall be prominently displayed and made part of the note and the loan closing statement regarding the method of computation of any rebate. No prepayment penalty shall be assessed against the borrower following the fifth
anniversary date of the mortgage. No prepayment penalty shall exceed five percent (5%) of the outstanding balance of the loan.

Section 12. KRS 294.120 is amended to read as follows:

(1) Every mortgage loan company may require borrowers to pay all necessary and reasonable expenses incurred in connection with the making, closing, disbursing, extending, readjusting, or renewing of loans. Without limiting the generality of the foregoing, such expenses may include appraisal, attorneys' fees, abstract, recording and registration fees, title examination, title insurance, mortgage insurance, credit report, survey, drawing of papers, origination fees, loan closing costs, and taxes or charges imposed upon or in connection with the making and reporting of any mortgage.

(2) Every mortgage loan company also may require the borrowers to pay the cost of all other necessary and incidental services rendered by the mortgage loan company or by others in connection with loans in reasonable amounts. Without limiting the generality of the foregoing, such costs may include the cost of services of inspectors, engineers, and architects.

(3) Such initial charges as described in subsections (1) and (2) of this section may be collected by the mortgage loan company from the borrower and paid to any person rendering such services, or paid directly by the borrower.

(4) In lieu of such initial charges to cover such expenses and costs as described in subsections (1) and (2) of this section, a mortgage loan company may make a reasonable charge, part or all of which may be retained by the mortgage loan company which renders such service, or part or all of which may be paid to others who render such services.

(5) The fees and charges authorized by this section shall be in addition to interest authorized by law, and shall not be deemed to be a part of the interest collected or agreed to be paid on such loans within the meaning of any law of this
Commonwealth which limits the rate of interest which may be exacted in any transaction.

(6) No person shall receive any fee or other compensation of any kind in connection with procuring any loan, except for services actually rendered as above provided, and in no event shall a mortgage loan company or mortgage loan broker require the payment of a fee greater than one hundred dollars ($100) as a condition to submitting a loan application unless the commissioner shall otherwise prescribe by rule.

(7) Upon receipt of a loan application, the mortgage loan company shall provide the applicant with a written explanation of the nature of all fees, expenses and other costs allowable under subsections (1) and (2) of this section which, whether certain or uncertain, may be incurred or required of the borrower in connection with the approval, making, closing and disbursement of the loan.

(8) The mortgage loan company shall furnish a loan settlement statement to each borrower upon request one (1) business day prior to the settlement date in a form consistent with the provisions of the Real Estate Settlement Procedures Act of 1974 and any amendments thereto, and in all other regards the mortgage loan company shall make the necessary and appropriate disclosures consistent with the provisions of that act and any amendments thereto. A copy of the loan settlement statement and any other disclosure documents shall be retained in the records of the mortgage loan company.

(9) All "letters of commitment," or any other contracts or agreements between prospective borrowers and a mortgage loan company or a loan broker, where the borrowers employ services, for a fee or commission, to obtain a loan commitment or funding from a lending institution shall indicate the terms and conditions thereof, including a full and detailed description of the services the broker or company undertakes to perform, a specific statement of the circumstances in which the broker
or company will be entitled to obtain or retain consideration and the period that such agreement shall remain in effect.

(8) Failure on the part of any party, with the exception of the borrower, to fulfill the terms of any loan commitment, letter of commitment, agreement or contract for the loan of money within the time and on such terms specified therein, or the failure to make a bona fide effort to secure a loan after receiving a fee for such service, shall constitute default by the mortgage loan company and any other person so in default; and any person damaged by such default may sue at law or equity for damages, reasonable attorneys' fees and interest at the legal rate of interest under KRS 360.010. Every cause of action for damages under this subsection survives the death of any person who might have been a plaintiff or defendant. No person may sue under this subsection more than five (5) years after any act constituting default.

(11) The failure to disclose a dual-agency capacity or effecting transactions upon terms and conditions other than those stated in the letter of commitment, loan commitment or any other contract for the loan of money, or entering into an agreement which establishes unfair terms and conditions or compensation, as the commissioner shall define by rule, or any contract of loan in the making or collection of which any act shall have been done which constitutes a willful violation of any provision of this section or of KRS 294.110 shall be void, and the mortgage loan company or the lender, if not the mortgage loan company, shall have no right to collect, receive or retain any interest or charges whatsoever on such loan, but the unpaid principal of the loan shall be paid in full.

Section 13. KRS 294.160 is amended to read as follows:

Every mortgage loan company and mortgage loan broker shall make and keep such accounts, correspondence, memoranda, papers, books, data and other records as the commissioner prescribes, or that are required by federal law. All records so required shall be preserved for three (3) years from the date of collection of the last installment
payment due under each agreement unless the commissioner by rule prescribes otherwise for particular types of records. Every mortgage loan company and mortgage loan broker shall file such financial reports as the commissioner by regulation prescribes. If the information contained in any document filed with the commissioner is or becomes inaccurate or incomplete in any material respect, the licensee shall promptly file a correcting amendment.

Section 14. KRS 294.170 is amended to read as follows:

(1) Every mortgage loan company and mortgage loan broker shall keep at its principal office correct and complete books of accounts and minutes of proceedings of its directors, principals, or partners. Complete records of all business transactions at the principal office shall be maintained at the principal office. Each branch office shall keep detailed records of all transactions at such branch office and shall furnish full control records to the principal office.

(2) No mortgage loan company or mortgage loan broker by any system of accounting or any device of bookkeeping shall, either directly or indirectly, enter any of its assets upon its books in the name of any person, partnership, association, or corporation, or under any title, designation or value that is not thoroughly descriptive of any assets.

(3) The affairs of every mortgage loan company and mortgage loan broker and the records required to be maintained by KRS 294.160 are subject at any time or from time to time to such periodic, special, or other examinations by the commissioner or an examiner of the commissioner within or without this state and with or without notice to the mortgage loan company and mortgage loan broker, as the commissioner deems necessary or appropriate in the public interest. All books, papers, and records of assets of the mortgage loan company shall be subject to his inspection.
(4) The examiner shall make a thorough examination into the condition, workings and affairs of the association and report any violation of law or any unauthorized unsafe practices or any failure to keep and have correct any required books and records as he may find to the commissioner.

(5) A mortgage loan company or mortgage loan broker shall pay a fee for each such examination based on fair compensation for time and actual expense. For the purpose of avoiding unnecessary duplication of examinations, the commissioner, insofar as he deems it practicable in administering this section, may cooperate with any agency of the state or federal government, other states, or the federal National Mortgage Association, **Government National Mortgage Association, and Federal Home Loan Mortgage Corporation**, and may accept such examinations in whole or in part in lieu of an examination by the commissioner.

(6) The commissioner or his examiners or designated representative shall have access to all books and papers of a mortgage loan company and mortgage loan broker which relate to their business, and books and papers kept by any officers, agents, or employees, relating to or upon which any record of its business is kept.

Section 15. KRS 294.220 is amended to read as follows:

(1) It shall be unlawful for any person to make or cause to be made, in any document filed with the commissioner or in any proceeding under this chapter, any statement which is, at the time and in light of the circumstances under which it is made, false or misleading in any material respect.

(2) It shall be unlawful for any mortgage loan company or mortgage loan broker, in connection with the operation of a mortgage loan business or the management or servicing of mortgage contracts, directly or indirectly:

(a) To employ a device, scheme, or artifice to defraud;

(b) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person;
(c) To fail to disburse funds in accordance with a loan commitment;

(d) To delay closing of any mortgage loan for the purpose of increasing interest, costs, fees, or charges payable by the borrower;

(e) Upon receipt of a customer's written request, to delay beyond two (2) business days the issuance of a written loan payoff amount or to delay beyond ten (10) business days the issuance of a payment history.

(3) Unless exempted by KRS 294.020, it shall be unlawful for any person to transact any mortgage loan business in this state unless it:

(a) Qualifies to do business in Kentucky as required by KRS Chapter 271B; and

(b) Complies with the provisions of this chapter.

SECTION 16. A NEW SECTION OF KRS CHAPTER 294 IS CREATED TO READ AS FOLLOWS:

(1) Reports of examination, and correspondence that relates to the report of examination, of a mortgage loan company or mortgage loan broker shall be considered confidential information. No officer or director of a mortgage loan company or mortgage loan broker, employee of the department, or employee of a state or federal regulatory authority shall release any information contained in the examination, except when:

(a) Required in a proper legal proceeding in which a subpoena and protective order insuring confidentiality has been issued by a court of competent jurisdiction; or

(b) The information is referred to an appropriate prosecuting attorney for possible criminal proceedings.

(2) The department may furnish to and exchange information and reports with officials and examiners of other properly authorized state or federal regulatory authorities.
(3) Every official report concerning a mortgage loan company or mortgage loan broker, and every report of examination, shall be prima facie evidence of the facts therein stated for all purposes in any action in which the department, mortgage loan company, or mortgage loan broker is a party.

Section 17. KRS 294.990 is amended to read as follows:

(1) Any person who willfully violates any provision of this chapter, except KRS 294.220(1), or who willfully violates KRS 294.220(1) knowing the statement to be false or misleading in any material respect, shall be guilty of a Class D felony.

(2) Any person who willfully violates any rule or order of the commissioner, authorized under this chapter, shall be guilty of a Class A misdemeanor, but no person may be imprisoned for violation of any rule or order of which that person did not have actual knowledge.

(3) The commissioner may refer the evidence available concerning violations of this chapter or any rule or order hereunder to the appropriate prosecuting attorney, who may, with or without reference, institute the appropriate criminal proceeding under this chapter.

(4) Nothing in this chapter shall limit the powers of the state to punish any person for any conduct which constitutes a crime.

(5) The commissioner may assess a fine of not less than one thousand dollars ($1,000) nor more than five thousand dollars ($5,000) against any mortgage loan company or mortgage loan broker that violates any provision of this chapter. The Attorney General shall institute an action, in the name of the Commonwealth, in the Franklin Circuit Court or the Circuit Court of the county in which the violation occurred, for the recovery of the fine.

(6) Any person who shall engage in the businesses regulated by this chapter without first securing a license therefor shall be guilty of a misdemeanor and upon
conviction shall be punished by a fine of not less than five hundred dollars ($500) nor more than one thousand dollars ($1,000).

[(7) Any person who, after a cease and desist order has been issued by the commissioner, violates any provision of the cease and desist order, shall be punished by a fine of not less than five hundred dollars ($500) nor more than one thousand ($1000). The fine shall not be deemed to limit the power of the commissioner to revoke any license.]

Section 18. The following KRS section is repealed:

294.115 Broker to furnish disclosures in writing to borrower.
AN ACT relating to banking.

Amend various statutes in KRS Chapter pertaining to banking to include savings and loan association in the definition of national bank; change the membership of the Financial Institutions Board; permit the commissioner to designate certain employees to sign documents under his instructions; require any bank with branches to use the same name for all branches in Kentucky; delete the requirement that each bank director own a minimum of capital stock; delete requirement that minimum capital stock be based on population of city and require capital stock in the amount of $2,500,000; provide that not less than 50 percent of the minimum capital stock be designated as surplus; delete provision that allows investment in real property when all or a portion of the improvements for use as its home office or for branch offices so long as the real estate is used for carrying on its legitimate business as permitted by the Constitution; delete requirement that net profits be computed by deducting bad or suspended debts; authorize the commissioner to call at any time, rather than at least twice a year, for publication of a financial statement; require that the assessment schedule be set by regulation rather than the statute; the report required of banks to be made to the commissioner must specify any information the commissioner requires; delete from definition of revolving credit plan purchases by check or other device; require board of directors of any combined bank that operates as a branch of the surviving bank to meet quarterly rather than monthly; permit a Kentucky bank to acquire a branch in another state if that state permits the acquisition; permit banks to rely conclusively on the form and terms of account in transferring or releasing joint account funds subsequent to the date of death of one or more named joint account holders; establish a 5 year statute of limitations for an action for an injury by a trustee to the rights of a beneficiary of a trust; provide that KRS Chapter 413 shall not apply to an express trust that is both continuing and subsisting; amend KRS 41.220, 287.820, 287.990, and 413.130 to conform; repeal KRS 287.061 which pertains to publication of an application for approval of a bank or branch and repeal KRS 287.205 that provides when a national bank may act as fiduciary.

HB 516 - AMENDMENTS

HCS - Amend KRS 287.235 to establish that no gain or loss shall be recognized for Kentucky income tax purposes by a common trust fund under certain circumstances.
Feb 5-introduced in House
Feb 6-to Banking and Insurance (H)
Feb 9-posted in committee
Feb 12-reported favorably, 1st reading, to Calendar with Committee Substitute
Feb 23-3rd reading, passed 89-1 with Committee Substitute
Feb 24-received in Senate
Feb 25-to Banking and Insurance (S)
Mar 11-reported favorably, 1st reading, to Consent Calendar
Mar 12-2nd reading, to Rules
Mar 13-posted for passage in the Consent Orders of the Day for March 17, 1998
Mar 17-3rd reading, passed 27-9
Mar 18-received in House
Mar 19-enrolled, signed by each presiding officer, delivered to Governor
Mar 27-signed by Governor
AN ACT relating to banking.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 287.010 is amended to read as follows:

As used in this chapter, unless the context requires otherwise:

(1) "Bank or state bank" means any bank which is now or may hereafter be organized under the laws of this state or a combined bank and trust company;

(2) "National bank" or "national bank association" means a bank created by Congress and organized pursuant to the provisions of federal law, including savings and loan associations;

(3) "Out-of-state bank" means a bank chartered under the laws of any state other than Kentucky;

(4) "Home state" means:
   (a) With respect to a state bank or out-of-state state bank, the state by which the bank is chartered; and
   (b) With respect to a national bank, the state in which the main office of the bank is located;

(5) "Home state regulator" means, with respect to an out-of-state state bank, the bank supervisory agency of the state in which such bank is chartered;

(6) "Host state" means a state, other than the home state, in which the bank maintains, or seeks to establish and maintain, a branch;

(7) "Commissioner" means the commissioner of financial institutions;

(8) "Department" means the Department of Financial Institutions;

(9) "Population" means the population as indicated by the latest regular United States census;

(10) "Trust company" includes every corporation authorized by this chapter to do a trust business;
(11) "Undivided profits" means the composite of the bank's net retained earnings from current and prior years' operations;

(12) "Capital stock" shall mean, at any particular time, the sum of:
   (a) The par value of all shares of the corporation having a par value that have been issued;
   (b) The amount of the consideration received by the corporation for all shares of the corporation that have been issued without par value except such part of the consideration as has been allocated to surplus in a manner permitted by law; and
   (c) Such amounts not included in paragraphs (a) and (b) of this subsection as have been transferred to stated capital of the corporation, whether through the issuance of stock dividends, resolution of the bank's board of directors under applicable corporate law or otherwise by law; and

(13) "Surplus" means the amount of consideration received by the corporation for all shares issued without par value that has not been allocated to capital stock or the amount of consideration received by the corporation in excess of par value for all shares with a par value or both.

Section 2. KRS 287.013 is amended to read as follows:

(1) There is created a Financial Institutions Board. The board shall consist of twelve (12) members appointed by the Governor who shall serve terms of four (4) years, except the initial terms shall be established as hereafter provided. It is recommended that the board appointments made by the Governor be selected from the following:
   (a) Three (3) members selected from the banking industry regulated by the department with appropriate recognition as to bank size and geographic diversity;
(b) Three (3) members selected from the broker/dealer securities industry regulated by the department;
(c) One (1) member selected from the credit union industry regulated by the department;
(d) One (1) member selected from the consumer finance or industrial loan industry regulated by the department;
(e) One (1) member selected from the savings and loan industry regulated by the department;
(f) Three (3) members selected from the public at large who are knowledgeable concerning financial institutions, the legislative process and consumer interests, two (2) of whom are not employees, officers or directors of any financial institution; and
(g) The commissioner, who shall also serve as chairman of the board.

(2) All members of the board from the banking industry, securities industry, credit union industry, consumer finance, or industrial loan industry shall be persons with practical experience in the industry so represented and currently serving at the executive level of that industry at the time of their appointment.

(3) At the first meeting of the board, a drawing by lot shall be conducted to determine the length of each original member's term. Initially, there shall be four (4) four (4) year terms, five (5) three (3) year terms, and two (2) two (2) year terms. Vacancies in the membership of the board shall be filled in the same manner as original appointments. Appointments to fill vacancies occurring before the expiration of a term shall be for the remainder of the unexpired term.

(4) No member of the board, other than the commissioner, shall serve more than two (2) consecutive terms on the board.
(5) The board shall first meet at the call of the Governor and thereafter as the board shall determine, but at least quarterly, at a time and place determined by the chairman. The board may elect other officers for the conduct of its business. A majority of board members shall constitute a quorum, and a decision shall require the majority vote of those present. Each board member shall have one (1) vote, and voting by proxy shall be prohibited.

(6) Board members shall receive one hundred dollars ($100) per diem for each board meeting which they attend and shall be reimbursed for other reasonable and necessary expenses incurred while engaged in carrying out the duties of the board.

(7) The board shall:

(a) Prepare and submit at the Governor's request a list of candidates qualified to serve as commissioner and recommend to the Governor a proposed salary for each nomination for commissioner;

(b) Recommend to the Governor a proposed salary structure for other departmental staff in order to provide competitive salaries for recruitment and retention of staff;

(c) Receive and comment on various reports relating to the department and its activities as submitted to the board by the commissioner or the Governor; and

(d) Review, consider and make recommendations to the commissioner on any matters referred to the board by the commissioner or the Governor.

(8) In no event shall the board or its members interfere with the statutory duties of the commissioner whose decisions shall be governed by law.

Section 3. KRS 287.020 is amended to read as follows:

(1) The commissioner may promulgate, amend, and repeal any administrative regulations, forms, and orders as are necessary to interpret and carry out the provisions and intent of this chapter. He shall devise a seal for his department, a description of which, together with an impression thereof and a certificate of
approval by the Governor, shall be filed in the office of the Secretary of State. The seal shall be renewed whenever necessary.

(2) The commissioner of financial institutions and his deputies shall be allowed their necessary traveling and other expenses of conducting their office.

(3) The commissioner of financial institutions may issue a finding of permissible activities, services, or products to authorize banks to engage in any banking activity in which the banks could engage were they operating as national banks at the time the authority is granted. Any finding shall be specifically limited to the activity, service, or products contained therein and shall be mailed to all banks. This section shall not apply to activities prohibited under Subtitle 9 of KRS Chapter 304.[{The hearing procedures of KRS 287.061 shall be applicable to the issuance of a finding.}]

(4) Nothing herein contained shall be construed to repeal, modify, or alter the restrictions of KRS 287.105 relative to the leasing of motor vehicles, or of KRS 287.180 relative to the establishment of branches.

(5) The commissioner may designate the deputy commissioner, division directors, general counsel, or branch managers to sign documents under his instructions.

Section 4. KRS 287.030 is amended to read as follows:

(1) As used in this section, "person" includes a natural person, partnership, corporation, association, business trust, voting trust, or similar organization.

(2) No persons, except corporations, shall engage in the business of private banking in this state.

(3) No bank incorporated under the laws of another state or national bank having its principal place of business outside this state shall transact any banking business in this state except to lend money, unless specifically authorized by law or administrative regulation, or except as permitted following a merger transaction within the meaning of Section 44 of the Federal Deposit Insurance Act pursuant to 12 U.S.C. sec. 1811 et seq., approved after June 1, 1997.
(4) No person who after July 13, 1984, owns or acquires more than one-half (1/2) of the capital stock of a bank shall act as insurance agent or broker with respect to any insurance except credit life insurance, credit health insurance, insurance of the interest of a real property mortgagee in mortgaged property, other than title insurance.

(5) No bank incorporated under the laws of the Commonwealth of Kentucky shall make any loan or discount on the security of the shares of its own capital stock, or the shares of stock of a bank holding company which controls the bank to the extent that such loan or discount secured by such shares exceeds the amounts permitted by Section 23(A) of the Federal Reserve Act (12 U.S.C. sec. 371c) as that section reads on July 15, 1986, nor be the purchaser or holder of any such shares, except that a bank may take property of any kind to satisfy or protect a loan previously made in good faith and in the ordinary course of business; and stock so purchased or acquired, shall, within six (6) months from the time of its purchase or acquisition, be sold or disposed of at public or private sale. This subsection shall not affect or modify in any way KRS 386.025, but said section shall remain in full force and effect.

(6) Any state or national bank with branch offices in Kentucky shall use at all times the same name for all its branch offices in Kentucky.

Section 5. KRS 287.050 is amended to read as follows:

(1) Before filing the articles of incorporation of any financial institution mentioned in KRS 287.040, the incorporators shall present a copy of their proposed articles to the commissioner who shall investigate the financial standing, moral character and capability of each of the incorporators and proposed executive officers and directors, if known, and determine whether there is reasonable assurance of sufficient volume of business for the proposed corporation to be successful, and
whether the public convenience and advantage will be promoted by the opening of
the proposed corporation.

(2) In the event that the institution for which a charter is sought is to be created solely
for the purpose of effectuating a merger or consolidation to facilitate the formation
of a bank holding company, the commissioner may waive all or any part of the
requirements of this chapter [subsection (1) of this section].

(3) If the commissioner determines that it is expedient and desirable to permit the
proposed corporation to engage in business, he shall approve the articles of
incorporation in writing, and the articles then may be filed and recorded as provided
in the general corporation law.

(4) All amendments to the articles of incorporation of any financial institution
mentioned in KRS 287.040 shall be approved by the commissioner before filing
with the Secretary of State.

Section 6. KRS 287.060 is amended to read as follows:

(1) Before any financial institution mentioned in KRS 287.040 may transact any
banking or trust business, it shall file a written oath with the commissioner. The
oath shall be taken by each director of the institution, and shall state in substance:

(a) That such director is a citizen of the United States, and the State of Kentucky,
or, if not, the place of his residence;

(b) That he will faithfully discharge the duties of his office and administer the
affairs of the institution, so far as the duties of his office require;

(c) That he will uphold the laws of the state, and particularly the banking and
trust laws.

(2) The oath shall be taken before any officer authorized to administer oaths, and shall
be taken upon the election of any subsequent director or reelection of any director.
The oath shall be maintained by the bank and be subject to review at

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examinations[transmitted to the commissioner immediately upon its execution and shall be filed and preserved by the commissioner].

(3) The commissioner shall issue to the institution a certificate entitling it to transact the business for which it was organized after the following requirements have been met:

(a) The oath mentioned in subsections (1) and (2) of this section has been filed; and

(b) The commissioner has received satisfactory proof that the accounts of the banking institution's depositors will be insured by the Federal Deposit Insurance Corporation; and

(c) The commissioner has received satisfactory proof that the institution has subscribed and paid-in the required capital and has otherwise fully complied with all pertinent laws and regulations; and

(d) A period of thirty (30) days has elapsed since the rendition by the commissioner of a final order, as defined in KRS 13B.010, and an appeal to the appropriate court has not been taken from such order.

(e) If an appeal from a final order of the commissioner has been timely filed, no certificate shall be issued until all the requirements of paragraphs (a) to (c) of this subsection have been met and until:

1. The appeal has been finally disposed of by the last possible court of review, including the United States Supreme Court; or

2. All further opportunities for appeal have expired as a result of the failure to timely file an appeal.

Section 7. KRS 287.065 is amended to read as follows:

(1) Each director of a bank or trust company shall own in his own right unpledged capital stock of that bank or trust company, or of a corporation holding at least eighty percent (80%) of the outstanding capital stock of that bank or trust company,
having a book value of at least one thousand dollars ($1,000) at the time such person becomes a director, and the certificates of such stock shall remain in the exclusive custody and control of that bank or trust company during his term of office.

(2) A majority of the directors of any board must be residents of Kentucky during their term of office.

(2)(3) Each director shall exercise such ordinary care and diligence as necessary and reasonable to administer the affairs of the bank in a safe and sound manner. In this regard, the bank shall furnish each director with a copy of an appropriate publication outlining the duties of a bank director and an updated copy of the Kentucky banking law, and maintain in the bank updated copies of federal banking laws, as determined by administrative regulations.

Section 8. KRS 287.070 is amended to read as follows:

(1) The capital stock of any financial institution mentioned in KRS 287.040 organized prior to May 31, 1938, shall be maintained in the amount required by the law in effect on May 30, 1938.

(2) The minimum capital stock of any bank or trust company organized after May 30, 1938 shall be two million five hundred thousand dollars ($2,500,000). Additional capital may be required depending upon an investigation of the application, at the discretion of the commissioner, as follows, according to the city in which it is located:

- Cities of up to 7,999 population .................................................. $ 25,000
- Cities of 7,999 to 19,999 population ........................................... $ 50,000
- Cities of 20,000 to 100,000 population ......................................... $100,000
- Cities of over 100,000 population ................................................ $200,000

(3) The minimum capital stock of any combined bank and trust company, combined bank and real estate title insurance company or combined trust and real estate title insurance company or combined bank trust and real estate title insurance company,
organized after May 30, 1938, shall be not less than twice the amount stated in subsection (2) of this section.

Section 9. KRS 287.080 is amended to read as follows:
The minimum capital required of a financial institution by KRS 287.070 shall be paid in full in money. Not less than fifty percent (50%) of the minimum capital required shall be designated as surplus, and in addition thereto there shall be so paid in a surplus of not less than fifty percent (50%) of the minimum capital required. Such money shall be in the custody of the directors before the corporation may commence business. None of the original minimum capital of a financial institution may be designated as undivided profits.

Section 10. KRS 287.103 is amended to read as follows:
(1) It is hereby declared to be the policy of the Commonwealth of Kentucky that the investment of funds, by a bank chartered under the laws of Kentucky or a national banking association having its principal office in Kentucky, in real and personal property as now or hereafter provided by this chapter, be recognized as a normal, proper, necessary, and integral part of the legitimate business of such state or national banks.

(2) Upon approval of the commissioner in the case of a state bank, or the proper federal supervisory authority in the case of a national bank, the institution may invest its funds in real property and/or improvements on such real property when all or a portion of the improvements are for use as its home office or for branch offices so long as the said real estate is used for carrying on its legitimate business as permitted by Section 192 of the Constitution of the State of Kentucky.

(3) All property owned and held by a state or national bank under this section shall be deemed to be property that is proper and necessary for carrying out its legitimate business within the meaning of KRS Chapter 271B or any section of the Kentucky Revised Statutes relating to escheat.
Section 11. KRS 287.105 is amended to read as follows:

Subject to such limitations and conditions as the commissioner may from time to time prescribe by general regulations, any bank or trust company organized under the laws of this state may purchase, hold and become the owner and lessor of personal property acquired upon the specific request of and for the use of a customer and may incur such additional obligations as may be incident to becoming an owner and lessor of such personal property, provided, however, that the net unrecovered investment of such bank or trust company in such personal property shall, for the purposes of KRS 287.280 only, be deemed to be an indebtedness of the lessee thereof, and such personal property shall be considered to be collateral securing such indebtedness.

Section 12. KRS 287.214 is amended to read as follows:

Notwithstanding the provisions of any other law, a bank may take, receive, reserve and charge on money due or to become due on any contract or other obligation in writing, where the original principal amount is fifteen thousand dollars ($15,000) or less, interest at any rate allowed national banking associations by the laws of the United States of America. A trust company shall not make any extensions of credit on its own account, but may make extensions of credit for trust assets under management.

Section 13. KRS 287.350 is amended to read as follows:

1. The board of directors of any bank or trust company organized under the laws of this state may declare a dividend of so much of the net profits as they deem expedient. The net profits shall be computed by deducting all expenses, losses, and interest and taxes accrued or due from the bank.

2. Before any dividend is declared, other than upon its preferred stock, not less than ten percent (10%) of the net profits of the bank for the period covered by the dividend applicable to its common stock shall be carried to its surplus fund until such surplus fund amounts to a sum equal to the amount of its common capital stock.
(3) All debts due to a bank or trust company on which interest is due and unpaid for six (6) months, unless the debts are well secured or in the process of collection, are bad or suspended debts within the meaning of this section.

(4) The approval of the commissioner shall be required if the total of all dividends declared by such institution in any calendar year shall exceed the total of its net profits of that year combined with its retained net profits of the preceding two (2) years, less any required transfers to surplus or a fund for the retirement of preferred stock or debt.

Section 14. KRS 287.385 is amended to read as follows:

For the purpose of borrowing money from a state or national bank for their own higher educational purposes, the disabilities of nonage of minors are removed for all purposes, whether male or female. Any minor is authorized to make and execute any and all promissory notes, contracts, or other instruments necessary to be executed by him in order to borrow money for his own higher educational purposes, and such promissory notes, contracts or other instruments shall have the same force and effect as though they were the obligations of persons over the age of their majority, provided that no such obligation shall be valid if the rate of interest thereon exceeds six percent (6%) per annum, simple interest. Any promissory note, contract or other instrument entered into by any such person pursuant to the provisions of this section shall have the approval of the parent or guardian of such minor and of the financial officer of the institution of higher learning.

Section 15. KRS 287.420 is amended to read as follows:

Within ten (10) days after the commissioner calls upon a bank or trust company, it shall publish pursuant to KRS Chapter 424 on a form furnished by the commissioner, a condensed statement of its financial condition, at the close of business on the date named in the call. The commissioner may make the call at any time he desires and shall make at least two (2) calls in each year. Such published statement shall 

contain all information.
as the commissioner shall require, show the total amounts of loans, overdrafts, money invested in bonds and other securities, money due from banks, checks and other cash items, cash on hand, capital paid in, surplus fund, undivided profits (less expense and taxes paid), money due to other banks, individual deposits subject to check, demand certificates of deposit, time deposits, outstanding certified checks and cashier's checks and such other items as will show the actual financial condition of the bank or trust company making the report. The reports shall be signed and sworn to either by the president, vice president, or cashier, or one (1) and signed by at least three (3) of the directors. A copy of the report, certified to by the publisher, shall be kept in the files of the bank or trust company for review by the department.

Section 16. KRS 287.450 is amended to read as follows:

(1) Every state bank, branch of an out-of-state state bank, or trust company doing business under the laws of this state shall be subject to inspection by the commissioner or by an examiner appointed by the commissioner. Examination shall be made of each institution at least once every twenty-four (24) months, unless other examinations are accepted as provided in subsections (3), (4), and (5) of this section, and not more than twice unless it appears from examination or from the reports of the institution that it has failed to comply with laws or regulations relating to banks or trust companies, or has engaged in unsafe or unsound banking practices.

(2) The commissioner, deputy commissioner, and each examiner may compel the appearance of any person for the purpose of the examination, which shall be made in the presence of one (1) of the officers of the institution being examined.

(3) Any bank that becomes a member of a Federal Reserve Bank shall be subject to the examination required by the Federal Reserve Act, (38 Stat. 251) as amended, and the commissioner may, in his discretion, accept examinations made by the Federal Reserve authorities in lieu of examinations made under state laws. The
commissioner shall furnish to the Federal Reserve agent of the district in which the member bank is situated, copies of reports and examinations made of the member bank.

(4) The commissioner may, in his discretion, accept examinations made by the Federal Deposit Insurance Corporation in lieu of examinations made under state laws.

(5) The commissioner may, in his discretion, enter into cooperative, coordinating, and information-sharing agreements with any other bank supervisory agencies or any organization affiliated with or representing one (1) or more bank supervisory agencies with respect to the periodic examination or other supervision of any branch of an out-of-state state bank, or any branch of a state bank in any host state. The commissioner may accept reports of examinations and reports of investigation from other bank supervisory agencies and home state regulators in lieu of examinations made under state law. The commissioner may enter into joint examinations or joint enforcement actions with other bank supervisory agencies having concurrent jurisdiction over any branch of an out-of-state state bank or any branch of a state bank located in any host state. *Information produced or provided under this section shall be considered confidential as provided in KRS 287.470.*

Section 17. KRS 287.480 is amended to read as follows:

(1) The following fees shall be paid to the commissioner by corporations engaged in a banking or trust business:

(a) For the investigation incident to the approval of articles of incorporation, applications for branch banks and loan production offices, and applications to relocate a main or branch office, the fee shall be sufficient to cover the cost of the investigation based upon fair compensation for time and actual expense;

(b) For each report, a filing fee of twenty-five dollars ($25);

(e) For each state bank and branch of an out-of-state state bank subject to inspection and examination by the commissioner, an annual assessment based
on the assets of the banks and branches, other than assets held by it in a fiduciary capacity, as reported to the department by the banks and branches as of the thirty-first day of December of the previous year. The assessment schedule shall be at the rates the commissioner shall determine to be necessary to carry out the duties of the department and shall be reasonably related to the costs incurred by the department in regulating banks and branches. The assessment schedule shall be set by administrative regulation. The assessments for any one (1) year shall not exceed a sum equal to five cents ($0.05) per each one thousand dollars ($1,000) and any fraction thereof of the total nontrust assets;

(d) For any examinations under KRS 287.450, a fee shall be collected sufficient to cover the cost of the examination based upon fair compensation for time and actual expense;

(e) For the examination of the assets held by the institution in a fiduciary capacity, the fee shall be sufficient to cover the cost of the investigation based upon fair compensation for time and actual expense. The commissioner may accept examinations made of the trust department in combined banks and trust companies by examiners for the Federal Reserve System, Federal Deposit Insurance Corporation, or a certified public accountant; and

(d) Extraordinary services performed, in addition to examinations, for any financial institution, including institutions in liquidation under the supervision of the commissioner, shall be paid for by the institution upon the basis of fair compensation for time and actual expense.

(2) The commissioner, in his discretion, may enter into cooperative agreements with other bank supervisory agencies having concurrent jurisdiction over any branch of an out-of-state state bank or any branch of a state bank located in any host state, or any organization affiliated with one (1) or more bank supervisory agencies for the
collection, remittance, and sharing of fees authorized in subsection (1) of this section.

Section 18. KRS 287.490 is amended to read as follows:

(1) Every institution under the supervision of the department shall make a report to the commissioner whenever required by him to do so. The commissioner shall not require more than five (5) reports from any one (1) institution in any one year, unless he deems it necessary in order to obtain complete information, and each report shall be verified by the oath of the corporation's president or vice president, and its secretary or cashier, or two (2) principal officers.

(2) The reports shall show the actual condition of the bank making the report at the close of business on a date designated by the commissioner and shall specify any information required by the commissioner:

(a) The amount of its capital stock and the number of shares into which it is divided;

(b) The names of the directors, and the number of shares of stock held by them;

(c) The total amount of capital actually paid in, and the total amount of surplus and other reserve funds;

(d) The total amount due depositors, and all other liabilities;

(e) The total amount and character of overdrafts secured, overdrafts not secured and all other assets;

(f) The amount at which the lot and building occupied by the bank for the transaction of its business stands debited on its books, and the market value of all other real estate held, and how acquired, the amount at which it stands debited on the books, and where situated;

(g) The amount loaned on real estate;

(h) The indebtedness or liability of each officer, and of each director to the bank;

(i) The amount invested in bonds and stocks;

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(j) The amount loaned on stocks and bonds, on other securities, commercial paper and other notes and bills;
(k) The actual amount of money on hand and on deposit in other banks, and the name of such banks where deposited;
(l) Any other property held, or money loaned, deposited, invested or placed, not otherwise mentioned in this section, and the place where situated and the value of the property, and the amount loaned, deposited, or placed; and
(m) Any other information required by the commissioner.

(3) Any officer, director or board of directors of a bank or trust company shall immediately notify the commissioner concerning any information relating to that financial institution of which they have personal knowledge, involving fraud, defalcation, misfeasance or violations of this chapter. Failure to so notify the commissioner shall be grounds for officer or director removal pursuant to KRS 287.690.

Section 19. KRS 287.710 is amended to read as follows:

As used in KRS 287.720 to 287.770, unless the context otherwise requires:

(1) "Bank" means a bank organized under the laws of this state or of the United States, or any assignee of the bank's rights under a revolving credit plan.

(2) "Credit card" means any single card, plate or other credit device that is reusable by a debtor from time to time to obtain extensions of credit under a revolving credit plan. Checks, drafts and similar instruments that can be used only once to obtain a single credit extension are not credit cards.

(3) "Debtor" means a person to whom or for whose benefit credit is extended pursuant to a revolving credit plan and any other person having actual, implied or apparent authority to obtain extensions of credit under such plan for the debtor.

(4) To "extend credit" or "extension of credit" means the right granted by a bank to a debtor to defer payment of debt, incur debt and defer its payment, or purchase
goods, services or anything else of value and defer payment therefor pursuant to a revolving credit plan.

(5) "Finance charge" means the sum of all charges, payable directly or indirectly by the debtor, and imposed directly or indirectly by a bank as an incident to an extension of credit pursuant to a revolving credit plan, including interest and any amount payable under a point, discount or other system of additional charges, service or carrying charges, loan fee, finder's fee or similar charge, fees for an investigation or credit report or premiums or other charges required by the bank to be purchased from or through it or an agency named by it for any guarantee or insurance protecting the bank against the debtor's default or other credit loss. The term does not include amounts, if any, collected by the bank, or included in the extension of credit which are fees and charges prescribed by law which actually are or will be paid to public officials for determining the existence of or for perfecting or releasing or satisfying any security related to credit extended pursuant to the plan or taxes.

(6) "Revolving credit plan" or "plan" means an arrangement between a bank and a debtor pursuant to which:

(a) The bank may extend credit to the debtor by permitting the debtor to make purchases of goods, services and anything else of value or obtain loans, from time to time, directly from the bank or indirectly by use of a credit card, check or other device, as the plan may provide;

(b) The unpaid balances of purchases made, the principal of loans obtained and finance and other appropriate charges are debited to the debtor's account;

(c) A finance charge, if made, is not precomputed, but is computed on the outstanding unpaid balances of the debtor's account from time to time; and

(d) The bank renders bills or statements to the debtor at regular intervals, which need not be a calendar month (the "billing cycle"), the amount of which bills
or statements is payable by and due from the debtor on a specified date stated in such bill or statement or, at the debtor's option, may be paid in installments.

Section 20. KRS 287.905 is amended to read as follows:

(1) Any bank holding company which proposes to acquire control of a bank chartered in this state or a bank holding company which includes a bank chartered in this state, shall concurrently file with the commissioner copies of the application filed with the federal reserve board under applicable federal law. The commissioner shall approve such acquisition within ninety (90) days of acceptance of a complete application if he finds that:

(a) The terms of the acquisition are in accordance with the laws of this state;
(b) The financial condition, or the competence, experience and integrity of the acquiring company or its principals are such as will not jeopardize the financial stability of the acquired bank or bank holding company;
(c) The public convenience and advantage will be served by the acquisition; and
(d) No federal regulatory authority whose approval is required has disapproved the transaction because it would result in a monopoly or substantially lessen competition.

(2) A nonrefundable fee shall accompany each application and shall be set by the commissioner in accordance with KRS 287.480.

(3) The commissioner may examine or elect to participate in a joint examination, with the applicable federal or state regulatory agency, of any holding company or nonbank subsidiary of the holding company that controls or is affiliated with a state-chartered bank. The provisions of KRS 287.690 apply to the holding company or nonbank subsidiary of the holding company that controls or is affiliated with a state-chartered bank.

(4) The commissioner may enter into cooperative agreements with federal or state regulatory authorities to examine an out-of-state bank that is controlled by a
Kentucky bank holding company or is controlled by a bank holding company which includes a state-chartered bank, or accept reports of examinations of such out-of-state banks from federal or state regulatory authorities in lieu of conducting examinations.

(5) The commissioner may enter into cooperative agreements with federal or state regulatory authorities to exchange confidential information and reports of examination relating to interstate acquisitions of banks and bank holding companies.

(6) The cost of an examination shall be assessed against and paid by the company examined. The assessment for the examination shall be calculated in the same manner as that used for bank examinations.

Section 21. KRS 287.915 is amended to read as follows:

(1) Notwithstanding any other provision of KRS Chapter 287:

(a) An individual or bank holding company that controls two (2) or more banks having their principal offices in this Commonwealth may, from time to time, combine any or all of the commonly controlled banks in this Commonwealth into and with any one (1) of the banks, and thereafter the surviving bank, which shall have its principal office in this Commonwealth, shall continue to operate its principal office and may operate the other authorized offices of the banks so combined as branches of the surviving bank; and

(b) Any combination authorized by this section shall not require the approval of the commissioner of financial institutions, but on or before thirty (30) days prior to consummation of any combination, the proposed surviving bank shall notify the commissioner of the combination, and on the effective date of any such combination the charter of any combined bank organized under the laws of this Commonwealth shall be surrendered.

(2) Following any combination authorized by this section:
(a) The surviving bank may, subject to the approval of the commissioner as provided in KRS 287.180(2), establish and operate additional branches in any county where any bank involved in the combination had established a branch or main office;

(b) Any combined bank which is being operated as a branch of the surviving bank shall have a board of directors, a majority of which shall be residents of the combined bank's community, which shall meet not less often than quarterly[monthly] to advise the branch in a nonfiduciary capacity with respect to the branch's community activities and affairs, customer relations, and local charitable activities;

(c) The surviving bank shall maintain a record of the deposits in each of its offices resulting from such combination or thereafter established as provided in paragraph (a) of this subsection; and

(d) With the approval of the commissioner, all of a bank's offices in a county[all of a combined bank's former main office and all of the branches in one (1) county existing on the date of the combination authorized by this section] may be transferred, by a purchase and assumption or other transaction, by the surviving[the] bank to a newly chartered bank having its principal office in the same county[where the main office of the combined bank was located prior to the combination], or to an existing bank. If transferred to a newly chartered bank, the years in existence of the newly chartered bank shall be deemed to be in excess of five (5) years[or bank holding company. If transferred to a newly chartered bank, the years in existence of the newly chartered bank shall be deemed to be the same as the combined bank prior to the combination].

(3) For purposes of this section:
(a) The term "combine" or "combination" includes a merger or the acquisition of all or substantially all of the assets of a bank already controlled by an individual or bank holding company;

(b) An individual or bank holding company "controls" a bank if that individual or company, directly or indirectly, owns, controls, or has the power to vote at least eighty percent (80%) of the issued and outstanding voting securities of the bank;

(c) "Combined bank" means any bank participating in a combination authorized by this section other than the surviving bank;

(d) "Surviving bank" means a bank into which a combined bank has been combined;

(e) "Bank" includes a national bank, savings and loan association, and federal savings bank but does not include a bank which has been in existence less than five (5) years; and

(f) "Individual", "bank holding company" and "deposit" shall have the same meanings attributed to them in KRS 287.900(1).

Section 22. KRS 287.920 is amended to read as follows:

(1) As used in this section, unless the context requires otherwise:

(a) "Interstate merger transaction" means the merger or consolidation of banks with different home states, and the conversion of branches of any bank involved in the merger or consolidation into branches of the resulting bank; and

(b) "Resulting bank" means a bank that has resulted from an interstate merger transaction under this section.

(2) A Kentucky state bank may establish, maintain, and operate one (1) or more branches in a state other than Kentucky pursuant to an interstate merger transaction in which the Kentucky state bank is the resulting bank, or if the other state permits.
by acquisition of a branch or branches in the other state. Not later than the date on which the required application for the interstate merger transaction or branch acquisition is filed with the responsible federal bank supervisory agency, the applicant shall file an application on a form prescribed by the commissioner and pay the fee prescribed by KRS 287.480. The applicant shall also comply with the applicable provisions of KRS 287.180(2) and the commissioner shall base his approval or disapproval in the same manner as prescribed in KRS 287.180(2).

(3) An out-of-state state bank may establish, maintain, and operate one (1) or more branches in Kentucky pursuant to an interstate merger transaction in which the out-of-state state bank is the resulting bank. Not later than the date on which the required application for the interstate merger transaction is filed with the responsible federal bank supervisory agency, the applicant shall file an application on a form prescribed by the commissioner, pay the fee prescribed by KRS 287.480, and agree in writing to comply with the laws of this state applicable to its operation of branches in Kentucky. The applicant shall also comply with the applicable provisions of KRS 287.180(2) and the commissioner shall base his approval or disapproval in the same manner as prescribed in KRS 287.180(2).

(4) The bank to be acquired in an interstate merger transaction under the provisions of subsections (2) and (3) of this section shall have been involved in operation for a period of five (5) years or more. No interstate merger transaction under subsections (2) or (3) of this section shall be approved if the transaction would result in a bank holding company having control of banks or branches in this state holding more than fifteen percent (15%) of the total deposits and member accounts in the offices of all federally-insured depository institutions in this state as reported in the most recent year-end reports made by the institutions to their respective supervisory authorities which are available at the time of the transaction.
(5) An individual or bank holding company that controls two (2) or more banks may, from time to time, combine any or all of the commonly controlled banks in this Commonwealth into and with any one (1) of the banks, and thereafter the surviving bank shall continue to operate its principal office and may operate the other authorized offices of the banks so combined as branches of the surviving bank.

(6) A branch of an out-of-state state bank may conduct any activities that are authorized under the laws of this state for state banks. Additionally, the branch of an out-of-state state bank is authorized to conduct any activities relating to the administration of trusts that are authorized under the laws of its home state, if the activities are conducted in conformity with the laws of its home state.

(7) A branch of a Kentucky state bank located in a host state may conduct any activities that are:

(a) Authorized under the laws of the host state for banks chartered by the host state; or

(b) Authorized for branches of national banks located in the host state, but whose principal location is in a state other than the host state.

Section 23. KRS 386.735 is amended to read as follows:

Unless previously barred by adjudication, consent or any limitation established by KRS Chapter 413, any claim against a trustee for breach of trust is barred as to any beneficiary who has received a final account or other statement fully disclosing the matter and showing termination of the trust relationship between the trustee and the beneficiary unless a proceeding to assert the claim is commenced within six (6) months after receipt of the final account or statement. In any event and notwithstanding lack of full disclosure a trustee who has issued a final account or statement received by the beneficiary and has informed the beneficiary of the location and availability of records for his examination is protected after three (3) years. A beneficiary is deemed to have received a final account or
statement if, being an adult, it is received by him personally or if, being a minor or disabled person, it is received by his representative.

Section 24. KRS 391.315 is amended to read as follows:

(1) **(a)** Sums remaining on deposit at the death of a party to a joint account belong to the surviving party or parties to the account as against the estate of the decedent unless there is clear and convincing written evidence of a different intention at the time the account is created. If there are two or more surviving parties their respective ownerships during lifetime shall be in proportion to their previous ownership interests under KRS 391.310 augmented by an equal share for each survivor of any interest the decedent may have owned in the account immediately before his death; and the right of survivorship continues between the surviving parties.

**(b)** In transferring or releasing joint account funds subsequent to the date of death of one (1) or more of the named joint account holders, a financial institution or other appropriate third party may rely conclusively on the form and terms of the account to pay in accordance with paragraph (a) of this subsection. The transfer or release of those joint account funds has no bearing on the actual rights of ownership of the funds as between the surviving party or parties to the account and the dower or curtesy interest of any surviving spouse. The transfer or release by a financial institution or third party in accordance with this section shall constitute a full release and discharge of the financial institution or third party from all claims relating to ownership.

(2) If the account is a P.O.D. account, on death of the original payee or of the survivor of two or more original payees, any sums remaining on deposit belong to the P.O.D. payee or payees if surviving, or to the survivor of them if one or more die before the original payee; if two or more P.O.D. payees survive, there is no right of
survivorship in event of death of a P.O.D. payee thereafter unless the terms of the account or deposit agreement expressly provide for survivorship between them.

(3) If the account is a trust account, on death of the trustee or the survivor of two or more trustees, any sums remaining on deposit belong to the person or persons named as beneficiaries, if surviving, or to the survivor of them if one or more die before the trustee, unless there is clear and convincing evidence of a contrary intent; if two or more beneficiaries survive, there is no right of survivorship in event of death of any beneficiary thereafter unless the terms of the account or deposit agreement expressly provide for survivorship between them.

(4) In other cases, the death of any party to a multiple-party account has no effect on beneficial ownership of the account other than to transfer the rights of the decedent as part of his estate.

(5) A right of survivorship arising from the express terms of the account or under this section, a beneficiary designation in a trust account, or a P.O.D. payee designation, cannot be changed by will.

Section 25. KRS 413.120 is amended to read as follows:

The following actions shall be commenced within five (5) years after the cause of action accrued:

(1) An action upon a contract not in writing, express or implied.

(2) An action upon a liability created by statute, when no other time is fixed by the statute creating the liability.

(3) An action for a penalty or forfeiture when no time is fixed by the statute prescribing it.

(4) An action for trespass on real or personal property.

(5) An action for the profits of or damages for withholding real or personal property.

(6) An action for an injury by a trustee to the rights of a beneficiary of a trust.

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An action for an injury to the rights of the plaintiff, not arising on contract and not otherwise enumerated.

An action upon a bill of exchange, check, draft or order, or any endorsement thereof, or upon a promissory note, placed upon the footing of a bill of exchange.

An action to enforce the liability of a steamboat or other vessel.

An action upon a merchant's account for goods sold and delivered, or any article charged in such store account.

An action upon an account concerning the trade of merchandise, between merchant and merchant or their agents.

An action for relief or damages on the ground of fraud or mistake.

An action to enforce the liability of bail.

An action for personal injuries suffered by any person against the builder of a home or other improvements. This cause of action shall be deemed to accrue at the time of original occupancy of the improvements which the builder caused to be erected.

Section 26. KRS 413.340 is amended to read as follows:

The provisions of this chapter shall not apply to an express trust that is both continuing and subsisting, nor to an action by a vendee of real property in possession to obtain a conveyance. For purposes of this subsection, a subsisting trust is an express trust with respect to which the trustee is acting within its powers and with respect to which no beneficiary has a cause of action against the trustee.

Section 27. KRS 41.220 is amended to read as follows:

Not less than three (3) solvent banks shall be designated as depositories for state funds. Each bank designated shall have not less than the minimum capital stock as required in paragraphs (2) and (3) of KRS 287.070. Banks shall be designated as depositories for state funds upon agreement of the State Treasurer and the secretary of the Finance and Administration Cabinet. Those designated shall be entered in the
executive journal. If at any time it appears that the capital of any depository has become impaired, the state's deposits shall be withdrawn and another depository named.

(2) The State Treasurer and the secretary of the Finance and Administration Cabinet shall determine the needs for moving state funds from one (1) designated depository to another.

Section 28. KRS 287.820 is amended to read as follows:

(1) For the purpose of this section:

(a) "Loan production office" means a bank office located at a place other than the principal or branch office, at which bank employees solicit and originate loans for final approval and disbursement of funds at the principal or branch office; and

(b) "Disbursement of funds" is the process by which a bank officer in a principal or branch office issues a negotiable instrument at the principal or branch office.

(2) No bank shall operate a loan production office without prior approval of the commissioner. The commissioner shall approve the application unless he finds that:

(a) The proposed operation of the loan production office is not in accordance with this section;

(b) The financial standing, moral character, and capability of the bank and its management which proposes to operate a loan production office will jeopardize the financial stability of the bank;

(c) There is no reasonable assurance of sufficient volume of business for the proposed loan production office to be successful; and

(d) The public convenience and advantage will not be promoted by the opening of the proposed loan production office.
(3) All extensions of credit originated in a loan production office shall be in accordance with disclosure provisions, usury rates, and other fees and charges authorized by law for banks.

(4) Loan production offices shall not accept deposits or conduct any other banking functions except those enumerated in paragraph (a) of subsection (1) of this section.

(5) The department may examine the operations of any loan production office for the purpose of determining that the scope of its activities does not exceed that allowed in this section. Banks operating loan production offices shall maintain copies of records relating to extensions of credit originated in loan production offices at the principal office for examination purposes.

(6) The application and appeal process set forth in §KRS 287.061 and KRS Chapter 13B and the cease and desist powers of the commissioner set forth in KRS 287.690 shall apply to loan production offices.

Section 29. KRS 287.990 is amended to read as follows:

(1) Any person who violates subsection (2) of KRS 287.030 may be fined not less than five hundred dollars ($500) nor more than one thousand dollars ($1,000) for each day he is engaged in the private banking business.

(2) Any institution that fails to make the report required by KRS 287.420 to the commissioner within five (5) days after the report is due or demanded, or that fails to have the report published as required by KRS 287.420, may be assessed and, if assessed, shall pay a penalty of two hundred dollars ($200).

(3) If any person violates subsection (3) of KRS 287.440 his office shall ipso facto become vacant. The president or cashier of any bank or trust company to which any person becomes indebted in violation of subsection (3) of KRS 287.440 shall immediately report such fact to the commissioner, who may remove the person so offending.
(4) Any receiver of an insolvent institution who fails to comply with the provisions of this chapter shall be subject to the same penalties provided for solvent institutions and officers so offending.

(5) Any directors of a bank who knowingly violate, or knowingly permit any officer or employee of the bank to violate, any of the laws relating to banks, shall be jointly and severally liable to the creditors and stockholders for any loss or damage resulting from such violation. If the loss or damage is not made good within a reasonable time, the commissioner, with the consent of the Attorney General, shall institute proceedings to revoke the corporate powers of the bank.

(6) Any deputy commissioner or any examiner who has knowledge of the insolvency or unsafe condition of a state bank or trust company, or that it is inexpedient to permit the bank or trust company to continue business, and who fails to immediately present a signed report of such facts to the commissioner, or who violates any of the provisions of this chapter, shall forfeit his office and shall be fined not less than one hundred ($100) nor more than two thousand dollars ($2,000) for each offense.

(7) Any commissioner who has knowledge of the insolvency or unsafe condition of a state bank or trust company, or that it is inexpedient to permit the bank or trust company to continue business, and who willfully fails to take the action prescribed by this chapter, or who violates any of the provisions of this chapter, shall forfeit his office and shall be fined not less than five hundred ($500) nor more than five thousand dollars ($5,000) for each offense.

(8) Any bank or trust company that knowingly fails to make a report required by law or by the commissioner within the time designated for the making thereof, or fails to include in such report any matter required by law or by the commissioner, or fails to publish a report within thirty (30) days after it should have been published, or fails to pay when due the fees for filing reports or for an examination of the bank, shall be subject to a penalty of one hundred dollars ($100) for each day of delinquency,
but the aggregate penalty for each kind of offense shall not exceed one thousand dollars ($1,000).

(9) Each person, bank, or trust company that willfully makes or transmits a false report or refuses to submit its books, papers, and assets for examination, or any officer of a bank who refuses to be examined under oath concerning the affairs of the bank, shall be severally fined not less than five hundred dollars ($500) nor more than five thousand dollars ($5,000).

(10) Whenever any fine imposed by subsection (1), (2), (4), (6), (7), (8), (9), (15), (16), (17), or (18) of this section is not paid, the Attorney General shall institute an action, in the name of the state, in the Franklin Circuit Court or the Circuit Court of the county in which the offense was committed, for the recovery of the fine.

(11) Any person violating any of the provisions of KRS 287.225 shall be guilty of a misdemeanor and fined not less than fifty dollars ($50) nor more than two thousand dollars ($2,000).

(12) Any person who willfully makes charges in excess of those permitted by KRS 287.720 to 287.770 shall be guilty of a misdemeanor and upon conviction shall be punished by a fine not exceeding five hundred dollars ($500) or by imprisonment for not more than six (6) months, or both.

(13) Any bank which violates any provision of KRS 287.720 to 287.770, except as a result of an accidental or bona fide error, shall be barred from the recovery of any finance charges permitted by KRS 287.740 and 287.750, and the debtor, or his legal representatives, may recover back, in an action against the bank, any amounts paid to the bank on account of such finance charge; provided such action is commenced within two (2) years from the date such violation first occurred; but the bank may nevertheless recover from the debtor an amount equal to the principal of extensions of credit made pursuant to a revolving credit plan and any charges not prohibited by KRS 287.760.
(14) Notwithstanding the provisions of subsections (12) and (13) of this section, any failure, other than a willful and intentional failure, to comply with any provisions of KRS 287.710 to 287.770 may be corrected during the billing cycle next succeeding the receipt by the bank of written notice thereof from the debtor, and if so corrected, the bank shall not be subject to any penalty under KRS 287.710 to 287.770.

(15) Any bank or trust company which violates or any officer, director, employee, agent, or other person participating in the conduct of the affairs of a bank who violates the terms of any order issued under KRS 287.690 which has become final shall forfeit and pay a fine of not more than one thousand dollars ($1,000) per day for each day such violation continues. The fine shall be assessed by the commissioner by written notice. As used in this subsection, the term "violates" includes any action causing, participating in, counseling, aiding, or abetting a violation. In determining the amount of the fine the commissioner shall consider the financial resources and good faith of the bank or person charged, the gravity of the violation, the history of previous violations and such other factors as justice requires.

(16) Any bank which violates the provisions of KRS 287.065(2) may be fined not less than one hundred dollars ($100) nor more than five hundred dollars ($500). The fines may be assessed by the commissioner by written notice.

(17) Any bank which violates any provisions of KRS 287.100(10) may be fined not less than one thousand dollars ($1,000) nor more than two thousand dollars ($2,000) for the first violation, and may be fined not less than two thousand dollars ($2,000) nor more than five thousand dollars ($5,000) for any subsequent violations.

(18) Any officer or director who violates the provisions of KRS 287.280(1) may be fined not less than one hundred dollars ($100) nor more than five hundred dollars ($500) for each violation, and any officer or director who violates the provisions of KRS 287.280(2) may be fined not less than five hundred dollars ($500) nor more than
two thousand dollars ($2,000) for each violation. The fine may be assessed by the commissioner by written notice.

Section 30. KRS 413.130 is amended to read as follows:

(1) In every action upon a merchants' account as described in subsection (l0) of KRS 413.120, the limitation shall be computed from January 1 next succeeding the respective dates of the delivery of the several articles charged in the account. Judgment shall be rendered for no more than the amount of articles actually charged or delivered within five (5) years preceding that in which the action was brought. If any merchant willfully postdates any article charged in such account, or the receipt for the delivery of it, he shall forfeit ten (10) times the amount of the article postdated, to be credited against the account. This credit shall be allowed in an action on the account, without any written pleadings setting it up.

(2) In an action to recover a balance due upon a mutual open and current account concerning the trade of merchandise between merchant and merchant or their agents, as described in subsection (ll) of KRS 413.120, where there have been reciprocal demands between the parties, the cause of action is deemed to have accrued from the time of the last item proved in the account claimed, or proved to be chargeable on the adverse side.

(3) In an action for relief or damages for fraud or mistake, referred to in subsection (l2) of KRS 413.120, the cause of action shall not be deemed to have accrued until the discovery of the fraud or mistake. However, the action shall be commenced within ten (10) years after the time of making the contract or the perpetration of the fraud.

Section 31. KRS 287.235 is amended to read as follows:

(1) Common trust funds shall not be considered as an entity for income or other tax purposes, nor shall investment in such fund make taxable any property which is otherwise exempt therefrom; and for purposes of taxation, the status of the common
trust fund and of each participant therein shall be determined as though there were
no common fund and as though each participant was the owner of its proportionate
share of every asset held in the common fund. The bank or trust company
maintaining said fund shall file a report of said fund with the property valuation
administrator as of the ad valorem tax date and shall file annually such income tax
information as may be required by the Revenue Cabinet.

(2) Notwithstanding subsection (1) of this section, if a common trust fund transfers
substantially all of its assets to one (1) or more regulated investment companies
in exchange solely for stock in the company or companies to which such assets
are transferred and such stock is distributed by such common trust fund to the
participants in such common trust fund in a transaction which would qualify
under Section 584(h) of the Internal Revenue Code of 1986, as amended, for the
nonrecognition of gain or loss of such transfer or distribution by the common
trust fund, then no gain or loss shall be recognized for Kentucky income tax
purposes by the common trust fund by reason of such transfer or distribution or
by the participants in such common trust fund by reason of such exchange.

Section 32. The following KRS sections are repealed:

287.061 Application for approval -- Hearing.

287.205 When national bank may act as fiduciary.
AN ACT relating to elder abuse.

Amend KRS 209.020 to include uniform definitions, and require the Cabinet for Human Resources to promulgate administrative regulations for these; amend KRS 209.100 to include "exploitation" in the description of abuse and neglect; amend KRS 209.990 to require that any person who knowingly or willingly financially exploits an adult is guilty of a Class C felony; create a new section of KRS 209 to require the Cabinet for Human Resources to develop a protocol to provide for prevention and intervention of elder abuse, neglect, or exploitation that outlines levels of need and identifies state agencies capable of intervening at each level, create a public awareness program; amend KRS 311.625 to limit witness to an advance directive; amend other sections of KRS 209 to conform.

HB 652 - AMENDMENTS

HCS/EN - Delete requirement that cabinet create a public awareness program and develop protocols to outline levels of need and the state agencies capable of intervening at each level; require the cabinet to have access to financial records of elders when an investigation of abuse, neglect or exploitation is conducted; require the cabinet to create an Elder Abuse Committee to develop a model protocol on elder abuse and neglect in Kentucky through the involvement of state agency personnel who directly or indirectly provide services to the elderly or their families; require coordination of the committee's activities with local long-term care ombudsmen and local governmental human service groups; require the committee to explore the need for statewide resource directories, to enhance public awareness campaigns for elder abuse and neglect and to provide forums for the exchange of information to educate the elder population and their families on the rights of elders; and require an annual report to the Governor and the Legislative Research Commission on their activities, products and recommendations for public policy.

Feb 19-introduced in House
Feb 20-to Health and Welfare (H)
Feb 24-posted in committee
Mar 10-reported favorably, 1st reading, to Calendar with Committee Substitute
Mar 11-2nd reading, to Rules; recommitted to Appropriations and Revenue (H)
Mar 12-taken from Committee, placed in the Orders of the Day
Mar 16-3rd reading, passed 89-0 with Committee Substitute
Mar 17-received in Senate
Mar 18-to Health and Welfare (S)
Mar 23-reported favorably, 1st reading, to Consent Calendar
Mar 24-2nd reading, to Rules; posted for passage in the Consent Orders of the Day for March 25, 1998
Mar 25-3rd reading, passed 37-0
Mar 26-received in House; enrolled, signed by each presiding officer
Mar 27-delivered to Governor
AN ACT relating to the use of information technology.

Establish KRS Chapter 369 and create new sections of that chapter relating to electronic signatures and electronic records; establish the purposes; define "electronic", "electronic record", "electronic signature," and "record"; establish exemptions to the application of this Act; direct that a person cannot be required to accept an electronic signature or an electronic record unless both parties have agreed to its use prior to transmission; allow the recipient of an electronic record or an electronic signature to establish his own conditions for acceptance; direct that a state or local governmental entity or agency is not required to accept an electronic record or electronic signature unless the entity or agency has agreed to accept it and unless the manner and medium of transmission is acceptable to the entity or agency; direct that if parties to a private sector transaction agree, or, in dealings with a state or local governmental entity or agency, if that entity or agency agrees to accept an electronic signature or electronic record, the following apply: (1) information, records, and electronic signatures shall not be denied legal effect, validity, or enforceability solely on the grounds that they are in electronic, duplicate, or imaged form, (2) where a statute or administrative regulation requires a manual signature, an electronic signature shall have the same force and effect as a manual signature, (3) where a statute or administrative regulation requires information to be "written" or "in writing," an electronic record shall satisfy that requirement, (4) where a statute or administrative regulation requires information to be presented or retained in its original form, an electronic record shall satisfy that requirement if there exists reliable assurance as to the integrity of the data or information from when it was first generated to its final form; amend KRS 61.950 to allow the Kentucky Information Resources Management Commission to promulgate administrative regulations establishing electronic signature standards for the executive branch of state government.

Feb 24-introduced in House
Feb 25-to State Government (H)
Feb 27-posted in committee
Mar 4-reported favorably, 1st reading, to Calendar
Mar 5-2nd reading, to Rules; posted for passage in the Regular Orders of the Day for March 6, 1998
Mar 9-3rd reading, passed 94-0
Mar 10-received in Senate
Mar 11-to State and Local Government (S)
Mar 19-reported favorably, 1st reading, to Consent Calendar
Mar 20-2nd reading, to Rules
Mar 25-3rd reading, passed 37-0
Mar 26-received in House; enrolled, signed by each presiding officer
Mar 27-delivered to Governor

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AN ACT relating to the use of information technology.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

SECTION 1. KRS CHAPTER 369 IS HEREBY ESTABLISHED AND A NEW SECTION CREATED TO READ AS FOLLOWS:

Sections 1 to 3 of this Act shall be construed consistent with what is commercially reasonable under the circumstances and to effectuate the following purposes:

1. To facilitate and promote on-line state government services;

2. To facilitate the flow of authorized electronic records within state government, between the public and private sectors, and between private sector entities; and

3. To promote public confidence in the integrity and reliability of electronic records.

SECTION 2. A NEW SECTION OF KRS CHAPTER 369 IS CREATED TO READ AS FOLLOWS:

For purposes of Sections 1 to 3 of this Act, unless the context expressly requires otherwise:

1. "Electronic" means relating to or by means of electrical, digital, magnetic, optical, electromagnetic, or any other form of technology that entails capabilities similar to these technologies;

2. "Electronic record" means any digital representation of data or information generated, communicated, received, or stored by electronic means for use in an information system or for transmission from one information system to another;

3. "Electronic signature" means an electronic identifier whose use is intended by the person using it to have the same force and effect as the use of a manual signature and containing the following characteristics:
   (a) It is unique to the person using it;
   (b) It is capable of verification; and
   (c) It is under the sole control of the person using it; and
(4) "Record" means information that is inscribed, stored, or otherwise fixed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

SECTION 3. A NEW SECTION OF KRS CHAPTER 369 IS CREATED TO READ AS FOLLOWS:

(1) Sections 1 to 3 of this Act do not apply to:

(a) Any situation in which their application would be inconsistent with the express intent of the parties to a written document;

(b) Any legal requirement governing the creation or execution of any document that serves to convey rights and obligations under a will or trust;

(c) Any legal requirement governing the conveyance of any interest in real property;

(d) Any legal requirement governing the creation or transfer of any negotiable instrument or any instrument establishing title or an interest in title.

(2) Nothing in Sections 1 to 3 of this Act shall be construed to:

(a) Require a recipient or any other person asked to rely on an electronic record or an electronic signature to accept the electronic record or electronic signature or to respond to or act upon an electronic record or electronic signature, unless the parties have freely and voluntarily agreed to the use of an electronic record or electronic signature prior to transmission;

(b) Preclude the recipient of an electronic record or an electronic signature from establishing the conditions under which the recipient will accept the electronic record or electronic signature, unless the parties have freely and voluntarily agreed to the conditions under which the recipient would accept the electronic record or electronic signature prior to transmission; or

(c) Require a state or local governmental entity or agency to accept an electronic record or electronic signature, unless the entity or agency has
agreed to accept the electronic record or electronic signature in advance of transmission and the manner and medium of transmission is acceptable to the entity or agency.

(3) If all parties to a private sector transaction agree to the use of an electronic record or an electronic signature, or, in dealings with a state or local governmental entity or agency, if that entity or agency agrees to accept an electronic record or an electronic signature:

(a) Information, records, and electronic signatures shall not be denied legal effect, validity, or enforceability solely on the grounds that they are in electronic, duplicate, or imaged form.

(b) Where a statute or administrative regulation requires a manual signature, or provides for certain consequences if a document is not manually signed, an electronic signature shall have the same force and effect as the use of a manual signature.

(c) Where a statute or administrative regulation requires information to be "written," or "in writing," or provides for certain consequences if it is not, that statute or administrative regulation shall be satisfied by an electronic record.

(d) Where a statute or administrative regulation requires information to be presented or retained in its original form, or provides consequences for the information not being presented or retained in its original form, that statute or administrative regulation shall be satisfied by an electronic record if there exists reliable assurance as to the integrity of the data or the information from the time when it was first generated to its final form, as an electronic record or otherwise.

Section 4. KRS 61.950 is amended to read as follows:
(1) The commission shall meet at least four (4) times each year and report its findings no less than semiannually to the Legislative Research Commission and the Governor. All reports of the commission shall be made available to the general public. In addition, the commission, upon the call of its officers, may hold meetings at any time it deems necessary.

(2) The commission’s roles and duties shall include the following:

(a) Providing overall leadership, policy direction, strategic planning, and coordination of information resources management for the executive branch of state government and public universities;

(b) Formulation of a five (5) year statewide information resources management plan, to be updated every two (2) years, from long-range information resources management plans submitted by agencies of the executive branch, including the public universities, as the commission may require;

(c) Defining, maintaining, and publishing a timely information resources management architecture relating to the management of information resources by executive branch state agencies, and implementing processes and procedures to ensure compliance with the information resources management architecture;

(d) Coordinating, through policy and interagency agreements and monitoring, an appropriate program of training and education for executive branch state and local agencies regarding strategic information systems planning, and the selection and use of information technologies to facilitate effective information resources management, appropriate employee skill building, and career development;

(e) Promoting executive level awareness, support, and involvement with information resources management throughout the executive branch of government;
(f) Reviewing and approving or disapproving, in whole or part, executive branch agency five (5) year strategic information resources plans, and forwarding those plans with findings and recommendations to the agency head, the Governor's Office for Policy and Management, and the Legislative Research Commission for use during the preparation and enactment of the biennial budget. Commission review shall be based upon the extent to which the plan is compliant with statewide information resources standards, policies and guidelines; is suited to supporting the mission of the agency; and furthers implementation of statewide initiatives identified in the statewide plan. As part of the review process, the commission shall monitor and evaluate the progress of the current plan and the executive branch agency's use of information technologies and shall include its assessment of these activities in the findings and recommendations;

(g) Identifying and assessing opportunities for multiagency development and use of information resources, or the development of executive branch agency projects which would improve the quality and availability of information. When identifying these opportunities the commission may require executive branch agencies to evaluate the opportunities as alternatives to their own plans, and may forward these findings as provided in paragraph (f) of this subsection;

(h) Maintaining supportive relationship and coordinating activities with the adjunct Communications Advisory Council provided for in KRS 61.955 and 61.957, and the Geographic Information Advisory Council established by Executive Order 92-1049, October 1, 1992, as necessary to ensure coordination and implementation of unified, comprehensive, statewide strategies involved with, or affected by, information technology;
(i) Establishing and maintaining relationships with other planning organizations as necessary to ensure coordination and implementation of comprehensive statewide strategies involved with, or affected by, information technology;

(j) Reviewing and recommending to the Department of Personnel and other associated agencies appropriate job classifications related to information resources management, to include both technical and managerial positions;

(k) Establishing and maintaining an information dissemination service or clearinghouse for:
   1. Current practices of state agencies regarding information resources management;
   2. Emerging and advancing information resources technologies;
   3. Information resources vendor performance in the public sector;
   4. Technical resources in the Commonwealth; and
   5. Elements of the information resources management architecture;

(l) Establishing and maintaining research and development capacity for beneficial applications of information resources technology for the state's public sector, which includes:
   1. Conducting research on current and emerging information resources technologies and their potential to enhance governmental services; and
   2. Sponsoring and evaluating pilot projects to assist with the successful adoption by other state agencies;

(m) Fostering and encouraging the interest and cooperation of the state information resources technology community for improvement and enhancement of public services delivery;

(n) Serving as catalyst for information technology advancements in the public sector;
(o) Recommending procedures and legislation to improve the accessibility of machine readable public records by state agencies, citizens, and businesses; and

(p) Recommending procedures and legislation to ensure the privacy of individuals, with particular emphasis on the potential for invasion of individual privacy.

(3) Nothing in KRS 61.940, 61.945, or this section shall be construed to alter or diminish the provisions of KRS 171.410 to 171.740 or the authority conveyed by these statutes to the Archives and Records Commission and the Department for Libraries and Archives.

(4) The commission may promulgate necessary administrative regulations for the furtherance of this section, including administrative regulations establishing electronic signature standards for the executive branch of state government.

(5) The commission may establish committees or work groups composed of commission and noncommission members as necessary to advise the commission in carrying out its responsibilities, duties, and powers. Persons connected with the automated information and communications resources industries, as specified in KRS 61.945, may participate on committees or work groups, but shall not have a vote.

(6) The commission may adopt bylaws and operating policies necessary for its efficient and effective operation.
AN ACT relating to liens.

Create new section of KRS Chapter 14 to establish as a division in the Office of the Secretary of State the Kentucky Lien Information System; direct the system to be operational beginning on January 4, 1999; create a new section of Article 9 of KRS Chapter 355 to require a secured party to file in the Office of Secretary of State a financing statement, or any amendment, assignment, continuation, release, or termination related thereto; permit the Secretary of State to receive a fee of $1 for the filing; provide filing exception for certain collateral, accounts, and fixture filings; amend KRS 355.9-105 to define "identification number" and "system"; amend KRS 355.9-402, 355.9-403, 355.9-404, 355.9-405, and 355.9-406 to require financing statements, amendments, assignments, releases, continuations, and terminations to contain the identification number of the debtor; amend KRS 355.2A-103 to conform.

HB 739 - AMENDMENTS

HFA (1, S. Cave) - Provide that the filing is for purposes of notice only.
HFA (2, S. Cave) - Require filing by secured party in Office of Secretary of State beginning on January 4, 1999.
SFA (1, R. Stivers) - Provide that filings with the Secretary of State are for information purposes only.

Feb 26-introduced in House
Feb 27-to Banking and Insurance (H)
Mar 2-posted in committee
Mar 5-reported favorably, 1st reading, to Calendar
Mar 6-2nd reading, to Rules; posted for passage in the Regular Orders of the Day for March 9, 1998
Mar 10-floor amendments (1) and (2) filed; 3rd reading, passed 93-0
Mar 11-received in Senate
Mar 12-to Banking and Insurance (S)
Mar 18-reported favorably, 1st reading, to Consent Calendar
Mar 19-2nd reading, to Rules
Mar 23-floor amendment (1) filed
Mar 24-taken from the Consent Orders of the Day, placed in the Regular Orders of the Day
Mar 25-3rd reading, passed 35-0 with floor amendment (1)
Mar 26-received in House; posted for passage for concurrence in Senate amendment
Mar 31-House concurred in Senate floor amendment (1); passed 92-0
AN ACT relating to liens.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

SECTION 1. A NEW SECTION OF KRS CHAPTER 14 IS CREATED TO READ AS FOLLOWS:

(1) It is the intent of the General Assembly that a statewide computerized lien information system be created to accumulate, index, and disseminate information relative to liens and related filings made with the Secretary of State according to Article 9 of KRS Chapter 355.

(2) The Kentucky Lien Information System is hereby created and established as a division within the Department of State.

(3) The Kentucky Lien Information System shall be operational beginning on January 4, 1999.

SECTION 2. A NEW SECTION OF ARTICLE 9 OF KRS CHAPTER 355 IS CREATED TO READ AS FOLLOWS:

(1) Notwithstanding a filing made to perfect a security interest in the place set forth in KRS 355.9-401, a secured party shall file a financing statement, or any amendment, assignment, continuation, release, or termination related thereto, in the Office of the Secretary of State. The financing statement, amendment, assignment, continuation, release, or termination filed under this section shall be on a form prescribed by the Secretary of State.

(2) The Secretary of State shall receive a fee of one dollar ($1) for the filing made under this section.

(3) The filing requirement of this section shall not apply when the collateral is timber to be cut or is minerals or the like, including oil and gas, other than coal, or accounts subject to subsection (5) of KRS 355.9-103, other than accounts arising out of the sale of coal, or when the financing statement is filed as a fixture filing.
under KRS 355.9-313 and the collateral is goods which are or are to become fixtures.

(4) The Secretary of State shall index all filings made under this section for inclusion in the Kentucky Lien Information System.

Section 3. KRS 355.9-105 is amended to read as follows:

(1) In this article unless the context otherwise requires:

(a) "Account debtor" means the person who is obligated on an account, chattel paper or general intangible;

(b) "Chattel paper" means a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods but a charter or other contract involving the use or hire of a vessel is not chattel paper. When a transaction is evidenced both by such a security agreement or a lease and by an instrument or a series of instruments, the group of writings taken together constitutes chattel paper;

(c) "Collateral" means the property subject to a security interest, and includes accounts and chattel paper which have been sold;

(d) "Debtor" means the person who owes payment or other performance of the obligation secured, whether or not he owns or has rights in the collateral, and includes the seller of accounts or chattel paper. Where the debtor and the owner of the collateral are not the same person, the term "debtor" means the owner of the collateral in any provision of the article dealing with the collateral, the obligor in any provision dealing with the obligation, and may include both where the context so requires;

(e) "Deposit account" means a demand, time, savings, passbook or like account maintained with a bank, savings and loan association, credit union or like organization, other than an account evidenced by a certificate of deposit;
(f) "Document" means document of title as defined in the general definitions of Article 1 (KRS 355.1-201) and a receipt of the kind described in subsection (2) of KRS 355.7-201;

(g) "Encumbrance" includes real estate mortgages and other liens on real estate and all other rights in real estate that are not ownership interests;

(h) "Goods" includes all things which are movable at the time the security interest attaches or which are fixtures (KRS 355.9-313), but does not include money, documents, instruments, investment property, accounts, chattel paper, general intangibles, or minerals or the like (including oil and gas) before extraction. "Goods" also includes standing timber which is to be cut and removed under a conveyance or contract for sale, the unborn young of animals, and growing crops;

(i) "Identification number" means a distinct alpha, numeric, or alphanumeric designation assigned to a person. The identification number for a person who is other than an individual shall be the Internal Revenue Service taxpayer identification number of the person. If the person is an individual, the identification number shall be the person's Social Security number or a number assigned in accordance with administrative regulations promulgated by the Secretary of State;

(j) "Instrument" means a negotiable instrument (defined in KRS 355.3-104), or any other writing which evidences a right to the payment of money and is not itself a security agreement or lease and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment. The term does not include investment property;

(k) "Mortgage" means a consensual interest created by a real estate mortgage, a trust deed on real estate, or the like;
An advance is made "pursuant to commitment" if the secured party has bound himself to make it, whether or not a subsequent event of default or other event not within his control has relieved or may relieve him from his obligation;

"Security agreement" means an agreement which creates or provides for a security interest;

"Secured party" means a lender, seller or other person in whose favor there is a security interest, including a person to whom accounts or chattel paper have been sold. When the holders of obligations issued under an indenture of trust, equipment trust agreement or the like are represented by a trustee or other person, the representative is the secured party;

"System" means the Kentucky Lien Information System created in Section 1 of this Act.

(2) Other definitions applying to this article and the sections in which they appear are:

"Account." KRS 355.9-106;
"Attach." KRS 355.9-203;
"Commodity contract." KRS 355.9-115;
"Commodity customer." KRS 355.9-115;
"Commodity intermediary." KRS 355.9-115;
"Construction mortgage." KRS 355.9-313(1);
"Consumer goods." KRS 355.9-109(1);
"Control." KRS 355.9-115;
"Equipment." KRS 355.9-109(2);
"Farm products." KRS 355.9-109(3);
"Fixture." KRS 355.9-313(1);
"Fixture filing." KRS 355.9-313(1);
"General intangibles." KRS 355.9-106;
"Inventory." KRS 355.9-109(4);
"Investment property." KRS 355.9-115;
"Lien creditor." KRS 355.9-301(3);
"Proceeds." KRS 355.9-306(1);
"Purchase money security interest." KRS 355.9-107;
"United States." KRS 355.9-103.

(3) The following definitions in other articles apply to this article:
"Broker." KRS 355.8-102;
"Certificated security." KRS 355.8-102;
"Check." KRS 355.3-104;
"Clearing corporation." KRS 355.8-102;
"Contract for sale." KRS 355.2-106;
"Control." KRS 355.8-106;
"Delivery." KRS 355.8-301;
"Entitlement holder." KRS 355.8-102;
"Financial asset." KRS 355.8-102;
"Holder in due course." KRS 355.3-302;
"Note." KRS 355.3-104;
"Sale." KRS 355.2-106;
"Securities intermediary." KRS 355.8-102;
"Security." KRS 355.8-102;
"Security certificate." KRS 355.8-102;
"Security entitlement." KRS 355.8-102;
"Uncertificated security." KRS 355.8-102.

(4) In addition Article 1 contains general definitions and principles of construction and interpretation applicable throughout this article.

Section 4. KRS 355.9-402 is amended to read as follows:
A financing statement is sufficient if it gives the names of the debtor and the secured party, is signed by the debtor, gives an address of the secured party from which information concerning the security interest may be obtained, gives a mailing address and identification number of the debtor, and contains a statement indicating the types, or describing the items, of collateral. A financing statement may be filed before a security agreement is made or a security interest otherwise attaches. When the financing statement covers crops growing or to be grown, the statement must also contain a description of the real estate concerned and must describe the production season. If the production season is not described, the financing statement shall be deemed to describe the crops produced in the production season which ends within twelve (12) months after the filing date of the financing statement. A financing statement shall not describe more than one (1) production season. When the financing statement covers timber to be cut or covers minerals or the like (including oil and gas), other than coal, or accounts subject to subsection (5) of KRS 355.9-103, other than accounts arising out of the sale of coal, or when the financing statement is filed as a fixture filing (KRS 355.9-313) and the collateral is goods which are or are to become fixtures, the statement must also comply with subsection (5). A copy of the security agreement is sufficient as a financing statement if it contains the above information and is signed by the debtor. A carbon, photographic or other reproduction of a security agreement or a financing statement is sufficient as a financing statement if the security agreement so provides or if the original has been filed in this state or in any other state.

A financing statement which otherwise complies with subsection (1) of this section is sufficient when it is signed by the secured party instead of the debtor if it is filed to perfect a security interest in:

(a) Collateral already subject to a security interest in another jurisdiction when it is brought into this state, or when the debtor's location is changed to this state.
Such a financing statement must state that the collateral was brought into this state, or that the debtor's location was changed to this state under such circumstances; or

(b) Proceeds under KRS 355.9-306 if the security interest in the original collateral was perfected. Such a financing statement must describe the original collateral; or

(c) Collateral as to which the filing has lapsed; or

(d) Collateral acquired after a change of name, identity or corporate structure of the debtor (subsection (7) of this section).

(3) A form substantially as follows is sufficient to comply with subsection (1) of this section:

Name of debtor (or assignor) .................................................................

Address ..............................................................................................

Name of secured party (or assignee) ....................................................

Address ..............................................................................................

(a) This financing statement covers the following types (or items) of property:

(Describe) ...........................................................................................

(b) (If collateral is crops) The above described crops are growing or are to be grown on:

(Describe real estate) ........................................................................

(c) (If applicable) The above goods are to become fixtures on (or) The above timber is standing on (or) The above minerals or the like (including oil and gas) or accounts will be financed at the wellhead or minehead of the well or mine located on:

(Describe real estate) ........................................................................
and this financing statement is to be filed in the same office as the real estate records. (If the debtor does not have an interest of record) The name of a record owner is .................................................................

(d) (If products of collateral are claimed) Products of the collateral are also covered.

Signature of debtor (or assignor) .................................................................
Signature of secured party (or assignee) ............................................................

(4) A financing statement may be amended by filing a writing signed by both the debtor and the secured party. An amendment does not extend the period of effectiveness of a financing statement. If any amendment adds collateral, it is effective as to the added collateral only from the filing date of the amendment. In this article, unless the context otherwise requires, the term "financing statement" means the original financing statement and any amendments.

(5) A financing statement covering timber to be cut or covering minerals or the like (including oil and gas), other than coal, or accounts subject to subsection (5) of KRS 355.9-103, other than accounts arising out of the sale of coal, or a financing statement filed as a fixture filing (KRS 355.9-313), must show that it covers this type of collateral, must recite that it is to be filed in the same office as the real estate records, and the financing statement must contain a description of the real estate. If the debtor does not have an interest of record in the real estate, the financing statement must show the name of a record owner.

(6) A mortgage is effective as a financing statement filed as a fixture filing from the date of its recording if:

(a) The goods are described in the mortgage by item or type;

(b) The goods are or are to become fixtures related to the real estate described in the mortgage;
(c) The mortgage complies with the requirements for a financing statement in this section other than a recital that it is to be filed in the real estate records; and

(d) The mortgage is duly recorded.

No fee with reference to the financing statement is required other than the regular recording and satisfaction fees with respect to the mortgage.

(7) A financing statement sufficiently shows the name of the debtor if it gives the individual, partnership or corporate name of the debtor, whether or not it adds other trade names or the names of partners. Where the debtor so changes his name or in the case of an organization its name, identity or corporate structure that a filed financing statement becomes seriously misleading, the filing is not effective to perfect a security interest in collateral acquired by the debtor more than four (4) months after the debtor notifies the secured party in writing of the change, unless a new appropriate financing statement is filed before the expiration of that time. A filed financing statement remains effective with respect to collateral transferred by the debtor even though the secured party knows of or consents to the transfer.

(8) A financing statement substantially complying with the requirements of this section is effective even though it contains minor errors which are not seriously misleading.

Section 5. KRS 355.9-403 is amended to read as follows:

(1) Presentation for filing of a financing statement and tender of the filing fee or acceptance of the statement by the filing officer constitutes filing under this article.

(2) Except as provided in subsection (6) of this section a filed financing statement is effective for a period of five (5) years from the date of filing. The effectiveness of a filed financing statement lapses on the expiration of the five (5) year period unless a continuation statement is filed prior to the lapse. If a security interest perfected by filing exists at the time insolvency proceedings are commenced by or against the debtor, the security interest remains perfected until termination of the insolvency proceedings and thereafter for a period of sixty (60) days or until expiration of the
five (5) year period, whichever occurs later. Upon lapse the security interest becomes unperfected, unless it is perfected without filing. If the security interest becomes unperfected upon lapse, it is deemed to have been unperfected as against a person who became a purchaser or lien creditor before lapse.

(3) A continuation statement may be filed by the secured party within six (6) months prior to the expiration of the five (5) year period specified in subsection (2) of this section. Any such continuation statement must be signed by the secured party, identify the original statement by file number and date filed, **contain the identification number of the debtor**, and state that the original statement is still effective. A continuation statement signed by a person other than the secured party of record must be accompanied by a separate written statement of assignment signed by the secured party of record and complying with subsection (2) of KRS 355.9-405, including payment of the required fee. Upon timely filing of the continuation statement, the effectiveness of the original statement is continued for five (5) years after the last date to which the filing was effective whereupon it lapses in the same manner as provided in subsection (2) of this section unless another continuation statement is filed prior to such lapse. Succeeding continuation statements may be filed in the same manner to continue the effectiveness of the original statement. Unless a statute on disposition of public records provides otherwise, the filing officer may remove a lapsed statement from the files and destroy it immediately if he has retained a microfilm or other photographic record, or in other cases after one (1) year after the lapse. The filing officer shall so arrange matters by physical annexation of financing statements to continuation statements or other relating filings, or by other means, that if he physically destroys the financing statements of a period more than five (5) years past, those which have been continued by a continuation statement or which are still effective under subsection (6) of this section shall be retained.
Except as provided in subsection (7) of this section a filing officer shall mark each statement with a file number and with the date and hour of filing and shall hold the statement or a microfilm or other photographic copy thereof for public inspection. In addition the filing officer shall index the statements according to the name of the debtor and shall note in the index the file number and the address of the debtor given in the statement.

(5) The uniform fee for filing and indexing an original or a continuation statement shall be as provided for in KRS 64.012. This fee includes the fee for filing and indexing a termination statement and for sending or delivering the terminated instrument and financing statement.

(6) A real estate mortgage which is effective as a fixture filing under subsection (6) of KRS 355.9-402 remains effective as a fixture filing until the mortgage is released or satisfied of record or its effectiveness otherwise terminates as to the real estate.

(7) When a financing statement covers timber to be cut or covers minerals or the like (including oil and gas), other than coal, or accounts subject to subsection (5) of KRS 355.9-103, other than accounts arising out of the sale of coal, or is filed as a fixture filing, the filing officer shall index it under the names of the debtor and any owner of record shown on the financing statement in the same fashion as if they were the mortgagors in a mortgage of the real estate described, and, to the extent that the law of this state provides for indexing of mortgages under the name of the mortgagee, under the name of the secured party as if he were the mortgagee thereunder, or where indexing is by description in the same fashion as if the financing statement were a mortgage of the real estate described.

Section 6. KRS 355.9-404 is amended to read as follows:

(1) Whenever there is no outstanding secured obligation and no commitment to make advances, incur obligations or otherwise give value, the secured party must on written demand by the debtor send the debtor, for each filing officer with whom the
financing statement was filed, a termination statement that states that he no longer claims a security interest under the financing statement, contains the identification number of the debtor, and identifies the original statement by file number and date filed. A termination statement signed by a person other than the secured party of record must be accompanied by a separate written statement of assignment signed by the secured party of record and complying with subsection (2) of KRS 355.9-405, including payment of the required fee. The uniform fee for filing and indexing such an assignment or statement thereof shall be three dollars ($3). If the affected secured party fails to file such termination statement as required by this subsection, or to send such a termination statement within ten (10) days after proper demand therefor he shall be liable to the debtor for one hundred dollars ($100), and in addition for any loss caused to the debtor by such failure.

(2) In the absence of a demand by the debtor for a statement of termination, and within fifteen (15) days after a secured transaction evidenced by record in the county clerk's or Secretary of State's office has terminated, the secured party must file with each filing officer with whom the financing statement was filed a termination statement to the effect that he no longer claims a security interest under the financing statement or other instrument, which shall be identified by file number and date filed. If the actual secured party willfully fails to send such a termination statement within fifteen (15) days after he no longer claims a security interest, he shall be liable to the debtor for twenty-five dollars ($25), and in addition for any loss caused to the debtor by such failure.

(3) On presentation to the filing officer of such a termination statement he must note it in the index. If he has received the termination statement in duplicate, he shall return one (1) copy of the termination statement to the secured party stamped to show the time of receipt thereof. Whenever a statement required under this chapter need be sent to a party to the transaction by the filing officer, it shall be sufficient
for the filing officer to send the statement to the party entitled to receive it, at his last known address. If the filing officer has a microfilm or other photographic record of the financing statement, and of any related continuation statement, statement of assignment and statement of release, he may remove the originals from the files at any time after receipt of the termination statement, or if he has no such record, he may remove them from the files at any time after one (1) year after receipt of the termination statement.

(4) The uniform fee for filing and indexing a termination statement for any financing statement filed prior to July 1, 1966, for which a termination fee was not paid when the financing statement was filed and for sending or delivering the terminated instrument and for sending or delivering the financing statement shall be three dollars ($3).
separate statement if it complies with the preceding sentence. On presentation to the filing officer of such a separate statement, the filing officer shall mark such separate statement with the date and hour of filing. He shall note the assignment on the index of the financing statement, or in the case of a fixture filing, or a filing covering timber to be cut, or covering minerals or the like (including oil and gas), other than coal, or accounts subject to subsection (5) of KRS 355.9-103, other than accounts arising out of the sale of coal, he shall index the assignment under the name of the assignor as grantor and, to the extent that the law of this state provides for indexing the assignment of a mortgage under the name of the assignee, he shall index the assignment of the financing statement under the name of the assignee. The uniform fee for filing and indexing such a separate statement of assignment shall be as provided in KRS 64.012. Notwithstanding the provisions of this subsection, an assignment of record of a security interest in a fixture contained in a mortgage effective as a fixture filing (subsection (6) of KRS 355.9-402) may be made only by an assignment of the mortgage in the manner provided by the law of this state other than this chapter.

(3) After the disclosure or filing of an assignment under this section, the assignee is the secured party of record.

Section 8. KRS 355.9-406 is amended to read as follows:

A secured party of record may by his signed statement release all or a part of any collateral described in a filed financing statement. The statement of release is sufficient if it contains a description of the collateral being released, the name and address of the debtor, the identification number of the debtor, the name and address of the secured party, and the file number of the financing statement. A statement of release signed by a person other than the secured party of record must be accompanied by a separate written statement of assignment signed by the secured party of record and complying with subsection (2) of KRS 355.9-405, including payment of the required fee. Upon
presentation of such a statement of release to the filing officer he shall mark the statement with the hour and date of filing and shall note the same upon the margin of the index of the filing of the financing statement. The uniform fee for filing and noting such a statement of release shall be as provided for in KRS 64.012.

Section 9. KRS 355.2A-103 is amended to read as follows:

(1) In this article unless the context otherwise requires:

(a) "Buyer in ordinary course of business" means a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest or leasehold interest of a third party in the goods, buys in ordinary course from a person in the business of selling goods of that kind but does not include a pawnbroker. "Buying" may be for cash or by exchange of other property or on secured or unsecured credit and includes receiving goods or documents of title under a pre-existing contract for sale but does not include a transfer in bulk or as security for or in total or partial satisfaction of a money debt.

(b) "Cancellation" occurs when either party puts an end to the lease contract for default by the other party.

(c) "Commercial unit" means such a unit of goods as by commercial usage is a single whole for purposes of lease and division of which materially impairs its character or value on the market or in use. A commercial unit may be a single article, as a machine, or a set of articles, as a suite of furniture or a line of machinery, or a quantity, as a gross or carload, or any other unit treated in use or in the relevant market as a single whole.

(d) "Conforming" goods or performance under a lease contract means goods or performance that are in accordance with the obligations under the lease contract.
(e) "Consumer lease" means a lease that a lessor regularly engaged in the business of leasing or selling makes to a lessee who is an individual and who takes under the lease primarily for a personal, family, or household purpose.

(f) "Fault" means wrongful act, omission, breach, or default.

(g) "Finance lease" means a lease with respect to which:

1. The lessor does not select, manufacture, or supply the goods;

2. The lessor acquires the goods or the right to possession and use of the goods in connection with the lease; and

3. One of the following occurs:
   a. The lessee receives a copy of the contract by which the lessor acquired the goods or the right to possession and use of the goods before signing the lease contract;
   b. The lessee's approval of the contract by which the lessor acquired the goods or the right to possession and use of the goods is a condition to effectiveness of the lease contract;
   c. The lessee, before signing the lease contract, receives an accurate and complete statement designating the promises and warranties, and any disclaimers of warranties, limitations or modifications of remedies, or liquidated damages, including those of a third party, such as the manufacturer of the goods, provided to the lessor by the person supplying the goods in connection with or as part of the contract by which the lessor acquired the goods or the right to possession and use of the goods; or
   d. If the lease is not a consumer lease, the lessor, before the lessee signs the lease contract, informs the lessee in writing (a) of the identity of the person supplying the goods to the lessor, unless the lessee has selected that person and directed the lessor to acquire
the goods or the right to possession and use of the goods from that person, (b) that the lessee is entitled under this article to the promises and warranties, including those of any third party, provided to the lessor by the person supplying the goods in connection with or as part of the contract by which the lessor acquired the goods or the right to possession and use of the goods, and (c) that the lessee may communicate with the person supplying the goods to the lessor and receive an accurate and complete statement of those promises and warranties, including any disclaimers and limitations of them or of remedies.

(h) "Goods" means all things that are movable at the time of identification to the lease contract, or are fixtures (KRS 355.2A-309), but the term does not include money, documents, instruments, accounts, chattel paper, general intangibles, or minerals or the like, including oil and gas, before extraction. The term also includes the unborn young of animals.

(i) "Installment lease contract" means a lease contract that authorizes or requires the delivery of goods in separate lots to be separately accepted, even though the lease contract contains a clause "each delivery is a separate lease" or its equivalent.

(j) "Lease" means a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, or retention or creation of a security interest is not a lease. Unless the context clearly indicates otherwise, the term includes a sublease.

(k) "Lease agreement" means the bargain, with respect to the lease, of the lessor and the lessee in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of
performance as provided in this article. Unless the context clearly indicates otherwise, the term includes a sublease agreement.

(1) "Lease contract" means the total legal obligation that results from the lease agreement as affected by this article and any other applicable rules of law. Unless the context clearly indicates otherwise, the term includes a sublease contract.

(m) "Leasehold interest" means the interest of the lessor or the lessee under a lease contract.

(n) "Lessee" means a person who acquires the right to possession and use of goods under a lease. Unless the context clearly indicates otherwise, the term includes a sublessee.

(o) "Lessee in ordinary course of business" means a person who in good faith and without knowledge that the lease to him is in violation of the ownership rights or security interest or leasehold interest of a third party in the goods leases in ordinary course from a person in the business of selling or leasing goods of that kind but does not include a pawnbroker. "Leasing" may be for cash or by exchange of other property or on secured or unsecured credit and includes receiving goods or documents of title under a pre-existing lease contract but does not include a transfer in bulk or as security for or in total or partial satisfaction of a money debt.

(p) "Lessor" means a person who transfers the right to possession and use of goods under a lease. Unless the context clearly indicates otherwise, the term includes a sublessor.

(q) "Lessor's residual interest" means the lessor's interest in the goods after expiration, termination, or cancellation of the lease contract.
"Lien" means a charge against or interest in goods to secure payment of a debt or performance of an obligation, but the term does not include a security interest.

"Lot" means a parcel or a single article that is the subject matter of a separate lease or delivery, whether or not it is sufficient to perform the lease contract.

"Merchant lessee" means a lessee that is a merchant with respect to goods of the kind subject to the lease.

"Present value" means the amount as of a date certain of one (1) or more sums payable in the future, discounted to the date certain. The discount is determined by the interest rate specified by the parties if the rate was not manifestly unreasonable at the time the transaction was entered into; otherwise, the discount is determined by a commercially reasonable rate that takes into account the facts and circumstances of each case at the time the transaction was entered into.

"Purchase" includes taking by sale, lease, mortgage, security interest, pledge, gift, or any other voluntary transaction creating an interest in goods.

"Sublease" means a lease of goods the right to possession and use of which was acquired by the lessor as a lessee under an existing lease.

"Supplier" means a person from whom a lessor buys or leases goods to be leased under a finance lease.

"Supply contract" means a contract under which a lessor buys or leases goods to be leased.

"Termination" occurs when either party pursuant to a power created by agreement or law puts an end to the lease contract otherwise than for default.

Other definitions applying to this article and the sections in which they appear are:

"Accessions." KRS 355.2A-310(1).

"Encumbrance." KRS 355.2A-309(1)(e).

"Fixtures." KRS 355.2A-309(1)(a).

"Fixture filing." KRS 355.2A-309(1)(b).

"Purchase money lease." KRS 355.2A-309(1)(c).

(3) The following definitions in other articles apply to this article:

"Account." KRS 355.9-106.

"Between merchants." KRS 355.2-104(3).

"Buyer." KRS 355.2-103(1)(a).

"Chattel paper." KRS 355.9-105(1)(b).

"Consumer goods." KRS 355.9-109(1).


"Entrust." KRS 355.2-403(3).

"General intangibles." KRS 355.9-106.

"Good faith." KRS 355.2-103(1)(b).


"Merchant." KRS 355.2-104(1).

"Mortgage." KRS 355.9-105(1)(f).

"Pursuant to commitment." KRS 355.9-105(1)(f).

"Receipt." KRS 355.2-103(1)(c).

"Sale." KRS 355.2-106(1).

"Sale on approval." KRS 355.2-326.

"Sale or return." KRS 355.2-326.

"Seller." KRS 355.2-103(1)(d).

(4) In addition Article 1 contains general definitions and principles of construction and interpretation applicable throughout this article.
KENTUCKY ADMINISTRATIVE DEVELOPMENTS AND INITIATIVES AFFECTING FINANCIAL INSTITUTIONS

Arthur L. Freeman
Commissioner, Kentucky Department of Financial Institutions
Frankfort, Kentucky

SECTION B
Commissioner

Deputy Commissioner  Office Of General Counsel

Division of Securities

Division of Financial Institutions

Division of Administration

Credit Union Branch  Banks Branch  Compliance Branch

(Non-Depository financial institutions: consumer loans, industrial loans, mortgage loans companies, mortgage loan brokers, sale of checks, check cashiers)
COMPLIANCE WITH REGULATORY REQUIREMENTS OF THE FDIC

** THE TEN MOST COMMON FDIC COMPLIANCE VIOLATIONS **

** YEAR 2000 PROJECT MANAGEMENT AWARENESS **

Phillip H. Schwartz
Regional Counsel
Federal Deposit Insurance Corporation
Memphis, Tennessee

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**SECTION C**
COMMON COMPLIANCE VIOLATIONS

TO: CHIEF EXECUTIVE OFFICER AND COMPLIANCE OFFICER

SUBJECT: Consumer Protection and Fair Lending Compliance Violations Most Often Cited by FDIC Examiners in 1996

As part of its review and analysis of compliance examinations conducted by the FDIC, the Division of Compliance and Consumer Affairs (DCA) has identified the most commonly cited violations of consumer and fair lending laws and regulations by FDIC-supervised institutions in 1996. A listing is attached. Also attached is a table showing the number of banks examined for compliance by the FDIC during 1996 and the number of banks cited for violations. The FDIC believes that sharing this information with its supervised institutions will enable them to improve in specific areas in the future.

Many of the violations cited can be avoided, corrected or minimized with an effective compliance program established by an institution's Board of Directors. Elements of an effective compliance program include:

- written policies and procedures;
- monitoring procedures for periodic proactive review, including the institution's lending policies;
- education/training of appropriate personnel;
- nondiscriminatory lending criteria;
- loan application procedures;
- periodic review of standard forms;
- a compliance audit program; and
- procedures to handle consumer complaints.

To implement an effective compliance program, the Board of Directors should designate a compliance officer with responsibility for:

- reviewing policies and procedures for compliance;
- training all employees in consumer laws and regulations;
- coordinating consumer complaints; and
- providing periodic reports to the Board regarding the effectiveness of the program and recommendations for any improvements.

For further information on establishing an effective compliance program, please refer to Appendix B of the FDIC's Compliance Examination Manual. To obtain a copy of the manual, please write to:

Federal Deposit Insurance Corporation
Department Number 0667
Washington, D.C. 20073

You may also access the manual over the Internet at the following address:

http://www.fdic.gov/banknews/examan.html
The FDIC's regional offices can assist your institution with its compliance efforts. For information about whom to contact, please refer to the attached regional office listing.

Carmen J. Sullivan
Director

Attachments -- available at the FDIC web site: http://www.fdic.gov/banknews

Distribution: FDIC-Supervised Banks (Commercial and Savings)
Violations of Consumer Laws and Regulations Most Often Cited During Compliance Examinations Conducted by the FDIC in 1996

Truth in Lending Act - Regulation Z

-- Section 226.19(a)(1). Requires the timely issuance of Truth in Lending disclosures for residential mortgage transactions. (Within 3 business days of acceptance of a consumer’s application for a residential mortgage.) A violation of this section was cited in 26% of the institutions examined.

-- Section 226.18(e). Requires the accurate disclosure to the consumer of the Annual Percentage Rate for transactions involving closed-end credit. A violation of this section was cited in 16% of the institutions examined.

-- Section 226.18(m). Requires that the creditor disclose that it has or will acquire a security interest in identified property in transactions involving closed-end credit. A violation of this section was cited in 14% of the institutions examined.

Real Estate Settlement Procedures Act (RESPA) - Regulation X

-- Section 3500.21(b). Requires timely delivery of the mortgage servicing disclosure to a consumer when an application for a residential mortgage transaction is taken. A violation of this section was cited in 46% of the institutions examined. (Note: This regulatory provision was substantially modified by the Economic Growth and Regulatory Paperwork Reduction Act of 1996. The effect of the changes will be to require fewer disclosures to the consumer and HUD has published proposed changes to the regulation in the Federal Register Vol. 62, No.90, May 9, 1997. See FIL-56-97, dated June 2, 1997.)

-- Section 3500.7(a). Requires the timely deliverance of the Good Faith Estimate to all applicants for a RESPA related transaction. A violation of this section was cited in 43% of the institutions examined.

-- Section 3500.8(b). Requires the use of the Uniform Settlement Statement when prescribed by the regulation. A violation of this section was cited in 25% of the institutions examined.

Equal Credit Opportunity Act - Regulation B

-- Section 202.5(d)(5). Prohibits requesting the race, color, religion or national origin of an applicant in a credit transaction except where it is required for monitoring purposes. A violation of this section was cited in 17% of the institutions examined.

-- Section 202.9(a)(1). Requires notice to the applicant of action taken on credit applications within prescribed time frames. A violation of this section was cited in 16% of the institutions examined.
-- Section 202.5(d)(3). Prohibits requesting the sex of an applicant for a credit transaction except as required for monitoring purposes. A violation of this section was cited in 14% of the institutions examined.

**Fair Housing Act - FDIC Regulation Part 338**

-- Part 338.7(a)(1)(i). Requires banks with assets of less than $10 million or with no offices located within a Metropolitan Statistical Area (MSA) to request certain data from their customers on applications for home loans and to retain that data in their files. A violation of this section was cited in 25% of the institutions examined. (Note: The FDIC recently revised Part 338 and the effect of the change will be to no longer require smaller institutions to request and retain certain data. Please refer to FIL-67-97, dated July 14, 1997, for more information.)

-- Part 338.3(a). Requires using the "Equal Housing Lender" logotype or slogan in advertisements. A violation of this section was cited in 13% of the institutions examined.

**Truth in Savings Act - Regulation DD**

-- Section 230.4(b). Requires disclosure of specified information about deposit accounts. A violation of this section was cited in 23% of the institutions examined.

-- Section 230.5(b)(1). Requires that notices and disclosures be provided to customers within prescribed time frames prior to maturity for accounts with maturities longer than one year. A violation of this section was cited in 15% of institutions examined.

-- Section 230.8(c). Requires additional disclosures in advertisements when an Annual Percentage Yield (APY) is stated. A violation of this section was cited in 15% of institutions examined.

**Flood Disaster Protection Act - FDIC Regulation Part 339**

-- Part 339.5. Requires that sufficient records be maintained to show the method used by the bank to determine if property securing the loan is located in a special flood hazard area. A violation of this section was cited in 31% of the institutions examined. (Note: The FDIC revised Part 339 effective as of October 1, 1996. The changes should enable institutions to comply more easily with the record keeping requirements. Please refer to FIL-71-96, dated September 9, 1996 for more information.)

**Expedited Funds Availability Act - Regulation CC**

-- Section 229.10(c)(1)(vii). Requires an institution to make funds available by the next day in an amount that is the lesser of $100 or the aggregate of deposits not subject to next day rules. A violation of this section was cited in 21% of the institutions examined.

-- Section 229.13(g). Requires an institution to provide a written notice to the customer with specified information when an exception hold will be placed on an account. A violation of this section was cited in 16% of the institutions examined.

**Home Mortgage Disclosure Act (HMDA) - Regulation C**

-- Section 203.4(a). Requires that an institution collect specified data and enter that information on a Loan Application Register. A violation of this section was cited in 30% of the institutions examined that were subject to HMDA. The same section also requires that the information collected must be entered on the LAR within 30 days following the end of the quarter in which final disposition was made on the application. A violation of this portion of the section was cited in 30% of the institutions examined that were subject to
HMDA.

Fair Credit Reporting Act

-- Section 615(a). Requires that an institution taking adverse action on a credit application because of information contained in a consumer report provide notice to the applicant that information contained in a credit report contributed to the action taken. A violation of this portion of the Act was cited in 15% of the institutions examined. Another provision of this section requires that if the denial of credit was based in whole or in part on a consumer report, the name, address and telephone number of the credit reporting agency must be disclosed to the consumer. A violation of this provision of the Act was cited in 15% of the institutions examined.

Electronic Funds Transfer Act - Regulation E

-- Section 205.11(c). Requires an institution to investigate allegations of error in an electronic transfer of funds within 10 business days after notice by the consumer that an error may have occurred. A violation of this section was cited in 7% of the institutions examined.
TRUTH IN LENDING ACT

TO: CHIEF EXECUTIVE OFFICER AND COMPLIANCE OFFICER
SUBJECT: Revisions to Regulation Z (Truth in Lending Act)

The Board of Governors of the Federal Reserve System has adopted final revisions to Regulation Z, which implements the Truth in Lending Act. The final rule, which is attached, took effect on November 21, 1997, but compliance is optional until October 1, 1998 (not December 22, 1997, as reported in FIL-127-97 dated December 10, 1997).

The revisions implement an amendment to the Truth in Lending Act contained in the Economic Growth and Regulatory Paperwork Reduction Act of 1996. The amendment permits creditors to provide a statement that the periodic payment on certain variable-rate loans may substantially increase or decrease together with a maximum interest rate and payment based on a $10,000 loan amount, instead of having to provide a 15-year historical example of index values. The Federal Reserve issued a proposed rule to implement the statutory changes in January 1997.

The changes to the regulation include:

- Revisions to Section 226.19(b)(2), "Certain Variable-Rate Transactions," that permit creditors to provide either:
  - The historical 15-year example or
  - The maximum interest rate and payment for a $10,000 loan (assuming the maximum periodic increases in rates and payments under the loan program) and the initial interest rate and payment for that loan, along with a statement that the periodic payment may increase or decrease substantially depending on changes in the interest rate;

- Revisions to Appendix H that provide new model forms and clauses for the revisions made to Section 226.19(b); and

- Changes to the "Official Staff Commentary" in Sections 226.19(b)(2) and Appendix H that provide additional guidance on the revised disclosure requirements.

For further information about the new rule, please call:

- Ms. Kyung H. Cho-Miller, Staff Attorney in the Federal Reserve System's Division of Consumer and Community Affairs, at (202) 452-3667;

- Ken Baebel, Senior Review Examiner in the FDIC's Division of Compliance and Consumer Affairs (202-942-3086, e-mail: JBaebel@FDIC.gov); or

- Andrea Winkler, Counsel in the FDIC's Legal Division (202-736-0762, e-mail: AWinkler@FDIC.gov).

Carmen J. Sullivan
Director
Attachment: Dec. 1 Federal Register, pages 63441-63447, available on the FDIC web site for FILs, www.fdic.gov/banknews

Distribution: FDIC-Supervised Banks (Commercial and Savings)

NOTE: Paper copies of FDIC financial institution letters may be obtained through the FDIC's Public Information Center, 801 17th Street, N.W., Room 100, Washington, D.C. 20434 (800-276-6003 or 202-416-6940).
Regional Director Memo

Compliance Examination Procedures for
Regulation Z in Response to Court Ruling

Classification Number: 6410 (S)
Date: 04/17/92
Transmittal Number: 92-058

1. Purpose. To forward the attached Legal Division opinion regarding First National Bank of Council Bluffs v. OCC and provide guidance on the FDIC's procedural policy as a result of the aforementioned case.

2. Background. The recent Eighth Circuit Court case First National Bank of Council Bluffs v. OCC (February 19, 1992) challenged the federal agencies' interpretation of the Truth in Lending Act (Act) and the joint statement of policy entitled Administrative Enforcement of the Truth in Lending Act - Restitution dated July 11, 1980. Both the Act and the policy statement state that reimbursement orders by federal agencies shall require adjustment to loan accounts transacted since the date of the immediately preceding examination, interpreted to mean the last examination in which Truth in Lending compliance was reviewed. The court ruled against the OCC's reimbursement order issued to the above bank, citing a literal translation of the Act to mean any immediately preceding examination for any purpose. Therefore, such preceding examination could be for safety and soundness or other specialty examination purpose, rather than the last examination in which compliance with the Act and its implementing Regulation Z were reviewed. This ruling has caused the federal agencies to review their procedures for handling such potential reimbursement orders in the future. The attached legal opinion outlines the FDIC's recommended approach to future reimbursement orders.

3. Procedures. Until further notice, reimbursement orders issued by the FDIC to state nonmember banks will follow the 1980 Statement of Policy and the Act, except for those institutions within the Eighth Circuit Court jurisdiction. The Eighth Circuit Court serves the following states: North Dakota, South Dakota, Minnesota, Iowa, Nebraska, Missouri, and Arkansas. Reimbursement orders to banks within these states will follow the Eighth Circuit Court Ruling for First National Bank of Council Bluffs and require reimbursement to those loan accounts transacted only since the immediately preceding examination, regardless of the examination type. For the purposes of these procedures, the term "examination" does not include visitations or state examinations. Regional Directors are encouraged to continue conducting concurrent safety and soundness, trust, and EDP examinations with compliance examinations, where feasible, in order to reduce the impact of this ruling on future reimbursement orders.

4. Responsibility and Action. This memorandum should be provided to appropriate members of your staff.

5. Effective Date. This memorandum is effective upon receipt.

MEMORANDUM TO: Ken A. Quincy
Chief
Compliance & Special Review

FROM: Larry L. Goodman
Senior Attorney

SUBJECT First National Bank of Council Bluffs v. OCC
No. 91-2289 (8th Cir. filed Feb. 19, 1992).

In response to our meeting with the other Federal banking agencies at the Board of Governors of the Federal Reserve System, on February 25, 1992,
concerning the above case and its impact, I concur in the general consensus that the FDIC should follow the decision in that circuit, the Eighth, but not in the other circuits. I also expressed my opinion that the OCC should not attempt to have a rehearing, which was the consensus of the other agencies as well, since it would serve no meaningful purpose.

The Petitioner, First National Bank of Council Bluffs, Council Bluffs, Iowa ("Bank"), offered variable interest rate consumer installment loans with the first year rate being a below market ("teaser") rate. After the initial year, the loan was at a going rate.

In the two year period between June 1986 and June 1988, the Bank made 691 variable interest rate loans with a teaser rate. The Bank's disclosure of the annual percentage rate to consumers was based on the teaser rate, not a composite rate as prescribed ("TILA") 15 U.S.C. 1601 et. seq., and Regulation Z, 12 C.F.R. Part 226.

Based on the consumer compliance examination as a June 30, 1988, the Office of the Comptroller of the Currency ("OCC") ordered adjustments to the accounts of consumers where the transaction was consummated after the most recent previous consumer compliance examination, June 1985. However, a safety and soundness examination had been conducted (as of December 31, 1987) in the interim. The Bank contended that the OCC could only order adjustments in connection with transactions consummated after the safety and soundness examination, since it was the most recent examination preceding the current consumer compliance examination. The basis for their contention was the fact the TILA states that no adjustment shall be ordered:

except in connection with violations arising from practices identified in the current examination and only in connection with transactions that are consummated after the date of the immediate preceding examination.

CONCUR:

Arthur L. Beamon
Associate General Counsel

15 U.S.C. 1607(e) (3) (i).

The court, finding the words "immediate preceding examination" clear and unambiguous, agreed with the Bank. Thus, adjustments were to be made only on transactions consummated after the most recent previous examination in time to the current examination, irrespective of the purpose for conducting the preceding examination.

The Federal Deposit Insurance Corporation's ("FDIC") interpretation of the language "immediate preceding examination" has mirrored that of the OCC's, in other words, the preceding consumer compliance examination at which truth in lending was covered, and not a safety and soundness examination. You have informed me, however, that approximately seventy (70%) percent of the FDIC's consumer compliance examinations are conducted concurrently with a safety and soundness examination. Therefore, the decision should have little impact on the FDIC, since it has such a high percentage of concurrent examinations.

Obviously, the FDIC should follow the Council Bluffs decision in the Eighth Circuit. However, in the other circuits, we can continue to interpret "immediate preceding examination" to mean the last consumer compliance examination prior to the current one, for the reason that the other circuits are not bound by the decision. But, assuredly, the decision will be cited by banks in other jurisdictions as being dispositive of the issue. Obviously, one cannot accurately predict whether other circuits will adopt the Eighth Circuit's position, but it certainly gives them a precedent to consider. Being aware of the Counsel Bluffs decision, I would certainly continue the practice of having a great number of consumer compliance examinations conducted in conjunction with safety and soundness examinations.
TO: CHIEF EXECUTIVE OFFICER AND COMPLIANCE OFFICER

SUBJECT: Requests for Relief from Reimbursement under the Truth in Lending Act

Historically, the FDIC has treated a request made by non-member banks seeking relief from making reimbursement under the Truth in Lending Act, 15 U.S.C. 1601 et seq. (TILA), as an application under its regulations. The Board has delegated authority to the Director of the Division of Compliance and Consumer Affairs (DCA) to grant or deny these requests. The Director has further delegated this authority to the Regional Directors (DCA) but only to deny requests where the amount of reimbursement totals less than $25,000.

The TILA grants the enforcement agencies very little discretion to grant relief from reimbursement for violations. Because of this limited discretion, the FDIC has not been able to grant relief in many instances. From 1991 through 1996, a total of 63 requests were reviewed at the Washington level and only one of these requests was granted. In that one instance, it was determined that the cited violation was, in fact, not a violation of Regulation Z.

Should a nonmember bank wish to pursue a request for relief, even though there is a strong likelihood that a request will not be granted, the request will be processed within established time frames (see FIL-26-96, "Regulatory Responsiveness," dated May 6, 1996, concerning application processing time lines):

Requests that can be processed under delegated authority by the Regional Director and Regional Counsel must be completed within 60 days after receipt unless the institution has agreed in writing to an extension of time to make the determination.

Requests requiring action by the Washington Office will be referred by the Regional Office to the Washington Office within 45 days of receipt. A decision will be made within 45 days of receipt in Washington.

Legal Background: Section 108(e) of the TILA, which governs enforcement of TILA, provides a very specific framework for requiring agency action on restitution. Once the FDIC determines that a disclosure error involving an inaccurate APR or finance charge has occurred, and that the error has resulted from "gross negligence," or a "clear and consistent pattern or practice of violations," the agency shall require an adjustment unless one of four stated exceptions applies, in which case the agency need not require an adjustment. If the exceptions apply, or in cases of similar disclosure errors, an agency may require an adjustment.

The use of the terms "shall require an adjustment," "need not require an adjustment" and "may require an adjustment" within the same section of the statute suggests that Congress intended the term "shall require" to be mandatory. The Congress used the word must, indicating the compulsory nature of its direction that an agency enforce the TILA with regard to the specific kinds of violations enumerated, as contrasted with the agency's discretion to order restitution in other situations.
"Where the violation resulted from a pattern or practice of violations, gross negligence, or a willful violation intended to mislead, an agency must, subject to the restrictions discussed below, order restitution to the consumer designed to assure that the consumer pays no more than the lower of the finance charge or annual percentage rate actually disclosed. In the case of violations not falling under any of the above criteria, each agency may in its discretion order restitution." Id. at 12; accord verbatim, S.Rep. No. 368, 96th Cong., 1st Sess. 26 (1979).

There are four instances where the FDIC has discretion to waive reimbursement. Three of these exceptions are straightforward and are fact specific. It would be unusual to find a bank which could successfully assert one of these exceptions as a defense, since it is unlikely that restitution would have been ordered in the first place as FDIC examiners carefully evaluate whether any of the exceptions exist before requesting that a bank make restitution.

The first three exceptions are where:

1. The error involves a fee or charge that would otherwise be excludable in computing the finance charge;

2. The error involved a disclosed amount which was 10 percent or less of the amount that should have been disclosed and either the annual percentage rate (APR) or finance charge was disclosed correctly; or

3. The error involved a total failure to disclose either the APR or finance charge.

The fourth exception is the one most frequently cited by an institution in requesting relief. It is the one that is most difficult to meet since it contains four elements, all four of which must be met for the exception to apply. The conditions are that:

- the error resulted from a unique circumstance,
- the disclosure violations are clearly technical and non-substantive,
- do not adversely affect information provided to the consumer, and
- have not misled or otherwise deceived the consumer.

The legislative history of TILA does not define the term "unique circumstance"; however, the FDIC considers the term "unique" to have the traditional meaning, including "unusual," "atypical," and "infrequent." Where violations involving the finance charge and APR are concerned, the requirement that the error be "clearly technical and nonsubstantive" generally cannot be met. Technical and nonsubstantive violations do not include those which could affect the outcome of a borrower's decision in credit shopping. See S. Rep. No. 368, 96th Cong., 1st Sess. 16-17 (1979). Congress intended the "technical and non-substantive" exception to be construed very narrowly for use in such situations as clerical or computer errors.

Similarly, where there is an understatement of the finance charge or APR, it is unlikely that there will be "no adverse effect on information provided to the consumer" and that the error would not have "misled or otherwise deceived the consumer." Thus, it is extremely rare that the conditions contained in the fourth exception are ever met. For example, some recent requests by institutions seeking relief from having to make reimbursement have included some of the following reasons as a defense that the FDIC determined to be unacceptable:

Consumers did not pay any additional amount because of inaccurate disclosures

Impact on the institution's reputation in its community
Size of the institution

Consumers signed the credit life insurance application but did not affirmatively indicate a desire to purchase the insurance.

Provider of form/software purchased by institution gave erroneous advice.

Consumers were given new disclosures but were not provided monetary reimbursement.

Examiners did not cite violation at previous examination.

Procedures for Making a Request: If an institution decides to make a request for relief from reimbursement, it should do so within 30 days of receipt of the report of examination containing the request to conduct a file search and make restitution to affected customers. The request should be directed to the attention of the Regional Director (DCA) and must address the statutory factors contained in Section 108(e) of the TILA. The Regional Director will notify the institution of the receipt of the request and that pending a final determination, the institution is not required to complete corrective action on the restitution request.

When restitution must be made, the FDIC expects the institution to carry out the reimbursement to the customer expeditiously according to the Joint Statement of Policy on Restitution adopted on July 11, 1980. (A copy of the Statement is attached.) When lump sum payments to consumers are required to be made, they must be provided to the consumer either by official check or a deposit into an existing unrestricted consumer asset account, such as an unrestricted savings, checking or NOW account. If, however, the loan is delinquent, in default, or has been charged off, the creditor may apply all or part of the reimbursement to the amount past due, if permissible under law.

There have been instances where institution personnel have inappropriately requested consumers to return reimbursement checks to the institution. This, and any like practice, is not permissible and the FDIC views any such attempts to prevent unrestricted access by the consumer to reimbursement proceeds as a serious breach of fiduciary duty as well as a violation of law and regulation. These violations will be subject to enforcement actions, including but not limited to, assessment of civil money penalties, orders to cease and desist, and possible removal/prohibition orders.

Questions about the procedures for requesting relief from reimbursement may be directed to any of the DCA Review Examiners in Washington or the Regional Offices listed in Attachment 2.

Carmen J. Sullivan
Director

Attachments (2)
Attachment 1
Attachment 2

Distribution: FDIC-Supervised Banks (Commercial and Savings)

Note: Paper copies of FDIC financial institution letters may be obtained through the FDIC's Public Information Center, 801 17th Street, N.W., Room 100, Washington, D.C. 20434 (202-416-6940 or 800-276-6003).
ATTACHMENT 1

ADMINISTRATIVE ENFORCEMENT OF THE TRUTH IN LENDING ACT - RESTITUTION

Joint Statement of Policy

The Depository Institutions Deregulation and Monetary Control Act of 1980 was enacted on March 31, 1980. The Truth in Lending Simplification and Reform Act amends the Truth in Lending Act, 15 U.S.C. 1601, et seq. effective March 31, 1980 and authorized the federal Truth in Lending enforcement agencies to order creditors to make monetary and other adjustments to consumers' accounts when an annual percentage rate (APR) or finance charge was inaccurately disclosed. It generally requires the agencies to order restitution when such disclosure errors resulted from a clear and consistent pattern or practice of violations, gross negligence, or a willful violation that was intended to mislead the person to whom the credit was extended. However, the Act does not preclude the agencies from ordering restitution for isolated disclosure errors.

This policy guide summarizes and explains the restitution provisions of the Truth in Lending Act, as amended. The material also explains corrective actions the financial regulatory agencies believe will be appropriate and generally intend to take in those situations in which the Act gives them the authority to perform equitable remedial action.

The agencies anticipate that most financial institutions will voluntarily comply with the restitution provisions of Section 608 as part of the normal regulatory process. If a creditor does not voluntarily act to correct violations, the agencies will use their cease and desist authority to require correction pursuant to: 15 U.S.C. 1607 and 12 U.S.C. 1818(b) in the cases of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision; and 15 U.S.C. 1607 and 12 U.S.C. 1786(e)(1) in the case of the National Credit Union Administration.

Restitution Provisions

Definitions

Except as provided below, all definitions are those found in the Truth in Lending Act (Act) and Regulation Z, 12 CFR Part 226.

1. "Current examination" - the most recent examination begun on or after March 31, 1980, in which compliance with Regulation Z was reviewed.

2. "Irregular Mortgage Transaction" means a loan secured by real estate for which the annual percentage rate (APR) cannot be calculated using Volume I of the Federal Reserve System's Truth in Lending, Regulation Z, Annual Percentage Rate Tables.

3. "Lump sum method" means a method of reimbursement in which a cash payment equal to the total adjustment will be made to a consumer.

4. "Lump sum/payment reduction method" means a method of reimbursement in which the total adjustment to a consumer will be made in two stages:

   a. A cash payment that fully adjusts the consumer's account up to the time of the cash payment; and,

   b. A reduction of the remaining payment amounts on the loan.
5. "Understated APR" means:

a. For other than irregular mortgage transactions, a disclosed APR, which, when increased by one-quarter of one percentage point, is less than the actual APR calculated under the Act, without taking into account the tolerance provided by section 107(c) of that Act.

b. For irregular mortgage transactions consummated before April 1, 1981, a disclosed APR which is less than the actual APR calculated under section 107(c) of the Act, including a one-half of one percentage point tolerance.

c. For irregular mortgage transactions consummated after March 31, 1981, but before April 1, 1982, a disclosed APR which, when increased by one-quarter of one percentage point (instead of one-half of one percentage point), is less than the actual APR calculated under the Act, without taking into account the tolerance provided by section 107(c) of that Act.

d. For all loans consummated after March 31, 1982 (including irregular mortgage transactions), which have an amortization of 10 years or less, a disclosed APR which, when increased by one-quarter of one percentage point, is less than the actual APR calculated under the Act, without taking into account the tolerance provided by section 107(c) of the Act.

e. For all loans consummated after March 31, 1982 (including irregular mortgage transactions), which have an amortization schedule of more than 10 years, a disclosed APR which is less than the actual APR, including the tolerance contained in section 107(c).

f. For all loans determined to contain a willful violation intended to mislead a consumer, a disclosed APR which is less than the actual APR including the tolerance contained in section 107(c).

6. "Understated finance charge" - A disclosed finance charge which, when increased by the greater of the finance charge dollar tolerance specified in the Act and Regulation Z or a dollar tolerance that is generated by the corresponding APR reimbursement tolerance, is less than the finance charge calculated under the Act.

De Minimis Rule

If the amount of adjustment on an account is less than $1.00, no restitution will be ordered. However, the agencies may require a creditor to make any adjustments of less than $1.00 by paying into the United States Treasury, if more than one year has elapsed since the date of the violation.

Corrective Action Period

1. Open-end credit transactions will be subject to an adjustment if the violation occurred within the two-year period preceding the date of the current examination.

2. Closed-end credit transactions will be subject to an adjustment if the violation resulted from a clear and consistent pattern or practice or gross negligence where:

a. There is an understated APR on a loan which originated between January 1, 1977 and March 31, 1980.

b. There is an understated APR or understated finance charge, and the practice
giving rise to the violation is identified during a current examination. Loans containing the violation that were consummated since the date of the immediately preceding examination are subject to an adjustment.

c. There is an understated APR or understated finance charge, the practice giving rise to the violation was identified during the prior examination and the practice is not corrected by the date of the current examination. Loans containing the violation which were consummated since the creditor was first notified in writing of the violation are subject to an adjustment. (Prior examinations include any examinations conducted since July 1, 1969).

3. Each closed-end credit transaction containing a willful violation intended to mislead the consumer consummated since July 1, 1969 is subject to an adjustment.

4. For terminated loans subject to 2 above, an adjustment will not be ordered if the violation occurred in a transaction consummated more than two years prior to the date of the current examination.

Calculating the Adjustment Consumers will not be required to pay any amount in excess of the finance charge or dollar equivalent of the APR actually disclosed on transactions involving:

1. Understated APR violations on transactions consummated between January 1, 1977 and March 31, 1980, or

2. Willful violations that were intended to mislead the consumer.

On all other transactions, applicable tolerances provided in the definitions of understated APR and finance charge may be applied in calculating the amount of adjustment to the consumer's account.

Methods of Adjustment

The consumer's account will be adjusted using the lump sum method or the lump sum/payment reduction method, at the discretion of the creditor.

Violations Involving the Non-Disclosure of the APR or Finance Charge

1. In cases where an APR was required to be disclosed but was not, the disclosed APR shall be considered to be the contract rate, if disclosed on the note or the Truth in Lending disclosure statement.

2. In cases where an APR was required to be disclosed but was not, and no contract rate was disclosed, consumers will not be required to pay an amount greater than the actual APR reduced by one-quarter of one percentage point, in the case of first lien mortgage transactions, and by one percentage point in all other transactions.

3. In cases where a finance charge was not disclosed, no adjustment will be ordered.

Violations Involving the Improper Disclosure of Credit Life, Accident, Health, or Loss of Income Insurance

1. Through March 31, 1982:

   a. If the creditor has not disclosed to the consumer in writing that credit life, accident, health, or loss of income insurance is optional, the insurance shall be treated as having been required and improperly excluded from the finance
charge. An adjustment will be ordered if it results in an understated APR or finance charge. The insurance will remain in effect for the remainder of its term.

b. If the creditor has disclosed to the consumer in writing that credit life, accident, health, or loss of income insurance is optional, but there is either no signed insurance option or no disclosure of the cost of the insurance, the creditor shall, unless a claim was made on the insurance policy and paid, be required to send a written notice to the affected consumer disclosing the cost of the insurance and notifying the consumer that the insurance is optional and may be canceled within 45 days to obtain a full refund of all premium charged. If the creditor receives no response from the consumer within 45 days, the insurance will remain in effect and no further corrective action, with respect to that loan, will be required.

c. After March 31, 1982, the above violations of section 106(b) of the Act will be treated as APR or finance charge violations for adjustment purposes, as applicable.

Special Disclosures

Adjustments will not be required for violations involving the disclosures required by 106(c) and (d).

Obvious Errors

If an APR was disclosed correctly, but the finance charge required to be disclosed was understated, or if the finance charge was disclosed correctly, but the APR required to be disclosed was understated, no adjustment will be required if the error involved a disclosed value which was 10 percent or less of the amount that should have been disclosed.

Agency Discretion

Adjustments will not be required if the agency determines that the disclosure error resulted from any unique circumstances involving a clearly technical and nonsubstantive disclosure violation which did not adversely affect information provided to the consumer and which did not mislead or otherwise deceive the consumer.

Safety and Soundness

In connection with loans consummated before April 1, 1980, if full adjustments would have a significantly adverse impact upon the safety and soundness of the creditor, partial adjustments which do not have such an impact may be required. In connection with loans consummated after March 31, 1980, full adjustments will always be required. However, the affected creditor will be permitted to make the full adjustment in partial payments over an extended period to minimize the adverse impact to its safety and soundness.

Exemption from Restitution Orders

A creditor will not be subject to an order to make an adjustment if within 60 days after discovering a disclosure error, whether pursuant to a final written examination report or through the creditor's own procedures, the creditor notifies the person concerned of the error and adjusts the account to ensure that such person will not be required to pay a finance charge in excess of that actually disclosed or the dollar equivalent of the APR disclosed, whichever is lower. This 60-day period for correction of disclosure errors is unrelated to the provisions of the Civil Liability section of the Act.

By order of the Federal Financial Institutions Examination Council.
REGIONAL OFFICE CONTACTS

ATLANTA - Ms. Lisa Drag, Review Examiner (404) 817-2525
BOSTON - Ms. Carol-Ane Woodard, Review Examiner (617) 320-1731
CHICAGO - Mr. Christopher Lombardo, Review Examiner (312) 382-7584
DALLAS - Mr. Wayne Perun, Review Examiner (214) 220-3357
KANSAS CITY - Ms. Janet Kincaid, Review Examiner (816) 234-8153
MEMPHIS - Mr. James Francomacaro, Review Examiner (901) 821-5231
NEW YORK - Mr. John Soffronoff, Review Examiner (212) 704-1405
SAN FRANCISCO - Ms. Carol Saccomonto, Review Examiner (415) 978-0475

WASHINGTON OFFICE CONTACTS

LEGAL - Ms. Andrea Winkler, Counsel, Compliance and Enforcement (202) 736-0762
DCA - Mr. Ken Baebel, Sr. Review Examiner, Compliance and Enforcement (202) 942-3086
Ms. Alice Beshara, Review Examiner, Compliance and Enforcement (202) 942-3087
Mr. Eric Kooistra, Review Examiner, Compliance and Enforcement (202) 942-3339
TO: CHIEF EXECUTIVE OFFICER

SUBJECT: Interagency Statement on Year 2000 Project Management Awareness

The Federal Financial Institutions Examination Council (FFIEC) on May 5, 1997, issued the attached press release and interagency statement providing guidance on the scope of the activities necessary for insured financial institutions to make all information-processing systems capable of recognizing dates in the Year 2000 and beyond.

The attached statement updates the FFIEC's statement "The Effect of Year 2000 on Computer Systems," issued in June 1996, and it reflects the federal agencies' concerns about the industry's readiness for the Year 2000. The statement outlines the agencies' supervisory strategy to ensure an orderly transition into the next century.

Financial institutions should be well into the "assessment" phase of their Year 2000 project management plan. As noted in the statement, mission-critical systems should be identified and priorities set for Year 2000 work by the end of the third quarter of 1997. For mission-critical applications, the agencies strongly recommend that programming changes be largely completed and testing well underway by December 31, 1998. This time line for testing critical applications has been accelerated since the June 1996 interagency statement to ensure that system interdependencies are not disrupted. Reprogramming for other applications should also be completed by December 31, 1998, to allow a full year for testing and adjustments.

The statement discusses three Year 2000-related issues requiring management attention:

- reliance on vendors,
- risks posed by exchanging data with external parties, and
- the potential effect of Year 2000 noncompliance on corporate borrowers.

Other operational issues related to Year 2000 planning are also highlighted.

The FDIC and state banking authorities will review the conversion efforts of all FDIC-supervised banks in 1997, using the attached examiner questionnaire and examination procedures or similar tools. Meanwhile, management is encouraged to use these examination tools to assess the adequacy of its own efforts in addressing Year 2000 issues. If you foresee significant problems meeting the target time lines in this guidance, please notify your Division of Supervision regional office.

The attached interagency statement and related information on Year 2000 issues are available on the Internet via the World Wide Web at

http://www.fdic.gov/banknews/fils/

and


For more information, please contact your Division of Supervision Regional Office.
For immediate release

May 5, 1997

Federal Bank Regulators Outline Year 2000 Project Management Goals

The Federal Financial Institutions Examination Council's Task Force on Supervision today issued an Interagency Statement for the banking industry and federal examiners, intended to focus their attention on the critical issues financial institutions need to address quickly to resolve Year 2000 computer problems and avoid major service disruptions.

The FFIEC Task Force first alerted the industry to the Year 2000 problem in June 1996, and recommended that institutions perform risk assessments and plan a strategy to address vulnerable systems.

Today's Statement outlines a project management process that strongly encourages federally insured depository institutions to complete an inventory of core computer functions and set priorities for Year 2000 goals by September 30, 1997. Banks are expected to largely complete programming changes, and have testing well underway for mission critical systems by December 31, 1998.

In an appendix to the Statement, the Task Force included an examiner questionnaire to help regulatory agencies conduct assessments of financial institution planning efforts, which are expected to be completed shortly. Based on the results of these assessments, regulators will prioritize supervisory reviews, using examination procedures contained in a second appendix to the Statement. The regulators expect to complete examinations of conversion efforts by mid-1998.

Federal financial regulators are concerned that systemic disruptions and potential failures could result if computers used by financial institutions cannot properly read date-sensitive information when the calendar year changes to 2000. For this reason, an institution's reprogramming planning should include consideration of the vendors whose products and services a financial institution uses; the other banks, clearing houses and customers with whom it exchanges data electronically; and, corporate borrowers, whose creditworthiness might be diminished by significant service disruptions.

In a statement today, the Task Force said, "The Year 2000 presents a number of very difficult challenges for the financial services industry, which relies heavily on effective computer communications between banks, external data networks and data processing centers, and their customers. The Interagency Statement adopted today emphasizes the important issues that banks, thrifts and credit unions need to address right now to meet critical deadlines in preparation for the Year 2000."

The Interagency Statement outlines five management phases necessary to complete a computer conversion program: awareness, assessment, renovation, validation, and implementation. During the final stage, systems should be certified as compliant and accepted by business users. Federal regulators intend to work closely with institutions that face unusual difficulties.

The Interagency Statement is attached. It is also available on the Internet at http://www.FFIEC.gov/Y2K/ and by telephone FAX BACK at 888-882-0982.
To: Chief Executive Officers of all federally supervised financial institutions, providers of data services, senior management of each FFIEC agency, and all examining personnel.

Purpose:

This Interagency Statement is intended to emphasize the need to make all information processing systems Year 2000 compliant and identify specific concerns that should be considered in managing a conversion program. The FFIEC first alerted the industry in June 1996 of the Year 2000 problem. At that time, we recommended that financial institutions perform a risk assessment of their processing systems and begin developing an action plan to address vulnerable systems. This Interagency Statement expands on those topics and stresses a number of areas which may need special attention. It also describes the supervisory strategy that the federal banking agencies will pursue in monitoring Year 2000 conversion efforts of financial institutions, as well as third-party data processing servicers, and software suppliers servicing insured financial institutions.

The Year 2000 poses serious challenges to the industry. Many experts believe that even the most prepared organizations may encounter some implementation problems. The federal banking agencies want to ensure that financial institutions avoid major disruptions and will work with the industry to reach that goal. They will implement a supervisory plan designed to: heighten awareness of the Year 2000 problem within the industry; perform an assessment of the planning efforts of financial institutions for Year 2000; conduct a supervisory review of all institutions for Year 2000 preparedness; and work with institutions that face difficulties. The agencies will undertake follow-up activities to ensure institutions focus on problem areas and take appropriate supervisory action if they are unable to encourage a financial institution to devote adequate attention to achieving Year 2000 compliance.

This Statement has four major parts: an outline of the Year 2000 project management process; identification of three external risk issues that the Year 2000 conversion plan should consider; other operational issues that may be relevant to an institution's Year 2000 planning; and a description of the federal banking agencies' supervisory strategy.
Year 2000 Project Management:

The Year 2000 problem presents a number of difficult challenges to financial institution management. Information systems are often complex and have been developed over many years through a variety of computer languages and hardware platforms. For many financial institutions, correction of those problems will be costly and complex. A lack of skilled mainframe programmers and system experts compounds the problem.

Year 2000 conversion projects will require executive management sponsorship and an effective project management process. The project management process begins with an awareness of the issue and an assessment of the extent of Year 2000 problems within financial institution systems. This includes identification of affected applications and databases. Mission critical applications should be identified and priorities set for Year 2000 work by the end of the third quarter of 1997. Financial institutions and service providers should be well into this phase of the project. Code enhancements and revisions, hardware upgrades, and other associated changes follow the assessment phase and should be largely completed by December 31, 1998.

Since the 1996 Interagency Statement, it has become clear that testing mission critical system interdependencies, particularly those with external systems, will be time consuming and could take up to at least one year in more complex data processing environments. Accordingly, for mission critical applications, the federal banking agencies strongly encourage the industry to assure that programming changes are largely completed and that testing be well underway by December 31, 1998. This is a change from the June 1996 Interagency Statement due to the importance of fully testing connectivity between major servicers and other financial institutions.

Year 2000 project management processes are expected to be more formalized in financial institutions with complex systems or which rely on in-house application development. In all financial institutions, regardless of size or complexity, strong leadership, effective communication, and accountability are necessary to ensure that Year 2000 initiatives will be successful. The following describes the discovery, planning, and implementation process in managing an institution's conversion program:

**Awareness Phase** - Define the Year 2000 problem and gain executive level support for the resources necessary to perform compliance work. Establish a Year 2000 program team and develop an overall strategy that encompasses in-house systems, service bureaus for systems that are outsourced, vendors, auditors, customers, and suppliers (including correspondents).

**Assessment Phase** - Assess the size and complexity of the problem and detail the magnitude of the effort necessary to address Year 2000 issues. This phase must identify all hardware, software, networks, automated teller machines, other various processing platforms, and customer and vendor interdependencies affected by the Year 2000 date change. The assessment must go beyond information systems and include environmental systems that are dependent on embedded microchips, such as security systems, elevators and vaults.

Management also must evaluate the Year 2000 effect on other strategic business initiatives. The assessment should consider the potential effect that mergers and acquisitions, major system development, corporate alliances, and system interdependencies will have on existing systems and/or the potential Year 2000 issues that may arise from acquired systems.

The financial institution or vendor should also identify resource needs, establish time frames and sequencing of Year 2000 efforts. Resource needs include appropriately skilled personnel, contractors, vendor support, budget allocations, and hardware...
capacity. This phase should clearly identify corporate accountability throughout the project, and policies should define reporting, monitoring, and notification requirements. Finally, contingency plans should be developed to cover unforeseen obstacles during the renovation and validation phases and include plans to deal with lesser priority systems that would be fixed later in the renovation phase.

Renovation Phase - This phase includes code enhancements, hardware and software upgrades, system replacements, vendor certification, and other associated changes. Work should be prioritized based on information gathered during the assessment phase. For institutions relying on outside servicers or third-party software providers, ongoing discussions and monitoring of vendor progress are necessary.

Validation Phase - Testing is a multifaceted process that is critical to the Year 2000 project and inherent in each phase of the project management plan. This process includes the testing of incremental changes to hardware and software components. In addition to testing upgraded components, connections with other systems must be verified, and all changes should be accepted by internal and external users. Management should establish controls to assure the effective and timely completion of all hardware and software testing prior to final implementation. As with the renovation phase, financial institutions should be in ongoing discussions with their vendors on the success of their validation efforts.

Implementation Phase - In this phase, systems should be certified as Year 2000 compliant and be accepted by the business users. For any system failing certification, the business effect must be assessed clearly and the organization's Year 2000 contingency plans should be implemented. Any potentially noncompliant mission-critical system should be brought to the attention of executive management immediately for resolution. In addition, this phase must ensure that any new systems or subsequent changes to verified systems are compliant with Year 2000 requirements.

External Issues:

Our discussions with Year 2000 experts, bankers, and field examiners indicate some financial institutions have not yet considered all the implications of the Year 2000 problem or lack conformance to time critical dates. More specifically, management should begin immediately to consider the following areas in its project planning process:

Reliance on Vendors - The agencies find that some financial institutions, relying on third-party data processing servicers or purchased applications software, have not taken a proactive approach in ensuring Year 2000 compliance by their vendors. Management should evaluate vendor plans and actively monitor project milestones. Institutions should determine if vendor contract terms can be revised to include Year 2000 covenants. Management should be aware of vendor specific responsibilities and their institution's vulnerability if the vendor cannot meet contractual obligations.

Alternate service or software providers should be considered if vendor solutions or time frames are inadequate. If purchased products or services belong to larger, integrated systems, financial institutions' testing and certification processes will have to be fully coordinated with their vendor's Year 2000 testing. Management must also ensure that vendors have the capacity (both financial and personnel) to complete the project and are willing to certify Year 2000 compliance.

Data Exchange - The Year 2000 problem also poses a risk to the quality of information that institutions exchange with other firms. Large volumes of date sensitive data are transferred electronically between financial institutions, their customers, and their regulators. Institutions will need to know how methods of data exchange differ among financial institutions, across vendors, and between other
institutions. Therefore, Year 2000 planning should allow sufficient time to assess the effect that Year 2000 solutions will have on data transfers. The project plan should also include testing and verification, as appropriate, of data exchanges with clearing associations, governmental entities, customers and international financial institutions.

Corporate Customers - Many corporate customers (borrowers) depend on computer systems that must be Year 2000 compliant. Corporate customers, who have not considered Year 2000 issues, may experience a disruption in business, resulting in potentially significant financial difficulties that could affect their creditworthiness. Financial institutions should develop processes to periodically assess large corporate customer Year 2000 efforts and may consider writing Year 2000 compliance into their loan documentation. Loan and credit review officers should consider in their credit analysis of large corporate customers whether the borrower's Year 2000 conversion efforts are sufficient to avoid significant disruptions to operations.

Other Year 2000 Operating Issues:

The following issues should also be considered in addressing Year 2000 planning:

Replacement vs. Repair - Cost and timing considerations will affect a financial institution's decision to replace or repair strategic systems. Those factors may dictate that some systems will be repaired in the short term and strategically replaced sometime after January 1, 2000. Conversely, it may be more cost effective to accelerate the replacement of strategic systems.

Cost and Monitoring - As the Year 2000 approaches and the urgency of fixing problems increases, the costs of obtaining/retaining qualified staff to address the problems will undoubtedly rise, perhaps significantly. Some experts believe that the limited availability of technical support will be a major obstacle to making systems Year 2000 compliant. Knowledge of market conditions for skilled programmers and developing programs to retain key personnel may be necessary to ensure that adequate resources are available throughout the project's life.

Mergers and Acquisitions (M&As) - The extent of Year 2000 conversion efforts will bear directly on corporate M&As' strategies since conversions resulting from M&As will compete for project managers and technical resources. Acquisition strategies should include the institution's Year 2000 assessment to the extent possible.

Remote Locations - Remote or overseas operations also need to devote attention to Year 2000 issues. In particular, management information systems for businesses that run semi-autonomously from the head office must be included in the financial institution's system inventory and plans. To the extent that such systems serve as critical controls for business operations, they could expose the financial institution to significant undetected vulnerabilities. Appropriate staff members throughout the organization must be aware of the risks associated with the Year 2000 issue and how they might be affected.

Contracts - Legal issues may arise from the lack of specificity in contract terms dealing with Year 2000 issues. Financial institutions should modify existing contracts which do not specifically address Year 2000 compliance by the vendor. Otherwise, conflicts may result regarding the commitment and responsibility to assure Year 2000 compliance. Current and future purchases should require Year 2000 certification. If contract changes or modifications are refused, then the institution should consider replacing the service or product.

Leap Year - All Year 2000 plans need to address the leap year - February 29, 2000 - issue. All date and calculation routines need to be reviewed to ensure that leap year
calculations are Year 2000 certified.

Supervisory Strategy:

The federal banking agencies plan to conduct a supervisory review of all financial institutions' Year 2000 conversion efforts by mid-1998. They will soon complete an assessment of financial institutions' Year 2000 planning efforts. The appropriate regulatory agency may use the examiner questionnaire in Appendix A, or a similar tool, to help conduct this assessment. Financial institutions will be provided with specific instructions from your agency about this part of their supervisory strategy. The agencies will use the results of their assessment to prioritize on-site examinations and will target first those institutions that have not actively begun a Year 2000 conversion program.

The federal banking agencies will utilize uniform examination procedures to facilitate Year 2000 examinations (Appendix B). Management is encouraged to use these examination tools to perform internal reviews or self-evaluations in connection with their own efforts to address the Year 2000 problem. Examiners will work with institutions that encounter significant problems addressing Year 2000 issues.

Focusing on financial institutions alone will not prevent Year 2000 disruptions. The federal banking agencies will work cooperatively to ensure that supervisory reviews include data processing service providers and third-party software vendors who provide services to federally insured financial institutions. This effort will include vendors who are a part of the Multiregional Data Processing Servicer program and the Shared Application Software Review program.

Appendix A

Year 2000 Examiner Questionnaire

Introduction

This questionnaire is designed to capture macro-level information on Year 2000 preparations from financial institutions and their information systems vendors. The information will help examiners prioritize their Year 2000 reviews. The questions are presented in a "yes - no" answer format. However, examiners may also ask open-ended questions to develop a thorough understanding of the institution's/vendor's Year 2000 capabilities.

Capability

1. Are the institution's/vendor's information processing (hardware and software) and delivery (telecommunications) systems capable and ready to handle Year 2000 processing?

Overall Plan

2. Does the institution/vendor have a Year 2000 problem resolution process that includes these basic phases:

    Awareness of the problem.

    Assessment of complexity.

    Renovation.

    Validation.
Implementation.

3. Has the institution/vendor prioritized internally and externally maintained systems (hardware, software, and operating systems)?

4. Has the institution considered the impact of the Year 2000 on internal, environmental systems that are dependent on embedded microchips, such as vaults, security and alarm systems, elevators, telephones, FAX machines, and HVAC (heating, ventilation, and air conditioning)?

Resource Implications

5. Has the institution/vendor established a budget for the year 2000 effort?

6. Has the institution/vendor determined whether it has sufficient resources (hardware, people, and dollars) necessary to ensure Year 2000 processing capabilities?

Sponsorship/Monitoring

7. Has the institution/vendor assigned overall responsibility for the Year 2000 effort to a senior manager?

8. Has the institution/vendor established project target dates and deliverables for the Year 2000 effort?

9. Does the process include regular reporting to and monitoring by senior management?

Timing

10. Does the institution's/vendor's Year 2000 plan call for the renovation of all mission critical systems to be largely completed by December 31, 1998?

11. Will the institution's/vendor's testing for Year 2000 renovations be well under way, for mission critical applications, by December 31, 1998?

Appendix B

Year 2000 Examination Procedures

Introduction

The following examination procedures are for general use in all federally supervised financial institutions and data centers that service these financial institutions. The examination procedures will help the examiner to determine if the institution has addressed the Year 2000 problems inherent in many computer software and hardware systems. The examination procedures are designed to focus on the state of Year 2000 preparedness of each examined institution.

The Tier I section represents general procedures designed for all institutions. Examinations of small institutions, particularly those that have purchased or leased their hardware and/or software systems from an external vendor, normally will stop at the end of the Tier I examination procedures. The examiner will then proceed to the examination conclusions section. The Tier II section includes more rigorous and detailed examination procedures designed for larger institutions, particularly those with in-house software development capabilities. In these environments, examiners normally will use both the Tier I and Tier II...
Examination Objectives

1. To determine whether the organization has an effective plan for identifying, renovating, testing, and implementing solutions for Year 2000 processing.

2. To assess the effect of Year 2000 efforts on the organization's strategic and operating plans.

3. To determine whether the organization has effectively coordinated Year 2000 processing capabilities with its customers, vendors, and payment systems partners.

4. To assess the soundness of internal controls for the Year 2000 process.

5. To identify whether further corrective action may be necessary to assure an appropriate level of attention to Year 2000 processing capabilities.

Examination Planning and Control

1. Determine the organization's source of information systems (IS) support for hardware (mainframe, mid-range, networks, personal computers) and related applications and operating system software. Note whether information systems processing is provided internally, externally, or a combination of both.

2. Review previous examination, audit, or consultant findings relative to Year 2000 issues.

3. Review management's responses to any significant Year 2000 findings.

4. Review responses to the Year 2000 Examiner Questionnaire.

5. Review the supervisory strategy and scope memorandum prepared for this organization relative to Year 2000 issues.

6. Determine the scope of the Year 2000 examination based on findings from the previous steps and discussions with the examiner-in-charge (EIC).

Select from the following examination procedures the steps necessary to meet the examination objectives. Note: Examinations do not require completion of all steps.

Tier I Procedures

1. Determine whether the organization's board of directors and senior management are aware of and understand the risks and complexities of the Year 2000 issue by:
   a. Obtaining and reviewing minutes of board of directors meetings for discussions of Year 2000 issues.
   b. Obtaining and reviewing minutes of committees established to address Year 2000 issues.

2. Determine whether management has developed a plan to ensure that the organization's computer systems are Year 2000 compliant.

3. Determine whether the organization's Year 2000 assessment includes computer controlled systems, such as telecommunications systems, ATMs, audio response systems, and other environmental systems with embedded microchips, such as vaults, security and alarm systems.
4. Determine whether the institution's management conducts continuing communications with its vendor(s) and/or servicer(s) to determine their progress toward implementing Year 2000 solutions.

5. Determine whether the organization has:

   a. Performed a "third party" software contract review to identify risks associated with licensing and maintenance agreement protections for Year 2000 processing.

   b. Reviewed all data processing outsourcing agreements to determine if the vendors have Year 2000 maintenance obligations.

   c. Included Year 2000 leap year considerations in their contract reviews.

   d. Established a process to certify that a vendor(s) and product(s) are Year 2000 compliant. If so, describe.

6. Determine whether management has assessed the financial and operational capabilities of its hardware and software vendors to provide Year 2000 processing capabilities. Note the results of this assessment.

7. Determine the status of the institution's Year 2000 project, including any anticipated barriers and how management plans to address them.

8. If it is evident that the institution's or vendor's/servicer's systems are not fully Year 2000 compliant, determine:

   a. Whether all affected applications will have Year 2000 renovation complete with testing well under way for mission critical systems by December 31, 1998.

   b. The significant applications that will not have Year 2000 renovation complete by December 31, 1998.

   c. Whether management has anticipated the effect to the organization's strategic and operating plans should all systems not be Year 2000 compliant by December 31, 1998.

   d. Management's contingency plans to assure the institution's ongoing operations if the institution's systems will not be Year 2000 compliant by December 31, 1998.

   e. Whether the institution has contingency plans should hardware or software systems not function correctly on January 1, 2000, because of the millennium date change.

9. Determine whether management has discussed the effect of the Year 2000 issue with its large corporate borrowing customers to ensure the customers' ability to meet financial and informational obligations to the institution.

10. Determine whether the organization has assessed the effect of Year 2000 processing capabilities, as applicable, with its payment systems providers, including:

    a. Wire transfer systems.
    b. Automated clearing houses.
    c. Check clearing providers.
    d. Credit card merchant and issuing systems.
    e. Automated teller machine networks.
f. Electronic data interchange systems.
g. Electronic benefits transfer systems.

11. Determine whether management has employed internal or external audit functions to assess the soundness of internal controls associated with the Year 2000 effort.

12. Determine whether management is aware of or contemplates any litigation related to the Year 2000 issue.

Generally, examinations of small financial institutions and those that rely on data service providers should proceed to the Examination Conclusions section.

Tier II Procedures

Audit

1. Assess internal and external audit personnel’s independence and involvement in reviewing the organization's Year 2000 efforts.

2. Review audit plans and budgets through 1999 and determine whether they identify specific audit resources necessary to address Year 2000 issues. Determine whether these plans are based on a formal inventory of all critical systems affected by Year 2000 issues. Also, determine the adequacy of audit resources allocated to Year 2000 issues.

3. Determine whether audit is actively involved in Year 2000 efforts to assess and monitor the effectiveness of the project management process and whether audit management communicates this information to the board of directors.

4. Review Year 2000 project audit reports and determine the adequacy of their scope and the timeliness and completeness of management responses. Also assess the appropriateness of audit follow-up on actions taken in response to Year 2000 project audit findings.

Management

5. Based on discussions with management and reviews of the minutes of committees established to address Year 2000 issues, evaluate the completeness of the project management process to assure the institution's computer systems are Year 2000 compliant. Note whether management has:

   a. Inventoried all hardware and software systems, including international locations.

   b. Identified hardware and software systems that require modifications for Year 2000 processing.

   c. Evaluated various alternatives for dealing with Year 2000 processing issues.

   d. Prioritized software and hardware systems to ensure that the most critical applications are addressed first.

   e. Considered all software systems, including core banking, investments, fiduciary, management information, retail delivery, and operating systems.

   f. Considered the effect of Year 2000 issues on mergers/acquisitions.

   g. Reviewed and approved milestones to ensure the timely completion of Year 2000 efforts.
h. Developed a testing strategy for Year 2000 modifications.

i. Ensured that any new systems are Year 2000 compliant.

j. Addressed the establishment and review of an effective system of internal controls over the Year 2000 effort.

k. Determined the groupings of systems for conversion.

l. Considered the role of the quality assurance function.

m. Determined the role of end users.

n. Determined the need for a configuration management plan.

o. Required thorough project management techniques, including periodic senior management and board project updates.

6. Determine whether management considered the availability of adequate resources for the Year 2000 initiative by identifying:

a. The type of technical expertise that will be needed.

b. The amount of time needed for corrective action.

c. The type and amount of financial resources that will be needed and whether the organization has sufficient financial resources to make all hardware (mainframe, mid-range, networks, personal computers) and related application and operating system software Year 2000 compliant.

d. Whether any other resources are required.

e. The effect of the Year 2000 project on earnings, capital, and liquidity and whether the assessment appears reasonable.

7. Determine whether the organization has persons or access to persons that have sufficient technical expertise to make all hardware/software systems Year 2000 compliant, and:

a. If outside resources will be used, whether these resources are under contract.

b. If not, what assurances management has that these resources will be available, when needed.

8. Determine how the board of directors and senior management are kept informed on the progress of Year 2000 efforts, particularly of any problems encountered during the validation and implementation phases.

9. Determine whether the board of directors and/or senior management have established clear lines of authority and responsibility for the Year 2000 effort.

10. Determine whether Year 2000 project teams receive sufficient support from the board of directors and senior management.

11. Review, as applicable, the selection process for any Year 2000 service provider(s) and whether the process appears adequate.

12. Evaluate the adequacy of the institution's Year 2000 conversion management process.
Systems and Programming

13. Determine whether the organization has assessed the ability of its computer systems to handle any needed software changes. If so, describe.

14. Determine the method(s) the organization uses or will use to resolve Year 2000 date calculations (e.g., conversion to four position year fields, windowing and others).

15. Evaluate whether the organization has/will devote(d) appropriate time to testing and error checking of all software changes.

16. Determine the programming languages and tools that the institution will use.

17. Identify whether a common application development platform is required.

18. Describe how the organization will maintain sound internal controls over the software change process for Year 2000 issues.

19. Determine whether the organization is coordinating modification and testing activities with vendors, servicers, and organizations with whom critical data is received or sent.

Computer Operations

20. Review management's assessment of the anticipated additional systems resources required specifically for operating systems, telecommunications (including ATM) networks, and security software, to handle Year 2000 processing. Describe the results of the assessment.

21. Evaluate the organization's Year 2000 assessment of the adequacy of computer resources for testing Year 2000 changes while performing day-to-day processing activities.

22. Describe management's assessment of the effect of any changes in operating practices resulting from the Year 2000 effort.

23. Determine whether any interim work procedures are required as part of the Year 2000 effort.

24. Review and describe the organization's assessment of the impact of Year 2000 efforts on business continuity/recovery planning.

25. Determine whether the organization compromised sound internal controls over operations as a result of addressing Year 2000 issues.

Examination Conclusions

26. Prepare examination report comments noting:

   a. The computer system's Year 2000 processing capability.

   b. Management's effectiveness in managing the Year 2000 process, including an assessment of the adequacy of resources devoted to Year 2000 problems.

   c. The adequacy of the organization's plans for identifying, correcting, testing, and implementing solutions for Year 2000 processing.

   d. The date methodologies selected to provide Year 2000 processing (in situations with
in-house programming capabilities).

e. The status of the organization's plan and the capability to complete necessary changes with testing well underway for mission critical systems by December 31, 1998.

f. Management's effectiveness in coordinating Year 2000 processing capabilities with its hardware and software vendors, corporate borrowing customers, and payment systems providers.

g. The effect of the Year 2000 effort on the organization's strategic and operating plans, including earnings, capital, and liquidity.

h. The effectiveness of the audit function and its assessment of internal controls for the Year 2000 process.

27. Prepare recommendations, as appropriate, for the EIC and/or other appropriate supervisors on any additional actions necessary to ensure the organization's safety and soundness associated with its Year 2000 processing capabilities.

28. Summarize the Year 2000 plan's strengths and weaknesses and describe the extent of the organization's Year 2000 readiness.

29. Discuss conclusions with the appropriate level of management and document responses.
To:
The Board of Directors and Chief Executive Officers of all federally supervised financial institutions, providers of data services, senior management of each FFIEC agency, and all examining personnel

Background:
On May 5, 1997, the FFIEC issued an interagency statement entitled "Year 2000 Project Management Awareness" (Interagency Statement) focusing on the project management process and other significant Year 2000 issues. Although the Interagency Statement provided a detailed overview of the Year 2000 project management process, subsequent discussions with financial institutions, vendors and consultants indicate the need for additional guidance regarding regulatory expectations of senior management and the board of directors concerning the business-wide implications of these issues.

Purpose:
The purpose of these safety and soundness guidelines is to outline the responsibilities of senior management and the board of directors for addressing the business risks associated with the Year 2000 problem. Senior management and the board of directors should actively manage efforts to plan, allocate resources and monitor progress to correct Year 2000 problems. This includes managing the internal and external risks presented by providers of data processing products and services (vendors), business partners, counter parties, and major loan customers.
Summary:

These guidelines outline the agencies’ expectations in the following areas:

- The Year 2000 problem is much more than a technology issue; it is an enterprise-wide challenge. Senior management and the board of directors must be actively involved in overseeing internal Year 2000 efforts and monitoring the business risks posed by vendors, business partners, counter parties, and major loan customers.

- In order to be fully informed and provide effective direction, management must provide the board with status reports, at least quarterly, on the financial institution’s Year 2000 efforts. Reporting must include information on the institution’s internal Year 2000 corrective efforts and the ability of the institution’s major vendors to provide Year 2000 ready products and services.

- The regulatory agencies are clarifying the Interagency Statement's guidance that suggested financial institutions seek certification from their vendors that their products and services are Year 2000 compliant. Formal certification is not required as it alone is not sufficient to ensure that a product or service would operate properly in the unique environment of many user institutions. Instead, financial institutions should (a) communicate with their vendors and conduct due diligence inquiries concerning Year 2000 readiness and also (b) implement their own appropriate internal testing or verification processes pertaining to these vendor products and services to ensure that their systems and data function properly together. Financial institutions should develop contingency plans for all vendors that service mission critical applications and establish a trigger date for implementing alternative solutions should the vendor not complete its conversion efforts on time.

- The Year 2000 problem requires an extensive project planning process to ensure that management addresses all business critical issues in a timely and prudent manner. Management must allocate sufficient human and financial resources to the project and should develop/monitor contingency plans for use if Year 2000 corrective efforts do not materialize as expected.

- To increase the probability of successfully resolving Year 2000 problems, financial institutions should work together to find common solutions by sharing successful practices, common testing methodologies and other non-proprietary information.
Enterprise Challenge:

The Year 2000 problem presents corporate-wide challenges for financial institutions, their vendors, business partners, counter parties, and customers. However, the regulatory agencies are concerned that many financial institutions view the Year 2000 issue solely as an information system (IS) problem rather than a broader, enterprise-wide challenge. Many institutions may not have adequately funded their Year 2000 programs and may lack the necessary resources to properly address the issue.

The board of directors should ensure that senior management is taking an enterprise-wide approach to address Year 2000 problems and must provide sufficient resources to resolve Year 2000 problems. For example:

- As the Year 2000 will affect most, if not all, of an institution’s accounting and risk control systems, there should be close coordination between business units and the institution’s operational and risk management functions as conversion programs are executed.
- Financial institutions relying on vendors for information processing services or products should determine their vendors’ progress in resolving Year 2000 issues and the readiness of their own systems and data for appropriate testing. Parties throughout the institution should be involved to coordinate readiness efforts and to develop contingency plans.
- The interdependencies of a financial institution's information systems will require comprehensive testing of applications with all internal and external systems that share information. Senior management should monitor the testing of all mission critical systems.
- The approach of the Year 2000 creates potentially adverse effects on the creditworthiness of borrowers. Corporate customers who have not considered Year 2000 issues may experience a disruption in business, resulting in potential financial difficulties affecting their creditworthiness. Financial institutions should develop processes to identify, assess, and control the potential Year 2000 credit risk in their lending and investment portfolios. The regulatory agencies are preparing additional guidance with respect to their expectations of senior management concerning these indirect risks and other important topics.
Reporting to the Board:

The board of directors must oversee the institution's Year 2000 efforts. Senior management must manage the project on a day-to-day basis, ensuring the appropriate prioritization of resources and establishment of proper benchmarks and time lines. The board must, at a minimum, require quarterly status reports from management that detail the organization's progress in addressing Year 2000 issues. The board should be immediately notified if the project fails to meet critical benchmarks.

The nature and extent of reporting should reflect the complexity of the institution's operations. Reports should include, but not necessarily be limited to, updates concerning the:

- Overall progress of the Year 2000 project, including any new efforts initiated since the last report.
- Progress plotted against the institution's Year 2000 project plan, including comparisons against performance benchmarks.
- Status of efforts by key vendors, business partners, counter parties, and major loan customers to address Year 2000 issues, including any weaknesses discovered and critical decision dates.
- Results of internal and external testing of information processing applications, databases, and systems.
- Contingency planning efforts that outline alternative courses of action in the event existing internal systems or external systems provided by vendors will not be ready for the Year 2000.

Reports to the board, for institutions that are responsible for the renovation of their own mission critical applications, should also be tailored to the complexity of its applications and should provide information that:

- Identifies the total number of applications inventoried during the assessment phase and details the number of mission critical applications in each stage of the five step project management process outlined in the Interagency Statement.
- Informs the board about the progress being made to complete the renovation, testing and implementation of mission critical applications.
- Identifies the number of mission critical applications grouped by the intended resolution strategy (e.g., repair, install vendor upgrade, eliminate/retire, outsource, test only).
- Summarizes the results of internal and external testing.

Board minutes should reflect, as appropriate, any material action taken by the board to address Year 2000 issues or concerns. Board reporting should be available for review by examiners during onsite and offsite supervisory activities.
Clarification of Certification Requirement:

The Interagency Statement suggested that financial institutions obtain certification from their vendors when products and services are Year 2000 compliant. However, the regulatory agencies recognize that certification alone is not sufficient to provide adequate assurance that a product will operate properly in the unique environments of the many user financial institutions. Only a comprehensive test of all internal and external systems and system interdependencies by each user financial institution will ensure that they will function properly together. Therefore, formal certification is not required. Instead, financial institutions should (a) communicate with their vendors and conduct due diligence inquiries concerning Year 2000 readiness and also (b) implement their own appropriate internal testing or verification processes pertaining to these vendor products and services to ensure that their systems and data function properly together. They should monitor closely their vendor’s progress in meeting target deadlines. The vendor’s plan should allow adequate time for user testing in a Year 2000 environment. Topics that should be addressed with vendors include:

- Dates that products will be Year 2000 ready and available for testing.
- Products that will not be Year 2000 ready, or will no longer be supported.
- Methods used to renovate the product or the system to address Year 2000 (e.g., field expansion, windowing).
- The pivot year, if the windowing method is used.
- Any efforts that require coordination between the institution, its vendor and any other parties involved in external testing.
- Vendor guidance on user testing of products.

Financial institutions should develop contingency plans for all vendors that service mission critical applications and establish a trigger date for implementing alternative solutions should the vendor not complete its conversion efforts on time. These plans should consider the institution’s own level of preparedness as well as that of their service providers. Contingency plans should be reviewed at least quarterly and adjusted, if necessary, to reflect current circumstances.

In establishing relevant trigger dates, management should have a thorough understanding of the complex interrelationships between its systems and those of its vendors. An institution also should consider the time necessary to convert the existing system to one that is ready for the Year 2000, the staff training time needed to implement an alternative system, and the availability of alternative systems. If, after a thorough analysis, it appears that the institution’s Year 2000 conversions, or those of its vendors, will not be completed on time, management should be ready to implement its contingency plans. If success is in doubt for complex applications, it may be necessary to begin implementation of the contingency plan while continuing to work on the desired solution. Additionally, it may be necessary to begin renovation on an existing system, if timely implementation of a replacement system is not assured.

For in-house developed applications, the contingency plan should identify how the institution will transition to an alternate system or to an external vendor. For institutions that rely on vendors, the contingency plan should identify alternative suppliers and outline migration plans. In addition, time frames for Year 2000 contingency plans should be consistent with the time frames set forth in the Interagency Statement. The statement establishes December 31, 1998, as the date that institutions will have completed programming changes and have testing well underway for mission-critical systems.
Project Planning and Management:

The Year 2000 problem requires extensive project planning to ensure proper allocations of resources, and to ensure management accountability. The project plan should be formally adopted, enterprise-wide in scope, and contain clearly defined objectives and deadlines. The project plan, at a minimum, should include the following:

- The tasks to be accomplished throughout the term of the project.
- Resource requirements and individuals assigned responsibility for various phases of the project.
- Specific dates for completion of key elements of the project.
- Strategy for responding to inquiries from customers and business partners regarding the institution’s Year 2000 readiness.

Senior management should actively manage resources to ensure that the project remains on schedule. Management should implement processes that monitor the Year 2000 efforts of its vendors, business partners, counter parties, and major loan customers.

The regulatory agencies are concerned that many financial institutions and service providers will underestimate the costs of Year 2000 projects, especially those costs associated with the testing phase. As the Year 2000 approaches, the demand for technical resources will likely rise and the supply of these resources is expected to diminish, thereby increasing costs. Financial institutions must exercise appropriate due diligence in their budget planning to ensure that they have sufficient financial and human resources to complete their Year 2000 plans in a timely manner.

Given the nature and extent of the Year 2000 challenge, management may need to adjust resources throughout the life of the project. If adjustments are needed, management must redefine the project’s scope, and, if appropriate, change the priorities of other data processing projects.

Industry Coordination:

The FFIEC member agencies strongly encourage financial institutions and their trade organizations to work collectively to address issues pertaining to the Year 2000. Effective industry cooperation can help reduce costs. By working together, financial institutions can share ideas, influence vendors, develop best management practices, and maintain their competitiveness with other industries. Financial institutions should consider enlisting industry associations and accounting firms for guidance. If the industry is to be successful in meeting the problems posed by the Year 2000, financial institutions will have to work cooperatively to share effective practices, common testing methodologies and other non-proprietary information.

Footnotes:

1 An application or system is mission critical if it is vital to the successful continuance of a core business activity. An application may be mission critical if it interfaces with a designated mission critical system.

2 Windowing for the Year 2000 involves the establishment of a "pivot year". Dates that are greater than or equal to the pivot year are interpreted to be 19xx. Dates that are less than the pivot year are interpreted to be 20xx.
Press Release

For immediate release

FFIEC Issues Guidance on Vendors and Customers' Year 2000 Risk

The Federal Financial Institutions Examination Council (FFIEC) today issued additional guidance for financial institutions on risks they face due to the Year 2000 date change -- risk from service providers and software vendors and from institutions' customers. Today's guidance follows previous FFIEC Year 2000 statements on project management and business risk.

"Regulators want to make sure senior management and boards of directors are fully aware of the wide range of risks that the Year 2000 date change poses for their institutions," said FFIEC Chairman Eugene A. Ludwig. "Regulators have made a major commitment to this challenge and all financial institutions are expected to do the same."

Vendor Due Diligence Guidance

Today's FFIEC guidance on Year 2000 risks from service providers and software vendors calls for financial institutions to develop a due diligence process that includes identifying mission-critical services and products provided by service providers and software vendors, monitoring procedures to verify that service providers and vendors are taking appropriate Year 2000 action, establishing contingency plans, and testing of these services and products within the environment of the financial institution to the extent possible.

The guidance encourages financial institutions to join other financial institutions through user groups to evaluate and test service providers and software vendors' Year 2000 efforts. These joint efforts may help financial institutions to solicit information and demand performance from service providers and software vendors that provide mission-critical products and services.

Financial institutions should develop contingency plans for all mission critical systems and ensure that they pursue alternative means of achieving Year 2000 readiness in the event the service provider or software vendor cannot complete critical efforts by "trigger dates."

As part of the FFIEC's efforts, the FFIEC agencies are conducting examinations of service providers and will provide the results of these examinations to the federally insured financial institution clients of these servicers. The FFIEC agencies also will inspect software vendors that agree to examinations and, where software vendors consent, the agencies will release the results of those examinations to serviced institutions. The agencies, however, will not certify service providers or software vendors as Year 2000 compliant as a result of these reviews.

Customer Risk Guidance

Today's customer risk guidance outlines a due diligence process that will help financial institutions identify material customers, evaluate their Year 2000 preparedness, assess their
Year 2000 customer risk, and implement controls to manage the risk. A financial institution can face increased credit, liquidity, or counterparty trading risk when its customers encounter Year 2000-related problems. By June 30, 1998, senior management should implement the due diligence process. By September 30, 1998, Year 2000 assessments, based on this due diligence process, should be substantially completed. The customer risk guidance includes sample forms and questionnaires to assist financial institutions in evaluating the Year 2000 preparedness of their customers.

The guidance recognizes that the due diligence process will vary among financial institutions, depending on the size of an institution and the size and technological sophistication of its customers. The FFIEC identifies three major types of customers: funds takers, funds providers, and capital market/asset management counterparties. For funds takers, such as borrowers and bond issuers, the guidance focuses on assessing how the Year 2000 will affect their ability to meet the terms of contracts.

The guidance notes that Year 2000 problems in the second group of customers, funds providers, can increase an institution's liquidity risk. Year 2000 due diligence plans for this group should focus particular attention to funding concentrations, including concentrations from one provider or group of providers.

Steps to limit Year 2000 risk from a third source -- counterparties and capital markets -- may include requirements for additional collateral or netting arrangements on contracts. The guidance underscores that failure by a capital market customer to meet its obligations because of the Year 2000 problem could cause liquidity problems and, in some cases, total loss on financial contracts.

The FFIEC will issue shortly two additional Year 2000 policy statements on testing and contingency planning.

**Interagency Statements**

**Guidance Concerning Institution Due Diligence in Connection with Service Provider and Software Vendor Year 2000 Readiness**

**Guidance Concerning the Year 2000 Impact on Customers**
HOW CONFIDENTIAL IS

BANK CUSTOMER INFORMATION?

Martha Andes Ziskind
PNC Bank, N.A.
Louisville, Kentucky
# HOW CONFIDENTIAL IS BANK CUSTOMER INFORMATION?

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HOW CONFIDENTIAL IS BANK CUSTOMER INFORMATION?

Martha Andes Ziskind

I. Introduction.

A. What is “customer information” in the Information Age?


Today, financial institutions have in their custody enormous amounts of information in addition to transaction records: financial statements, tax returns, credit reports, and often, purchased psychographic and demographic data. Consumers are concerned about (i) what banks do with the information and (ii) the circumstances under which banks make the information available to their affiliates, data processors and third party marketers. See Testimony of Dr. Alan F. Westin, For the Hearing of the Subcommittee on Financial Institutions and Consumer Credit, House Committee on Banking and Financial Services on Electronic Payments Systems, Electronic Commerce, and Consumer Privacy, September 18, 1997, hereafter “Westin Testimony.”

Dr. Westin has found in recent surveys that:

• Eighty-nine percent of the American public said (in late 1996) that they were concerned about threats to their personal privacy in America today, with 55.5% saying they were “very concerned.”

• Eighty-one percent of the public (in 1997) believe that “consumers have lost control over how personal information about them is circulated and used by companies.”
• Americans consider financial information held by banks and credit card firms to be in the top tier of privacy-sensitive data, right alongside medical records;

• Americans also have high confidence that banks are trustworthy keepers of their financial information (ranked alongside health care providers); However, the public does not rate credit card issuers as highly. Because of the marketing uses the public sees being made of credit card transaction information, credit card issuers score only at the medium level in public trust to use their customers’ personal data in “a reasonable way and respecting its confidentiality.” Westin, Testimony, pp 3-4.

B. Does American Law Adequately Protect Customer Information?

Contemporary legal scholars often maintain that there is no general statutory or common law protection for personal information, although they differ on whether legislation is necessary. (See, William J. Fenrick, Common Law Protection of Individuals’ Rights in Personal Information, 65 Fordham L. Rev. 951 (December, 1996); Scott Shorr, Personal Information Contracts: How to Protect Privacy Without Violating The First Amendment, 80 Cornell L. Rev. 1756 (September, 1995), Richard S. Murphy, Property Rights in Personal Information: An Economic Defense of Privacy, 84 Geo. L.J. 2381 (July, 1996), and Kathleen A. Linert, Database Marketing and Personal Privacy in the Information Age, 18 Suffolk Transnat’l L. Rev. 687 (Summer, 1995).

records privacy, contemporary analysts speak of "fair information practices" to guide the collection, retention, use and access to personal information. The recent U. S. Banking Industry Privacy Principles (Attachment A) adopted by the Bankers Round Table, the American Bankers Association, the Consumer Bankers Association, and the Independent Bankers Association, apply the concept of fair information practices to bank "customer information," not just to bank customer records, although case law as generally dealt with disclosure of transaction information.


While the average bank customer believes she has an absolute privacy right to her bank records, and banks have by custom and tradition acted in a manner consistent with this expectation of privacy, case law is inconsistent (or in Kentucky, virtually non-existent). Plaintiffs have framed actions based on implied contract, fiduciary duty, defamation, and invasion of privacy, but with the exception of implied contract, they have generally been unsuccessful in limiting disclosure to private parties. Litigants have been more likely to succeed in protecting bank information from unreasonable police search and seizure under state constitutional law. See, Burrows v. Superior Court, 529 P. 2d. 590 (Calif. 1974), and Commonwealth v. De John, 403 A. 2d. 1283 (Pa. 1978).


A number of courts have found that a bank has an implied contractual duty to keep customer financial information confidential, although this duty is not absolute. (81 A.L.R. 4th 377, supra, and cases therein). Exceptions may include a statutory disclosure requirement, response to legal process, the public interest, or protection of the bank's own interests, although courts disagree on when the exceptions may be appropriate. For example, in Indiana National Bank v. Chapman, 482 NE 2d 474 (Ind. App. 1985), the court stated that a bank impliedly contracts that it will not reveal a customer's financial status unless a public duty arises. The court found a public duty to disclose information about the payment history of a customer's auto loan to a state policeman conducting an arson investigation involving the borrower's car, even though the policeman did not have a subpoena for the records. The court noted that American courts disagree about when the duty of confidentiality may be breached, but held that statements made in good faith to a policeman conducting a criminal
investigation are protected against claims of invasion of privacy, slander, breach of implied contract, or negligence.

B. Disclosure of Bank Records as Constituting an Invasion of Privacy.

The American law of privacy as applied to customer information is discussed in detail in section III, The “Right to Privacy” in Personal Information. Courts have recognized a number of financial institution defenses to breach of privacy allegations, including the free speech protections of the First Amendment (Schoneweis v. Dando, 435 N.W. 2d 666 (Neb. 1989)), implied consent (Baldwin v. First National Bank, 362 N.W. 2d 85 (S.D. 1985)), public nature of the information disclosed (Vespa v. Safety Federal Savings & Loan Association, 549 P.2d 878 (Kan. 1976)); IRS subpoena (Schaut v. First Federal Savings & Loan Association, 560 F. Supp. 245 (N.D. Ill. 1983), dismd. without op., 735 F.2d 1366 (CA 7 Ill, applying Illinois law); and subpoena issued in the course of litigation (Rycroft v. Gaddy, 314 S.E. 2d 39 (S.C. 1984)).

C. A Note on State Financial Records Privacy Statutes.

Kentucky, Indiana and Ohio do not have state financial records statutes. For a compendium of state common law, statutory, and constitutional financial privacy protections as well as state fair credit reporting acts, see, Dreher Langer & Tomkies, L.L.P., Privacy Digest, 1994 with regular supplements. Cases interpreting state law are analyzed in Fisher, Law of Financial Privacy, infra.

III. The “Right to Privacy” in Personal Information.

A. The European Union Directive.

The scope of an American’s right to privacy is currently the subject of intense scholarly debate, but the issue has serious practical implications as well. In 1995, the Council of the Ministers of the European Union adopted a Council Directive “on the protection of individuals with regard to the processing of personal data and on the free movement of such data,” known as the EU Directive. (Directive 95/461 EC of the European Parliament and of the Council of 24 October 1995 on the Protection of Individual with Regard to the Processing of Personal Data and On the Free Movement of Such Data (1995). EU Member states must conform their privacy laws by
mid-1998. Article 25(2) of the EU Directive limits transfer of personal data to non EU countries unless these countries have "adequate" privacy protection for personal information. Whether the American scheme of privacy protection meets EU standards is the topic of debate and ongoing negotiation. See, Information Policy Committee, National Information Infrastructure Task Force, Options for Promoting Privacy on the National Information Infrastructure, Draft for Public Comment, April, 1997, at http://www.iiff.nist.gov/ipc-pub.html, p. 5, hereafter "Options". If the result of the negotiations is a national privacy law for U.S. companies, the impact will be felt by all businesses, whether or not they engage in TransAtlantic data transfer.

B. The Brandeis Formulation.


One example of the right to be left alone aspect of privacy is the Telephone Consumer Protection Act of 1991, Pub. L. No. 102-243, 47 USC 151 et seq. (1997), which requires telemarketers, including banks, to maintain "no call lists", restrict calling hours to 8:00 a.m. to 9:00 p.m., and to have a written Telemarketing Policy available on request to the public. The restrictions do not apply to telephone solicitations to existing customers. See 47 C.F.R. § 64.1200. Kentucky had a similar bill, S.B. 199 introduced into the 1998 legislature.

C. The Restatement Approach.

Professor William Prossor categorized the various tort actions in a 1960 law review article, The Right to Privacy, 48 Calif. L. Rev. 383 (1960). Prosser’s ideas are reflected in the Restatement (Second) of Torts (1977)
Section 652. The Restatement sets out four tort causes of action for invasion of privacy:

(1) unreasonable intrusions upon the seclusion of another (§ 652 B);
(2) appropriation of the other's name or likeness (§ 652 C);
(3) unreasonable publicity given to the other's private life (§ 652 D);
(4) publicity that unreasonably places the other in a false light before the public (§ 652 E).

While nearly every state recognizes the tort of invasion or privacy (652 A, Reporters Notes), few cases have applied the tort to disclosure of personal financial information, often because the disclosure was not widely disseminated. See § 652 D. Comment a. and Murphy, supra, pp 2390-2392. Further, there is no tort liability when disclosure is of information already a matter of public record, such as birthdate or marriage. See § 652 D, comment b. Plaintiffs have unsuccessfully argued that the inclusion of their names on customer lists sold to third parties constitutes the tort of appropriation. See infra, Section IV.

D. Kentucky Cases.

There are two interesting early Kentucky privacy cases, both of which antedate the Restatement (Second). Brents v. Morgan, 299 S.W. 967 (Ky. 1927), was the first Kentucky decision to recognize invasion of privacy. Morgan was a vet who owed $49.67 to his garage mechanic, George Brent. When Morgan repeatedly delayed payment, Brent put up a 5' X 8' notice that said:

Dr. W. R. Morgan owes an account here of $49.67. And if promises would pay an account this account would have been settled long ago. This account will be advertised as long as it remains unpaid. Id. at 968, cited in Murphy, Property Rights, supra, p. 2403.

Morgan won his suit for invasion of privacy on the grounds that the sign created an "evil opinion of him in the minds of tradesmen and the public generally." Id. Less than twenty-five years later, however, the Kentucky
Court of Appeals distinguished the Brents case from a case involving the disclosure of a debt to the debtor’s employer and held disclosure was not an invasion of privacy because “the average man realizes that most employers expect their employees to meet their obligations and that when they fall behind in so doing the employer may be asked to take the matter up with them.” Voneye v. Turner, 240 S.W. 2d 588,591 (Ky. 1951). Voneye contains a good history of the right to privacy to that time. But see, The Fair Debt Collection Practices Act, Pub. L. No. 95-409, 15 U.S.C. 1692 et. seq., which prohibits a third party debt collector from communicating with persons other than the consumer debtor. The Voneye decision contrasts to the famous case of Tournier v. National Provincial & Union Bank of England (1923), 1 K.B. 461, where the implied contract theory was first successfully articulated with respect to bank records. In the Tournier case, when a depositor failed to make good on an overdraft, the bank notified the plaintiff’s employer that the plaintiff wrote a check to a book maker, and the plaintiff’s employment was terminated. Lord Justice Scrutton applied the principle that a judge may imply contract terms which must have been in the minds of the contracting parties, and concluded that “applying this principle to such knowledge of life as a judge is allowed to have, I have no doubt that it is an implied term of a banker’s contract with his customer that the bank shall not disclose the account or, transactions relating thereto, of his customer . . . .” Id at 480, quoted in Indiana National Bank v.Chapman, supra.

IV. Customer Lists.

A. Common Law.

While the common law has afforded some limited protection to customer records, case law has consistently held that a customer has no protectible interest in her name, address and telephone number, when this information is sold or leased to direct marketers or compiled by list processors into psychodemographic customer lists. (On database marketing, see Saul Hansle, Getting to Know You, Institutional Investor 71 (June 1991); Linnert, Database Marketing, supra; Robert O. Harrow, Jr. Data Firm’s Getting Too Personal? The Washington Post, March 8, 1998, p. A01; and articles cited in Section I).

In Shibley v. Time, Inc., 341 N.E. 2d. 337 (Ohio Ct. App 1975), the court found that the sale and rental of magazine subscriber lists to direct mail
advertisers without the subscriber's consent did not invade the subscriber's privacy. For a stinging criticism of this case, see Fenrich, Common Law Protection, supra, p. 989-992.

A more recent case, Dwyer v. American Express Company, 652 N.E. 2d. 1351 (Ill. App. Ct. 1995), cited the Shibley case and upheld the American Express practice of segmenting cardholders by purchasing patterns ("Rodeo Drive Chic," "Value Oriented") and selling segmented cardholder lists to direct marketers. The court found that a single name and address had no intrinsic value; American Express created value by including the name on a segmented marketing list, and the company's practices did not "deprive any of the cardholders of any value their individual names may possess." Id., at 1356.


The current list challenge case involves the sale of a U.S. News and World Report subscriber's name to the Smithsonian, Avrahami vs. U.S. News and World Report, No. 96-203 (Cir.Ct., Arlington County, June 13, 1996). The progress of this case may be followed on the Electronic Privacy Information Center website at http://www.epic.org/privacy/junk mail/law.html. The trial court denied relief.

B. Statutes.

No state statutes have outlawed customer list generation and sale. California, however, permits cardholders to opt out of sale of their names by card issuers. Calif. Civil Code § 1748.12 provides legislative relief for the practice complained of in Dwyer. For an analysis attributing the continuing free-flow of customer lists in part to the economic power of the Direct Marketing Association, see Reidenberg, "Data Protection," supra.
V. Social Security Numbers.


Deposit account opening procedures require disclosure of a social security number, either because of government reporting requirements, e.g., the Bank Secrecy Act, Pub. L. No. 91-508, 12 U.S.C. 1951(a), or to submit a potential customer’s name to CHEX Systems. Several potential customers have challenged PNC Bank’s right to ask for social security numbers as a violation of the Privacy Act of 1974, Pub. L. No. 93-579, 5 U.S.C. 552a (1997), and they have provided a “Privacy Notice” in support of their refusal (Attachment B).

The Privacy Act of 1974 regulates the collection, maintenance, use and dissemination of information by federal agencies by balancing the federal government’s need to gather and use personal information with the individual’s desire to control personal information about herself. The Privacy Act of 1974 imposed disclosure requirements on governmental agencies requesting social security numbers, but it imposed no requirements on private industry.

B. Social Security Act.

Regulations issued pursuant to the Social Security Act of 1935 (42 U.S.C. 1301 (1997)), created the social security number (“SSN”) to track earnings for credit to each worker’s account. In 1962, Congress authorized the IRS to use the SSN as a taxpayer identification number (“TIN”). In 1972, the Social Security Act was amended to require that the SSN be used to identify persons applying for federal benefits. The SSN is now used as the identifier for Medicaid, FDC benefits, food stamps, school lunches and federal loans (42 U.S.C. 405). The SSN is the key to collecting delinquent support under the new Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, 42 U.S.C. 651, et. seq., and serves as the basis for the bank data match programs required by the Act. Kentucky’s Data Match program is contained in H.B. 161.
C. Challenges to Social Security Number Use.

Legal challenges to governmental use of SSNs as identifiers have generally been unsuccessful. Cantor v. Supreme Court, 353 F. Supp. 1307 (E.D. Pa 1973), upheld a state bar requirement that attorneys supply SSNs when they paid state bar dues, but see Greidinger v. Davis, 988 F. 2d. 134 (4th Cir. 1993), holding that the Virginia Voter Registration Statute imposed an "intolerable burden" on the right to vote because a registrant's SSN was disclosed with his name and address to any group obtaining a voter registration list.


Senator Feinstein (D. Calif.) has introduced S. 600, the Personal Information Privacy Act of 1997, to amend the Social Security Act to prohibit the purchase or sale of a social security number or the use of the SSN as an identifier without the written consent of the individual. The bill would also delete the SSN from the header information supplied by credit bureaus. The bill is an attempt to limit "identity theft."

E. State Law.

State law, generally does not restrict bank use of the SSN as an identifier, but see Ohio Rev. Code, Sec. 1349.17, which prohibits a merchant from requiring a customer to provide an SSN when a purchase is made by credit card or check. The SSN may not be disclosed to third parties or used to market other goods and services without consent.

VI. Federal Statutory Protections of Customer Information.

A. The Right to Financial Privacy ("RFP").

The illusory protection afforded to bank records by either the common law or the constitution was made quite clear in the case of Miller v. United States, 425 U.S. 435 (1976), where the Supreme Court held that an individual had no enforceable expectation of privacy in his deposit account records because they were the business records of the bank. Id. at 441-42. Some courts have, however, found protection under state constitutions. Congress responded in 1978 by enacting The Right to Financial privacy Act, Pub. L. No. 95-630, 12 U.S.C. 3401 (1997). The Act sets out certain
notice and other procedural requirements, when the federal government seeks the financial records of individuals or partnerships of five or fewer people. One significant exception to the prior notice requirement is the grand jury subpoena (12 U.S.C. 3402). The best guide to the technicalities of RFP Compliance is contained in L. Richard Fischer, The Law of Financial Privacy: A Compliance Guide, 2d ed. (1991), and annual supplements. Fisher also reports on state law matters and Fair Credit Reporting Act cases. For a recent case demonstrating the pitfalls for banks in complying with the RFP, see Lopez v. First Union National Bank of Florida, 129 F. 3d. 1186 (3d. Cir. 1997).

B. The Fair Credit Reporting Act ("FCRA").

The three largest credit bureaus, Experian, TransUnion, and Equifax, have files on nearly ninety percent of American adults. See, Information Policy Committee National Information Infrastructure Task Force, Options for Promoting Privacy on the National Information Infrastructure, Draft for Public Comment, April, 1997, supra.


Absent prior written consumer consent, a credit bureau may not provide a credit report unless the user certifies to the credit bureau that it has a permissible purpose to obtain the report (15 U.S.C. 1681b). Permissible purposes include:

(a) Extension of credit to, or review or collection of a consumer account.

(b) Employment.

(c) Underwriting insurance.
(d) Assessing credit risks as a potential purchaser, insurer, or servicer.

(e) Having a "legitimate business need" for the information in connection with a business transaction initiated by the consumer or to review an account to determine whether the consumer continues to meet the terms of the account.

Federal Trade Commission legal staff have recently opined that absent written consumer authorization, a cardholder protection program did not have a permissible purpose to obtain a list of program applicants' credit card accounts from a credit reporting agency. Federal Trade Commission, Opinion Letter, March 2, 1998, available at http://nnw.ftc.gov/os/statutes/fcra/buchman.htm.

Even though the service was sold by telephone, the company couldn't obtain the account numbers until the cardholder had provided written consent. Target marketing is not a permissible purpose. The authority of a credit bureau to provide name and addresses (not full credit reports) for target marketing purposes is being litigated. See TransUnion Corporation v. Federal Trade Commission, 81 F. 3rd. 228 (D.C.Cir. 1996).

2. Pre-screening.

As amended, the FCRA gives the consumer the option to opt out of being prescreened for credit and requires prescreening creditors to tell the consumer about the opt out right (15 U.S.C. 1681m). For the first time, creditors may prescreen a customer to whom it has made a "firm offer of credit". (15 U.S.C. 1681a(e)) provided the post screen criteria are established before the prescreen list is generated and the post screen criteria were not available at the time of prescreening (e.g. information received in a consumer's application, such as income).

3. Obligations to Correct Information.

For the first time, banks that report information to the credit bureau must correct any errors brought to the bank's attention by a consumer. (15 U.S.C. 1681s-2(a)(i)(b)). The bank can't simply send the consumer back to the credit bureau. Many banks have
established special addresses for credit bureau related complaints in order to take advantage of the safe harbor provisions of 15 U.S.C. 1681s-2(a)(i)(c), which protect a bank from liability for reporting erroneous information to a credit bureau.

4. **Employment.**

If banks use credit reports as employment criteria, they must get an applicant’s written permission before obtaining the report and provide a preliminary adverse action notice and a copy of the report before denying employment on the basis of a credit report. (15 U.S.C. 1681b(b)).

5. **Affiliate Information Sharing.**

Banks are now specifically authorized to share nontransaction information with affiliated companies provided the consumer is given notice of the sharing and an opportunity to “opt out.” 15 U.S.C. 1681a(2). No restriction is placed on sharing experience or transaction information. Non transaction information includes application, credit reports, and demographics. This authorization does not extend to information sharing with nonaffiliated third parties. Banks that share credit reports with third parties could find themselves deemed a credit reporting agency for FCRA purposes and subject to the onerous requirements imposed on credit bureaus. Note also that the proposed NASD Rule 3121 governing the use and release of customer confidential financial information would require a notice and opt out before even transaction information could be shared by a bank and its NASD member affiliate. NASD Notice to Members, NTM Number 97-12, 1997 NASD & Lexis 15 (March 1997). The proposed NASD Rule 3121 defines confidential information as “any financial information concerning a customer” except for (i) name, address, and telephone number, unless the customer specifies otherwise, and (ii) “information that can be obtained from unaffiliated credit bureaus or other similar companies in the ordinary course of business.” Rule 3121(d).
VII. Fair Information Practices.

Because the law imposes few limitations on nongovernmental collection, use or disclosure of personal information, many writers have supported the adoption of a code of fair information practices, particularly as concerns about computerized data collection have grown. Private industry codes are offered as alternatives to broad ranging privacy legislation.

A. Background.


B. The Computerization of Personal Data.

The increasing computerization of vast amounts of data and the growth of the internet have intensified the public's concern about informational privacy. "In the Information Age, inadequate protection of privileged
financial information among banks, credit bureaus, and software
manufacturers, especially when combined with other information, such as
demographic profiles, could result in the misuse or abuse of personal
information." Options, p. 39. Data mining and data warehousing is leading
to the creation of consumer profiles that merge traditional customer
application and transaction data with purchased lifestyle, demographic and
psychographic data, all of which is fed into the financial firms’ consumer
marketing databases. Westin, Testimony, p. 4. When public records were
paper based, compiling individual personal information took time and
money.

"Today, with commercial databases, networks, and CD
ROMs, anyone with a few skills and minimal resources can
pull together a complete profile on an individual in a few
minutes. These profiles may contain names, addresses,
telephone numbers (even if unlisted), and social security
numbers, in addition to real and personal property assets, as
well as corporate assets and other background information on
executives." Leslie I. Byrne, "Who Watches the Watchers?
A Consumer Prospective on Privacy," in L. Richard Fischer,
Compendium, supra, p.3.

C. The IITF Principles.

In 1993, Vice President Gore, established the Information Infrastructure
Task Force (IITF) to define the Clinton Administration’s vision for the
National Information Infrastructure (NII). The Task Force’s Informative
Policy Committee (IPC) created a Private Working Group, which issued
Principles for Providing and Using Personal Information in 1995, hereafter
IITF Principles. The IITF Principles apply to the collection and use of
information by private industry, not just by government agencies. The IITF
Principles are available at http://www.iitf.nist.gov/ipc/ipc-pub.html and are
reproduced in Fischer, Law of Financial Privacy, 2d. ed, supra, 1997
Cumulative Supplement, Appendix 6.5.

The IITF Principles set out three principles for the collection, use and
disclosure of information on-line:

(1) Personal information should be acquired, disclosed and used only in
ways that respect an individual’s privacy.
(2) Personal information should not be altered or destroyed.

(3) Personal information should be accurate, timely, complete and relevant for the purpose for which it is provided and used. Consumers should be told by information collectors:

(i) why the information is being collected;

(ii) what are the expected uses of the information;

(iii) how will the confidentiality and integrity of information be protected;

(iv) what will happen if the consumer chooses not to provide the information;

(v) what redress does the consumer have if information is wrongfully or inaccurately disclosed.

The Banking Industry Principles incorporate these elements, as do many bank privacy statements. See Attachments C, D, E. Many financial institutions posted Privacy Policies on their websites in anticipation of an FTC website check in March of this year. See FTC Press Release, February 28, 1998, Attachment F.

If the FTC concludes that website privacy is not being adequately protected, it will recommend to Congress that legislation is necessary. None of the bank websites Westin surveyed in the fall of 1997 had privacy statements that told visitors what would be done with the information collected online. Westin, Testimony, p. 8. Many have remedied this deficiency since September.
INTRODUCTION

Financial institutions in the United States are well aware of the need to protect privacy in all forms of commerce. With the advent of electronic banking, consumers are more attuned than ever to the need to protect personal information. The American Bankers Association (ABA), Consumer Bankers Association (CBA) and the Bankers Roundtable (BRT) have developed joint industry privacy principles for the benefit of bankers and consumers.

INDUSTRY PRIVACY STATEMENT

The membership of the participating understand the special duty that financial institutions have with safeguarding their customers' sensitive information. Though this information may be required to be obtained by law or sought by the institution for proper business purposes, such personal information is also vital to each bank's ability to provide its customers with quality service.

Our members recognize the reasonable expectation of privacy for all their customers and the importance of protecting that privacy. Bankers subscribe to these principles as one method to protect customer privacy. These principles may also serve as a foundation upon which individual banks can build their own privacy principles, either as a separate document, or in their institution's code of conduct, tailored to their particular needs and circumstances.

U.S. BANKING INDUSTRY PRIVACY PRINCIPLES

1. Recognition of a Customer's Expectation of Privacy

Financial institutions should recognize and respect the privacy expectations of their customers and explain principles of financial privacy to their customers in an appropriate fashion. This could be accomplished, for example, by making available privacy guidelines and/or providing a series of questions and answers about financial privacy to those customers.

2. Use, Collection and Retention of Customer Information

Financial institutions should collect, retain and use information about individual customers only where the institution reasonably believes it would be useful (and allowed by law) to administering that organization's business and to provide products, services and other opportunities to its customers.

3. Maintenance of Accurate Information

Financial institutions should establish procedures so that a customer's financial information is accurate, current and complete in accordance with reasonable commercial standards. Financial
institutions should also respond to requests to correct inaccurate information in a timely manner.

4. Limiting Employee Access to Information

Financial institutions should limit employee access to personally identifiable information to those with a business reason for knowing such information. Financial institutions should educate their employees so that they will understand the importance of confidentiality and customer privacy. Financial institutions should also take appropriate disciplinary measures to enforce employee privacy responsibilities.

5. Protection of Information via Established Security Procedures

Financial institutions should maintain appropriate security standards and procedures regarding unauthorized access to customer information.


Financial institutions should not reveal specific information about customer accounts or other personally identifiable data to unaffiliated third parties for their independent use, except for the exchange of information with reputable information reporting agencies to maximize the accuracy and security of such information or in the performance of bona fide corporate due diligence, unless 1) the information is provided to help complete a customer initiated transaction; 2) the customer requests it; 3) the disclosure is required by/or allowed by law (i.e. subpoena, investigation of fraudulent activity, etc.); or 4) the customer has been informed about the possibility of such disclosure for marketing or similar purposes through a prior communication and is given the opportunity to decline (i.e. "opt out").

7. Maintaining Customer Privacy in Business Relationships with Third Parties

If personally identifiable customer information is provided to a third party, the financial institutions should insist that the third party adhere to similar privacy principles that provide for keeping such information confidential.

8. Disclosure of Privacy Principles to Customers

Financial institutions should devise methods of providing a customer with an understanding of their privacy policies. Customers that are concerned about financial privacy will want to know about an institution's treatment of this important issue. Each financial institution should create a method for making available its privacy policies.
ATTACHMENT B

PRIVACY ACT NOTICE FROM BANK CUSTOMER
IN SUPPORT OF REFUSAL TO PROVIDE SOCIAL SECURITY NUMBER

FORMAL NOTICE
OF
PRIVACY ACT, TITLE 5 USC

You are hereby being formally put on NOTICE and being advised of the following facts and law as they pertain to the Social Security number and the Privacy Act, Title 5 USC:

A judgement of $1,000.00 plus costs and attorney's fees will be assessed against the individual, business or government agency that denies the requested right, service, benefit, or privilege wherein the person making the request declines to provide their social security number.

A social security number must be used only in the following instances:

1. To receive public assistance
2. To pay taxes and receive refunds

An individual may refuse to give their social security number if requested for any other reason than those listed above.

Form of the Privacy Act: (A) actual damages sustained by an individual as a result of refusal or failure to give a Social Security number shall be entitled to recovery of no less than the sum of $1,000.00; and (B) the costs of the action together with reasonable attorney fees as determined by the court.

Awards may be recovered from the government agency, business or individual who denies the right, benefit or privilege. See Federal court decisions set forth below:


2. The Act..."was enacted for (the) purpose of curtailing the expanding use of social security numbers...and to eliminate the threat to individual privacy and confidentiality of information passed by common numerical identifiers." Doyle v. Wilson, D. C. Del. 1982, 529 F. Supp. 1343.

3. "(a) (1) It shall be unlawful...to deny to any individual any right, benefit, or privilege provided by law because of such individual's refusal to disclose his social security account number." Guidelines and Regulations for Maintenance of Privacy and Protection of Records on Individuals.

THEREFORE: I do hereby declare my specific right not to disclose a Social Security Number to this place of business for the reasons stated above, and that I will sue under the Privacy Act if services are denied as a result of my non-disclosure of said number. By my presentation of this NOTICE to you you have been duly warned and put on NOTICE.
Our goal is to serve you as effectively and conveniently as possible—but also to make you feel confident that your relationship with Wachovia is treated with the appropriate confidentiality.

Trust, privacy and confidentiality are the guiding principles upon which Wachovia's foundation was built. With Wachovia's Privacy Policy, we're confident you will understand that these fundamental standards continue today.

For more information, view Wachovia's Privacy Policy.
Consumer Privacy and How It Affects You

- Overview
- Wachovia Employees
- Information Collection
- Records Security
- Accuracy
- Sharing Consumer Information
  - Within Wachovia
  - With Outsourcers
  - With Consumer Reporting Agencies
  - With Government
  - With 3rd Party Litigants
- Removal From Lists

**Overview**
Technology and new marketing practices have increased the amount of customer information collected and shared in today's marketplace. Consumers are concerned about the impact this development has or might have on their privacy and reputation. At Wachovia we are sensitive to the importance of these concerns. We want to serve consumers as effectively and conveniently as possible, and such service involves making use of technology and customer information. But we also want our customers to be confident that their relationship with Wachovia is treated with the appropriate confidentiality. We therefore commit to customers that we will take reasonable steps to protect the privacy of the information shared with us. Our customers are protected not only by state and federal laws but - even more importantly - by Wachovia's commitment to them.

**Wachovia Employees**
Wachovia employees are informed of their responsibility to protect confidential customer information and are bound by this Privacy Policy.
They are governed by a code of conduct that includes the responsibility to protect the confidentiality of customers' financial and other personal information.

Only employees actively engaged in the discharge of their assigned duties are authorized to access or use customer information.

Information Collection
Information about consumers is accumulated from a variety of sources. Some information is provided to Wachovia directly by customers themselves. Other data is developed by Wachovia as a function of providing a product or service to a customer. Still other information is obtained from outside sources. We will limit the use and collection of information about our customers to that which is necessary to administer our business, provide superior service, and offer opportunities that we think will be of interest to customers. This means that we will use information to help us identify and mitigate potential risks or loss to Wachovia. We will use information to help identify additional products or services which we believe customers might want to know about. We will use this information only in accordance with the principles set out in this Policy.

Records Security
We will maintain and grant access to customer information only in accordance with Wachovia's internal security standards.

Accuracy
Equally important, we will strive to ensure that the information concerning our customers is accurate. Customers are protected by the Fair Credit Reporting Act, which requires us to notify consumers whenever consumer reports from third parties have been used to solicit business from them. We may use such reports only for the purpose of prescreening business prospects when a customer or potential customer has authorized a consumer reporting agency to furnish us a report, or when making a customer or potential customer a firm offer of credit or insurance. Consumers are entitled to request credit reporting agencies to remove their names from lists supplied to us.

We must also notify an applicant if we decline any application made by them and have used a consumer report during the processing of the application. If this occurs, even if the report was not the basis for the decision to decline the application, we will provide the applicant with the name and address of the reporting agency. Consumers are entitled to obtain free copies of reports from reporting agencies and have such reports corrected by the agency concerned if those reports contain inaccurate information. If we declined an application for other reasons, we will tell the applicant why or give the applicant an opportunity to request the reasons.

Sometimes, as in the case of insurance, we are merely an agent for the carrier that actually provides the product. In such cases, any decision to decline an application for insurance will be made by the carrier, not by Wachovia, and the applicant's right to know whether a consumer report was used or why the application might have been declined will apply directly to the carrier, not Wachovia. In that situation, Wachovia will tell the applicant whom to contact in order to ask questions or obtain more information to ensure that the applicant's rights are protected. Wachovia intends to employ reasonable measures to ensure the accuracy, timeliness and completeness of our customer information. If we become aware of inaccuracies in our records, we will take prompt steps to make appropriate corrections.

Sharing Consumer Information
When Wachovia serves in a legally recognized fiduciary capacity, such as a trustee of a trust or the personal representative of an estate, no customer information arising from that fiduciary relationship is shared with other divisions within or other legal entities within the Wachovia organization of Wachovia without the express consent of the customer. Fiduciary relationships by law provide an even higher degree of confidentiality and privacy than general banking relationships. As part of our effort to provide customers with comprehensive and effective service, we use customer information to determine whether customers might want to know about certain Wachovia products and services. Even in nonfiduciary situations, to protect customer privacy, we will control carefully the way in which any information about customers is shared. Unless we have a customer's advance authorization to do otherwise, we will treat the customer's information only in the following ways:
Within Wachovia
We are permitted to share within the Wachovia organization information concerning a customer's account history and experiences with Wachovia. In some situations, a person might disclose or authorize the disclosure of medical information as part of an application for a specific product such as insurance. We will share any such medical information only with those who need to know this information in order to process the application. We will not allow this information to be used elsewhere within Wachovia for any other purpose.

We may also share among the legal entities that comprise the Wachovia organization:
- information someone has given us as part of an application for one of our products or services, or
- information we have received from a consumer reporting agency or other third party.

Customers may request us not to share this type of information by calling the toll free number at the end of this document, whereupon the information will not be shared.

With Outsourceses, 3rd Party Participants & 3rd Party Vendors
Sometimes specific customer information has to be shared with companies we hire to provide operational support, companies that participate with us in supplying products and services to customers, and companies that promote products and services on our behalf. Except in unusual situations (where they might be governed by federal or state laws to the contrary), these companies are not permitted to use our customer information for purposes other than the provision of the service intended. We will share your information with these companies only if they agree to treat it confidentially.

Occasionally, Wachovia makes a decision to sell a particular line of business (for example, mortgage servicing rights). Usually, an integral part of that business is its customer database. Wachovia reserves the right, in these unusual circumstances, to transfer ownership of such customer databases to the purchaser.

With Consumer Reporting Agencies & Other Companies
We will exchange information about our customers with reputable information reporting agencies, financial institutions, and merchants, in accordance with standard banking industry practice, so we can verify the existence and condition of customers' accounts. We do not share specific personal customer information with independent companies for any other purpose without the customer's consent.

With the Government
The Bank Secrecy Act, Internal Revenue Code, Right to Financial Privacy Act, the Welfare Reform Act and various other laws and regulations require us or our contractors, under certain circumstances, to provide certain customer information to government agencies. We will only disclose customer information to the government or others when we are required to do so by such laws, regulations, or by court order. State and federal laws impose certain mandatory disclosures of customer information by financial institutions. We must comply with laws that require mandatory production or disclosure.

With 3rd Party Litigants
If you are involved in a legal proceeding, both federal and state law provide parties to the litigation the right to compel the production of records and information from banks and other third party record keepers in certain situations. We will only disclose customer information to third party litigants when we are required to do so by lawful judicial process or by court order.

Removal from Lists
Consumers may request to be excluded from telephone solicitations by Wachovia and third party providers working with Wachovia. Persons who do not wish to receive such telephone calls may inform the person calling them accordingly and they will be placed on a list of persons we may not solicit by phone.
While this may mean consumers might not receive product information of interest to them, we will also respect anyone's wish not to receive promotional mail solicitations (i.e., mailings independent of routine statement and other customer service mailings) if so requested. To make this request, please call the toll-free number below.

Customers should be aware that third parties with which Wachovia might coincidentally have business relationships may also have access to customer information that has been obtained independently of Wachovia. Mailings and solicitations based on this information are not within Wachovia's control.

If you would prefer not to have your information (other than credit and experience history) shared among Wachovia's affiliates, or if you wish to be removed from Wachovia's lists for special offers, please call 1-888-226-4297. Our operators will be happy to process your request.
Norwest Privacy Principles

Our Customer Privacy Principles

At the family of banks and companies affiliated with Norwest Corporation, we know how important personal privacy is to you. Because of our interest in protecting your privacy, we continue to examine the practices of the banks and companies within the Norwest family. As a result, Norwest banks and companies have adopted the following privacy principles, continuing our commitment to provide To The Nth Degree® service to you, our valued customer:

1. Recognition of Your Expectation of Privacy.
We recognize that you expect privacy and security for your personal and financial affairs. We understand the need to safeguard our sensitive information about you that you have entrusted to us within the Norwest family. We maintain standards and procedures designed to protect misuse of this information.

2. Our Collection, Retention, and Use of Information about You.
We collect, retain, and use information about you only where we reasonably believe that it will help administer our business or provide products, services, and other opportunities to you. We collect and retain information about you only for specific business purposes -- and we will tell you why we are collecting and retaining it upon your request. We use information to protect and administer your records, accounts, and funds; to comply with certain laws and regulations; to help us design or improve our products and services; and to understand your financial needs and provide you with quality products and superior service. Our Use of Information brochure explains these concepts in greater detail.

3. Our Maintenance of Accurate Information.
We have procedures to help assure that your financial information is accurate, current, and complete in accordance with commercial standards. We also have procedures to respond to your requests to correct inaccurate information in a timely manner. While some of these procedures are required by federal or state law, the Norwest family of banks and companies have implemented additional procedures to maintain accurate, current, and complete financial information, including processes to update information and remove old information.

4. Limiting Employee Access to Information.
We have procedures and security levels that limit employee access to personally identifiable information to those employees with a business reason to know such information about you. We educate our employees about the importance of confidentiality and customer privacy through standard operating procedures, special training programs, and the Norwest Corporation "Code of Ethics." We take appropriate disciplinary measures to enforce employee privacy responsibilities.
5. Security Procedures to Protect Information.
We maintain security standards and procedures to help prevent unauthorized access to confidential information about you. We update and test our technology to improve the protection of our information about you and to assure the integrity of our information.

6. Restrictions on Disclosing Information to Parties Outside the Norwest Family.
We do not reveal specific information about your accounts or other personally identifiable data to parties outside the Norwest family for their independent use unless: (1) you request or authorize it; (2) the information is provided to help complete a transaction initiated by you; (3) the information is provided to a reputable credit bureau or similar information reporting agency; or (4) the disclosure otherwise is lawfully permitted or required. Our Use of Information brochure explains these concepts in greater detail.

Sometimes it is necessary to provide personally identifiable information about you to a third party, such as to a vendor or service company that we hire to prepare your account statements or to provide support or services for one or more of our products. These vendors and service companies agree to safeguard our confidential information about you and your products and services with us and must abide by applicable law.

8. Disclosing Our Privacy Commitment to You.
We want you to understand our commitment to personal privacy and our use of information. For this reason, we have prepared these Privacy Principles and a Use of Information brochure. These materials will answer most of the important questions that you may have about how we gather, protect, and use information within the Norwest family. You may obtain our Use of Information brochure at any Norwest Bank and many other Norwest business locations or by sending a request, along with a stamped, self-addressed return envelope, to: Norwest Operations Center (M.S. 6058), P.O. Box 5128, Sioux Falls, South Dakota 57117.

These Customer Privacy Principles apply to individuals, and we reserve the right to change them, along with related provisions, at any time.
At Chase, we strive to make life easier for our customers. One way that we do this is by using customer information to provide our customers with superior service and convenient access to the right products and services. We also recognize that our customers have important expectations regarding the use of that information.

Safeguarding customer information is a matter that we take seriously. That is why we at Chase have set forth the following principles to affirm our long-standing commitment to confidentiality:

- We share information regarding customers among our banks and affiliated companies only in accordance with strict internal security standards and confidentiality policies and with applicable law.
- We hold our employees fully accountable for adhering to those standards, policies and laws.
- We do not share information about our customers with other companies except in order to conduct our business, comply with applicable law, protect against fraud or make available special offers of products and services that we feel may be of interest to our customers. We may also provide information to regulatory authorities and law enforcement officials in accordance with applicable law.
- We have established high standards for protecting information regarding our customers from unauthorized alteration or destruction.
- We investigate customer inquiries regarding information received from Chase (or from a credit bureau reflecting information provided by Chase) that the customer believes to be inaccurate and take steps to correct information we determine to be incorrect. Customers should notify us if they receive information regarding their Chase relationship that they believe to be inaccurate.

At Chase, information regarding our customers is used solely in the legitimate conduct of our business, to deliver superior service and to design products and special offers...
that demonstrate our understanding of our customers and their needs.

As we move forward in developing new products and services in an era of vast technological change, we will continue to maintain our dedication to assuring that customer information is properly used and appropriately safeguarded.

November 1997

*These principles are currently applicable to Chase banks and affiliates in the conduct of their consumer business in the United States.*
FOR RELEASE: FEBRUARY 26, 1998

FTC STAFF TO SURVEY
CONSUMER PRIVACY ON THE INTERNET

Agency to Review 1,200 Web Sites
for Privacy Policy Disclosures

Beginning in March, the Federal Trade Commission staff will survey 1,200 commercial Web sites to determine the extent to which these sites, including sites directed to children, are disclosing how they collect and use personal information online. The staff also will analyze how many sites offer consumers choice regarding how their personal information is used. The Commission is currently preparing a report to Congress on the effectiveness of self-regulatory approaches to protecting consumers' privacy online. The survey results will be included in this report.

Over the past three years, the Federal Trade Commission has been examining the personal privacy and consumer protection issues raised by the collection and use of information about consumers as they use the Internet. A number of public workshops have been held by the agency's Bureau of Consumer Protection. Throughout the workshops, the online industry has advocated self-regulation as the most efficient and effective means of creating online privacy protections. In addition, trade association representatives have made commitments to develop privacy policies as guidance for their members, and to encourage their members to disclose their own information practices on their Web sites. As part of the report to Congress, the Commission also will assess existing industry guidelines and principles. The Commission requests that interested trade associations and industry groups submit their guidelines and principles for consideration.

The notice requesting industry guidelines and principles on online collection and use of consumers' personal information will be published in the Federal Register shortly. Submission is requested by March 31. All of the guidelines and principles submitted in response will be available for public inspection at the FTC's Consumer Response Center, Room 130, Sixth Street & Pennsylvania Avenue, N.W. Washington, D.C. 20580 and to the extent technically possible on the FTC's web site at: http://www.ftc.gov (no period).

The Commission's vote to approve the Federal Register notice was 4-0, with Commissioner Mary L. Azcuenaga not participating.

Copies of the notice, the transcripts of the workshops, a FTC staff report titled, "Consumer Privacy on the Global Information Infrastructure," as well as public commentary submitted for the workshops are available on the FTC's web site at http://www.ftc.gov and also from the FTC's Consumer Response Center; 202-326-3128; TDD for the hearing impaired 202-326-2502. To find out the latest news as it is announced, call the FTC NewsPhone recording at 202-326-2710.

MEDIA CONTACT:
Victoria Streitfeld
Office of Public Affairs

D - 31
IN-HOUSE COUNSEL / OUTSIDE BANK COUNSEL

PROFESSIONAL RESPONSIBILITY & UNAUTHORIZED PRACTICE OF LAW
CONSIDERATIONS IN DETERMINING WHAT INSIDE BANK COUNSEL CAN DO

Jessica R. Schumacher
Bank One Corporation
Bank One, Kentucky, NA
Louisville, Kentucky

and

Grace M. Giesel
Louis D. Brandeis School of Law
University of Louisville
Louisville, Kentucky

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SECTION E
## IN-HOUSE COUNSEL / OUTSIDE BANK COUNSEL

Professional Responsibility & Unauthorized Practice of Law Considerations In Determining What Inside Bank Counsel Can Do

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SECTION E
I. Unauthorized Practice

A. In General

The primary rationale by far for the regulation of the unauthorized practice of law is protection of the public from the unscrupulous, unskilled and incompetent. In Frazee v. Citizen's Fidelity Bank & Trust Co., 393 S.W.2d 778 (Ky. 1964), the Kentucky Court stated:

The basic consideration in suits involving unauthorized practice of law is the public interest. Public interest dictates that the judiciary protect the public from the incompetent, the untrained, and the unscrupulous in the practice of law.


Yet, attorneys are the complainers, not the public. In a survey of unauthorized practice activity in 1979, Professor Deborah Rhode noted that only 2% of the unauthorized practice matters dealt with that year involved customer complaints. Rhode, supra at 33 & 43. Professor Rhode termed the public “curiously unsupportive.” Id. at 3. See also ABA/BNA Lawyers Manual On Professional Conduct 21:8010.

The regulation of unauthorized practice of law outside of Kentucky has declined in the last third of the twentieth century, in part as a result of public needs and perceptions, and in part as the result of First Amendment See NAACP v. Button, 371 U.S. 415 (1963); B'hood of Railroad Trainmen v. Virginia ex. Rel. Va. State Bar, 377 U.S. 1 (1964); UMW Dist. 12 v. Illinois State Bar Ass'n, 389 U.S. 217 (1967). Antitrust concerns were also a factor. See Nonlawyer Activity, supra at 23-32. Christensen, supra at 199-201. See generally Christensen, supra at 190-197, for a discussion of the era in general.
In 1977 the American Bar Association discontinued publication of Unauthorized Practice News Christensen, supra at 190. In 1984 the American Bar Association Unauthorized Practice of Law Committee ceased to exist. See 1994 Survey, supra at xiv.

Unauthorized practice regulation has been described as "among the most complex, controversial problems facing the legal profession". 1994 Survey supra at vii. A prevalent criticism is that the legal profession regulates the unauthorized practice of law in the name of protection of the public, but no true evaluation of the need for protection, the public's desire for protection, or the cost of such protection has accompanied the regulation. See generally Alan Morrison, Defining the Unauthorized Practice of Law: Some New Ways of Looking at an Old Question, 4 Nova L.J. 363 (1980) (costs have not been a relevant consideration); Thomas D. Morgan, the Evolving Concept of Professional Responsibility, 90 Harv. L. Rev. 702 (1977) (public interest in justice at low cost is last consideration). 1994 Survey, supra at xvii (if unauthorized practice of law is to be based on public protection, specific harm must be established); Christensen, supra note 44, at 201-03 (same). See also ABA/BNA Lawyers Manual of Professional Conduct, 21:8011.

Further, many commentators have noted the patent conflict of interest present when the legal profession in the form of attorneys, bar associations and judges have the responsibility to decide the bounds of the practice of law. See Rhode, supra at 97 ("Enforcement of sweeping prohibitions has rested with those least capable of disinterested action"); Morgan, supra (noting the self-interest present); Comment, Control of the Unauthorized Practice of Law: Scope of Inherent Judicial Power, 28 U. Chi. L. Rev. 162 (1960). Professor Deborah Rhode's survey reported in the early 1980's reflected that consumers viewed unauthorized practice regulation as "self-protective", "monopolistic", and "greedy". See Rhode, supra at 40.

B. Kentucky's Ethical Proscription (Rules and Statute)

1. Kentucky Supreme Court Rule 3.130 (5.5).

The rule states:

A lawyer shall not:
(a) Practice law in a jurisdiction where doing so violates the regulation of the legal profession in that jurisdiction; or

(b) Assist a person who is not a member of the bar in the performance of activity that constitutes the unauthorized practice of law.

Most jurisdictions follow either a version of Rule 5.5 or DR 3-101, which
states:

(A) A lawyer shall not aid a non-lawyer in the unauthorized practice of law.

(B) A lawyer shall not practice law in a jurisdiction where to do so would be in violation of regulations of the profession in that jurisdiction.

2. The Practice of Law Defined by Supreme Court Rule 3.020

Kentucky defines the practice of law in **Supreme Court Rule 3.020** as follows:

The practice of law is any service rendered involving legal knowledge or legal advice, whether of representation, counsel or advocacy in or out of court, rendered in respect to the rights, duties, obligations, liabilities, or business relations of one requiring the services. But nothing herein shall prevent any natural person not holding himself out as a practicing attorney from drawing any instrument to which he is a party without consideration unto himself therefor. An appearance in the small claims division of the district court by a person who is an officer of or who is regularly employed in a managerial capacity by a corporation or partnership which is a party to the litigation in which the appearance is made shall not be considered as unauthorized practice of law.

3. The Criminal Statute: KRS524.130

Kentucky also has a criminal statute dealing with the unauthorized practice of law. **KRS524.130** states:

(1) Except as provided in KRS341.470 and subsection (2) of this section, a person is guilty of unlawful practice of law when, without a license issued by the Supreme Court, he engages in the practice of law, as defined by the Supreme Court.

(2) A licensed nonresident attorney in good standing, although not licensed in Kentucky, is not guilty of unlawful practice if, in accordance with rules adopted by the Supreme Court, he practices law under specific authorization.
4. In House Counsel Exception: Supreme Court Rule 2.111

Kentucky Supreme Court Rule 2.111 allows out of state attorneys to practice law in Kentucky as long as the employer is the only client.

Some other states do the same.

C. Unauthorized Practice in Kentucky by Kentucky Attorneys

1. General Summary

Kentucky has long regulated and attempted to define what is an activity within the definition of the practice of law and what is not. Many of these cases involved lay persons, though some did not.

A layperson can do acts within the definition of the practice of law if that layperson does so for himself (pro se). If a layperson does those same acts for another person, it is the unauthorized practice of law.

Kentucky has taken the position, traditionally, that a corporation cannot be licensed to practice law and thus cannot practice law authorizedly.

A layperson employee cannot do activities within the definition of the practice of law for the corporation because that layperson arguably would be acting for another. Even if the layperson is viewed as the clear agent of the corporation, the corporation is then practicing law-- impermissible action.

A corporation can, of course, employ attorneys to do activities within the practice of law definition for the corporation employer. As long as the attorney, inside or out, is representing only the employer, there is no unauthorized practice of law.

If an attorney employed by a corporation represents another party other than the employer, the corporation is said to be practicing law unauthorizedly via the attorney employee. Note here that the attorney, assuming the attorney is licensed fully in Kentucky, has full authority to perform the activities at issue. For example, the attorney can prepare a deed for another person the day before the attorney becomes employed by a corporation. It is solely by virtue of the involvement of the corporation that the attorney can be said to be assisting the corporation in the unauthorized practice of law.
2. A Critique

a. American Insurance Association v. Kentucky Bar Association

In American Insurance Association v. Kentucky Bar Association, 917 S.W.2d 568 (Ky. 1996), the Kentucky Supreme Court disagreed with almost all of the courts and ethics committees who have addressed the issue of representation of insureds by employee attorneys of insurers. The Court refused to allow an insurer's in-house lawyers or outside retained attorneys working on a set fee basis to defend insureds. The Court based the stance on the following:

1. The theory that such representation would constitute the unauthorized practice of law because it would violate the long held position that a corporation cannot practice law in the state of Kentucky; and

2. The conviction that such representation was doomed by the conflicts of interest presented by the situation.

The matter came before the Court because several insurers and insurer groups requested that the Supreme Court review an Advisory Ethics Opinion, E-368, Kentucky Bench & Bar, Fall 1994, 52, which the Kentucky Bar Association Board of Governors had rendered. The insurers asked the Supreme Court to review not only the Advisory Ethics Opinion but also an older Unauthorized Practice of Law Opinion, U-36, Kentucky Bench & Bar, Winter 1982, 36-37, since the Advisory Ethics Opinion appeared to rely upon it.

Unauthorized Practice Opinion U-36 specifically addressed the following question:

"May an insurance company employ in-house counsel (salaried employees) to represent their insured after a lawsuit has been filed?"

U-36 answered in the negative and relied on Kentucky case law which had held that a corporation cannot have a license to practice law and therefore cannot practice law except unauthorizably.

The Kentucky Supreme Court began by stating that it "hereby approve[s] and adopt[s]" Advisory Ethics Opinion E-368 and that it "choose[s] not to disturb" Unauthorized Practice Opinion U-36. The Court stated:

Notwithstanding the trends of other jurisdictions, any alleged nonsensical application of the prohibition against the
unauthorized practice of law, and the untapped resource of "competent, trained and scrupulous" in-house insurance defense counsel as pipe cleaners for a clogged legal system, we do not feel that U-36 deserves review.

The Court found "no compelling reason to overrule the more than fifty years of legal precedent which recognizes the principles outlined in that opinion," meaning the Unauthorized Practice Opinion, U-36. The Court quoted the 1943 case of Kendall v. Beiling, 175 S.W.2d 489 (Ky. 1943), a case dealing with the practice not of law but of optometry, stating, "'[t]here is scarcely any judicial dissent from the proposition that a corporation cannot lawfully engage in the practice of law.'" The Court continued by quoting from Hobson v. Kentucky Trust Company of Louisville, 197 S.W.2d 454 (1946), stating, "'a corporation [] cannot obtain license to practice law, since it is wholly incapable of acquiring the educational qualifications necessary to obtain such license, nor can it possess in its corporate name the necessary moral character required therefor.'" The Court then stated that "'[n]othing has changed since the rendering of Kendall and Hobson, or since the adoption of U-36 to assuage the moral dilemmas and ethical concerns connected to the unauthorized practice of law.'"

In dismissing contrary conclusions from other jurisdictions on the particular issue of in-house attorneys of insurers representing insureds, the Court stated: "we are convinced ... that few of the other jurisdictions to which Complainants cite have conducted any meaningful analysis of the issues presented, nor do these jurisdictions share our state's aversion to the practice of law by corporations." To support this statement the Court noted that the Kentucky Bar Association had distinguished the Tennessee case of In re Youngblood, 895 S.W.2d 322 (Tenn. 1995), by stating that Tennessee "does not proscribe a corporation from practicing law for the public".

This statement is incorrect. In fact, Tennessee does have an "aversion" to corporations practicing law. Tenn. Code Ann. 23·3·103 (1996) states:

No person shall engage in the "practice of law" or do "law business," or both, ..., unless such person has been duly licensed therefor, and while such person's license therefor is in full force and effect, not shall any association or corporation engage in the "practice or law" or do "law business," or both, ....
b. Why Corporations Cannot Practice Law Via In-House Attorneys

One would assume that an attorney is competent whether he or she works in-house or out. Thus, the rationale of unauthorized practice that the regulation is protecting the public from unskilled and incompetent charlatans evaporates.

Kentucky and other jurisdictions, when the issue involves an in-house attorney for a corporation, seem to have concerns about the zeal or loyalty of the in-house attorney. The primary stated rationale supporting the application of unauthorized practice regulation to employee attorneys of corporations has focused on the lawyer-client relationship and its personal nature. See Christensen, supra at 187-89. See also Frederick C. Hicks & Elliott R. Katz, The Practice of Law by Laymen & Lay Agencies, 41 Yale L.J. 69, 72 (1931). Because the attorney-client relationship is one of trust and confidence, that relationship cannot exist when the corporate employer controls the attorney. A New York court, writing in 1910 in the era of special concern with the threat of corporate competition in the legal services market, stated in In re Co-Operative Law Company, 92 N.E.15 (1910):

The relation of attorney and client is that of master and servant in a limited and dignified sense, and it involves the highest trust and confidence. It cannot be delegated without consent and it cannot exist between an attorney employed by a corporation to practice law for it, and a client of the corporation, for he would be subject to the directions of the corporation and not to the directions of the client....[The attorney’s] master would not be the client but the corporation, conducted to may be wholly by laymen, organized simply to make money and not to aid in the administration of justice which is the highest function of an attorney and counselor at law....There would be no remedy by attachment or disbarment to protect the public from imposition or fraud, no stimulus to good conduct from the traditions of an ancient and honorable profession, and no guide except the sordid purpose to earn money for stockholders.

Thus, this rationale focuses specifically on the idea that an attorney employed by a corporation but representing another client would have his or her independence of judgment impermissibly constrained as a result of the employer corporation exercising employer-like control. For another example of this sort of reasoning, see Richmond Ass’n of
Credit Men v. Bar Ass'n of the City of Richmond, 189 S.E. 153 (1937). See also Cal. Eth. Op. 1987-91, 1987 WL 109707 ("The rationale prohibiting a corporation from retaining attorneys to provide legal services to third parties was premised on the personal relationship of trust and confidence between attorney and client which would be undermined by a corporation undertaking to furnish its members with legal advice, counsel and professional services.").

The American Insurance Association opinion and U-36 surely evidence this sort of concern.

Secondly, without doubt, prohibiting corporations from employing lawyers who arguably represent parties other that the corporation keeps the competition from competing. As a restraint on competition in the legal services market, such regulation is suspect. If such regulation has, as a rationale, the restraint of competition, it is even more suspect. Restraining competition is not a "protection of the public rationale;" it is a "protection of attorneys" rationale and in particular a rationale to protect private attorneys.

One need look no farther than Hobson v. Kentucky Trust Co. of Louisville, 197 s.W.2d 454 (Ky. 1946), for concrete evidence of this anticompetitive motivation. The Court stated that the plaintiff, a private attorney, alleged that the Trust Company, a corporation, was practicing law "without being licensed or sworn so to do, and in unlawful competition with the plaintiffs." In Frazee v. Citizen's Fidelity Bank & Trust Co., 393 S.W.2d S.W.2d 778 (Ky. 1964), the complaint was not only that the bank was doing acts within the definition of the practice of law, but that it was advertising and soliciting business at a time when attorneys could not. Finally, in Unauthorized Practice Opinion U-32 (1981), after addressing the lawyer independence issue, stated:

If corporations were permitted to offer as an inducement legal services for the public in connection with their business, the end result would be that all legal work other than the actual courtroom trial of cases would be performed by corporations.

3. An Alternative: Professional Responsibility Rules, Not Unauthorized Practice of Law Regulation

a. Kentucky Supreme Court Rule 3.130 (1.8(f))

Kentucky Supreme Court Rule 3.130 (1.8(f)) states in relevant part:
A lawyer shall not accept compensation for representing a client from one other than the client unless:

(1) Such compensation is in accordance with an agreement between the client and the third party or the client consents after consultation;

(2) There is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

(3) Information relating to representation of a client is protected as required by Rule 1.6.

b. Kentucky Supreme Court Rule 3.130(1.7)

Kentucky Supreme Court Rule 3.130(1.7) states:

(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:

(1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and

(2) each client consents after consultation.

(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:

(1) The lawyer reasonably believes the representation will not be adversely affected; and

(2) The client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

c. Kentucky Supreme Court Rule 3.130(5.4(a))

Kentucky Supreme Court Rule 3.130(5.4(a)) states in part:

A lawyer or law firm shall not share legal fees with a nonlawyer, ....
d. Kentucky Supreme Court Rule 3.130(5.4(c))

**Kentucky Supreme Court Rule 3.130(5.4(c))** states:

A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.

4. Key Cases

a. Federal Intermediate Credit Bank of Louisville v. KBA, 540 S.W.2d 14 (Ky. 1976)

The Court noted that Kentucky State Bar Association v. First Federal Sav. & L. Ass'n., Ky., 342 S.W.2d 397 (1961), had "held that although a corporation may properly employ its own licensed attorney to render legal services wholly for itself, it cannot sell to the public a service that includes legal services performed by its salaried attorney."

The Court then stated: "we are of the opinion that a lending institution certainly may have its mortgages drafted by its own counsel, so long as it collects for itself no charge against the borrower for that service and, as emphasized hereinafter, either its own counsel or some other licensed attorney passes judgment on and is responsible for the final product."

The Court recognized that "Frazee v. Citizen's Fidelity Bank & Trust Co., Ky., 393 S.W.2d 778, 784 (1965), held that a bank or trust company cannot, through either salaried attorneys or lay employees, prepare deeds or mortgages for other persons; and Kentucky State Bar Association v. Tussey, Ky., 476 S.W.2d 177, 179 (1972), held that a lay employee cannot prepare legal instruments for his corporate employer, even though the employer is a party to the instrument."

The Court continued, "we are of the opinion that when a lending agency presents to the borrower for execution a real estate mortgage that has been completed on a form prepared by one lawyer, with information such as the property description and payment schedule copied by a lay person from a loan application and a title certificate furnished by another attorney, neither of the respective attorneys having examined the instrument in its final form prior to execution by
the borrower, the lending agency is practicing law without a license."

b. Kentucky State Bar Association v. Tussey, 476 S.W.2d 177 (Ky. 1972)

In this case the Court considered the situation of a lay employee preparing real estate mortgages for a bank. The Court stated that practicing law "'includes giving advice and preparing wills, contracts, deeds, mortgages, and other instruments of a legal nature.' Howton v. Morrow, 269 Ky. 1, 106 S.W.2d 81, 82 (1937). Ordinarily, therefore, the drawing of a real estate mortgage by one person for another would amount to the practice of law."

The Court continued, "In the case before us the bank was a party to the mortgages in question and would have the right to prepare such instruments if it were physically possible for it to do so. But a corporation is an artificial person, not capable of performing any act except through the agency of others, and for that reason it cannot come within the meaning of a 'person' as the word is used in [the statutes]."

And, finally, the Court stated that "the preparation of real estate mortgages for a bank by an officer of the bank, whether it be with or without remuneration from the mortgagee to the bank or to the officer, constitutes the practice of law."

c. Frazee v. Citizens Fidelity Bank & Trust Co., 393 S.W.2d 778 (Ky. 1964)

This opinion arose from a contempt proceeding against five trust companies for the unauthorized practice of law in performance of their fiduciary services. As fiduciaries, the trust companies, through salaried lay and legal employees, appeared in probate court, drafted all necessary papers and made final settlements of estates without other legal counsel.

With regard to rationale, the Court stated that "'[t]he basic consideration in suits involving unauthorized practice of law is the public interest. Public interest dictates that the judiciary protect the public from the incompetent, the untrained, and the unscrupulous in the practice of law. Only persons who meet the educational and character requirements of this Court and who, by virtue of admission to the Bar, are officers of the Court and subject to discipline thereby,
may practice law. The sole exception is the person acting in his own behalf."

The Court continued, "Faced with our constitutional responsibilities and in view of the public interest, we conclude that invoking the jurisdiction of the county probate court through pleadings or appearances is the practice of law. Consequently, when probate or fiduciary documents are filed in the probate court or other court of record by a corporate fiduciary, they must be in the name and by the authority of a licensed attorney, except as otherwise herein provided. Of course, a corporation may not engage in the practice of law through salaried attorneys even as an incident to its commercial business."

In a rather obvious bow to the illegitimate competition rationale, the Court stated, "A trust institution, qualified and authorized by law as a legitimate business enterprise, has an inherent right to advertise its trust services in appropriate ways. It shall not, directly or indirectly, offer to give legal advice or render legal services, and there shall be no invitation to the public, either direct or by inference in such advertisement, to bring their legal problems to the trust institution. Its advertisement shall be dignified and the qualifications of the institution shall not be overstated or overemphasized, and it shall not be implied in any advertisement that the services of a lawyer are only secondary or ministerial, or that by the employment of the services of the trust institution, the employment of counsel to advise the customer is unnecessary."

Finally, the Court provided a laundry list of "thou shalts" and thou shalt nots." The Court stated:

The following services shall not be performed by a bank or trust company, either through salaried attorneys or lay employees:
1. Drafting wills or trust instruments.
2. Offering wills for probate.
3. Handling formal court proceedings.
4. Drafting papers or giving advice concerning revocation of wills.
5. Resolving questions of domicile and residence.
6. Handling proceedings involving allowance of widows, children, or wards.
7. Drafting deeds and mortgages.
8. Preparation of filing of assignments of rent.
9. Drafting any formal legal documents to be used in the
discharge of a corporate fiduciary's duty.
10. Giving legal advice or legal counsel, orally or written, to
any person, firm or corporation.
11. In estate and inheritance taxes, and federal and state
income tax matters:
   a. Executing waivers of statute of limitations, without
      the advice of the attorney for the estate, trust or
      guardianship and/or a specialized outside tax attorney.
   b. Preparing and filing protest or claims for refund,
      except requests for a refund based on mathematical or
      clerical errors in tax returns filed by it as a fiduciary.
   c. Conferring with tax authorities regarding protests or
      claims for refund, except those based on mathematical
      or clerical errors in tax returns filed by it as a fiduciary.
   d. Handling petitions to the Tax Court.
12. Securing appropriate court orders for the prompt sale or
disposition of such assets of the estate as may be subject to
depreciation, deterioration or loss.
13. Preparing contracts or court orders as may be required to
conservate the estate or operate the business of the decedent
during the course of administration.
14. Terminating any pending litigation in which decedent had
an interest.
15. Instituting or defending on behalf of the executor,
administrator or trustee any litigation.

The following services relating to the administration of estates, trusts,
guardianships or other fiduciary activities may be performed by a
bank or trust company:
1. Using form custodians and management agent agreements
   prepared by its counsel.
2. Discussing the business and financial aspects of fiduciary
   relationships with customers and prospective customers and
   with persons who are considering a renunciation of the right to
   qualify as executor or administrator, or who propose to resign
   as a guardian or trustee.
3. Performing any clerical, accounting, financial, or business
   acts in the preparation of any inventory or account required of
   it as a fiduciary. Filing such inventory and account after
   furnishing a copy to the attorney for the estate, trust or
   guardianship in order that all legal aspects may be verified.
4. Performing acts jointly for themselves and for a co-fiduciary
relating to their joint duties, provided such duties, under this Statement, are otherwise proper for trust companies acting alone.

5. Acting as an agent for a foreign corporate fiduciary and performing such services as would be permitted under this Statement if the trust company were acting as the fiduciary.

6. Acting for the protection of their interest as fiduciaries in insolvency proceedings short of formal hearings before a referee in bankruptcy or in court.

7. Making appointments with the custodian of security for opening safedeposit boxes.

8. Opening safe-deposit boxes.


10. Searching tax records to determine the real and personal property which decedent had listed for tax purposes.

11. Marshaling assets of the estate; providing for the security and preservation of the interest of all beneficiaries of an estate, trust or guardianship.

12. Providing for the prompt protection or disposition of the assets of an estate, trust or guardianship that may be perishable, subject to rapid depreciation or otherwise in peril.

13. Paying uncontested claims.

14. Giving notice of the termination of a lease because of default by the lessee.

15. Demand and receiving payment of life insurance policies payable to the estate of the fiduciary's decedent or to the corporate fiduciary as trustee or as guardian.

16. Demand and collecting claims, without litigation.

17. Filing a copy of a will in a county other than the county of the decedent's domicile.

18. Demand the foreclosure of deeds of trust which are in default.

19. Notifying beneficiaries under a testator's will by furnishing such beneficiaries with applicable portion of testator's will relating to each beneficiary.

20. Securing death tax waivers in order to transfer property from the decedent's estate.

21. Giving and taking receipts of all types.

22. Engaging in advertising the business and financial aspects of their services as executor, trustee, or guardian and estate planner with a clear statement that all legal implications involved in each service will be handled in cooperation with the customer's own attorney.
23. Performing ministerial and clerical acts in the preparation and filing of any tax return required of it as a fiduciary.
   a. In the case of a federal estate or Kentucky inheritance tax return, filing such return after furnishing a copy to the attorney for the estate and affording him an opportunity to question and discuss same.
   b. In the case of fiduciary income and intangibles tax returns, copies of such returns shall be furnished the attorney for the estate, trust or guardianship prior to filing upon request by such attorney.
24. Collecting rents, payments due, interest, dividends and other income due the estate or trust.
25. Keeping all buildings and fixtures in repair during the course of administration of the estate or trust.
26. With court authority, continuing to operate any business of decedent.
27. Assembling such information and records as may be needed for the preparation and filing of any partial or intermediate settlement required by the court.
28. Assisting in location of heirs, their names, ages, residence and degree of relationship.

d. Kentucky State Bar Association v. First Federal Sav. & Loan Ass’n of Covington, 342 S.W.2d 397 (Ky. 1960)

The issue was whether First Federal Savings and Loan Association of Covington, Kentucky, engaged in the unauthorized practice of law. First Federal had hired an in-house attorney whose principal work consisted of examining and passing judgment on the validity of titles to property which will be mortgaged to the respondent as security for its loans.

First Federal, noted the Court, “had title examinations made by its attorney in connection with all real estate loans financed by it. Since this attorney was on a straight salary, he did not receive a legal fee for each of these examinations, nor was a specific attorney fee therefor charged the borrower. It is respondent's contention that since this legal service was being performed on its behalf and no direct charge was made for the service to the borrower, it could not be engaged in the practice of law.”

The Court stated, “A corporation may properly employ its own attorney to render legal services for it. The position of the Bar
Association is that the title examination service is not being rendered for respondent but for the borrower, and in addition (or in confirmation of that fact), the borrower is required to pay for it. If respondent, a corporation, is actually rendering a legal service to members of the public, and particularly if it is making a charge for such service, it is engaged in the unauthorized practice of the law."

The Court noted that "the title examination is not made exclusively for the benefit of respondent. A clear title is one of the conditions upon which it will make a loan. The examination is made primarily for the benefit of the borrower so that he can comply with this essential condition. The fact that a charge is made to the borrower for this service, if such a charge is made, simply confirms the fact that the legal service is being rendered for him."

Further, the Court stated that "in making loans respondent collects from the borrower a 'service charge' which ostensibly is made up of the actual costs of making a loan. On a 'loan settlement statement' furnished the borrower, which respondent at one time used, these 'service charges' were itemized as 'credit report,' 'survey,' 'appraisal,' 'exam. of title' and 'recording fees.' (Our emphasis.) In filling out this statement respondent did not normally list the separate charges but simply wrote in the total amount of the service charge which was fixed in accordance with its graduated scale (based upon the amount of the loan). However, on the veterans' loan forms submitted to the Veterans Administration, a specific charge was sometimes itemized for 'title examination.' In respondent's annual report to the Federal Home Loan Bank a substantial item of 'net operating income' is listed as, 'appraisal fees, legal fees and initial service charges.' (Our emphasis.)

The Court continued, "it is clear from this record that the 'service charge' made by respondent to the borrower included a variable amount which in fact (even if not in form) is a fee for the legal service of title examination. This is evident when we observe that the other items making up the 'service charge' (excepting the 'survey,' which apparently is rarely made) are substantially the same regardless of the amount of the loan and the increased 'cost' for a larger loan can only be attributable to the increased charge for the title examination. Likewise, respondent could not make a profit on these service charges (which it does) except upon this variable item which is not an actual fixed cost, (i. e., a specific expenditure of respondent for which it is entitled to reimbursement)."
Therefore, the Court concluded, “It is clear from this record that (1) respondent renders to the borrower a title examination service, which is a legal service, and (2) respondent makes a charge for this service. ... The inescapable fact is that respondent renders to the borrower and charges the borrower a fee for the legal service of title examination. The professional relationship between the borrower and respondent’s attorney is entirely absent.”

Finally, the Court stated, “A corporation, even though employing one or more lawyers, may not itself engage in the practice of law. Kendall v. Beiling, 295 Ky. 782, 175 S.W.2d 489. In essence the present case involves substantially the same character of service considered in Hobson v. Kentucky Trust Co., 303 Ky. 493, 197 S.W.2d 454. In that case we held that it constituted an unauthorized practice of law for a trust company, in acting as a fiduciary, to furnish as part of its trust services those services which were legal in nature, even though the legal advice upon which the company acted was given by an attorney in its employment. The furnishing of the title examination service in the present case falls within the same category.”

e. Hobson v. Kentucky Trust Co. Of Louisville, 197 S.W.2d 454 (Ky. 1946) (overruled in part by Frazee v. Citizens Fidelity Bank & Trust Co., 393 S.W.2d 778 (Ky. 1964))

The petition alleged that the Louisville Trust Company, a corporation, “engaged in the practice of law in this state without being licensed or sworn so to do, and in unlawful competition with the plaintiffs.” Specifically, the claim was “[a] That defendant engages regularly and for compensation, as a part of its business, in the drafting of wills, deeds, trust instruments and other legal documents in which it is appointed, as agent or other fiduciary that may be required to carry out the provisions of the particular writing. That in doing so it gives legal advice to the maker of such documents with reference to the disposition or transmission of estates, as well as the rights of the beneficiaries and other pecuniarily interested parties therein; and (b) that it has engaged in the practice of law by conducting necessary litigation, through its permanently employed attorneys or other hired employees that may be required of it as the duly appointed fiduciary in the administration of its powers conferred upon it as such.”

In finding that such acts were the unauthorized practice of law if done by an unlicensed actor, the Court stated that “the very nature of things a legislative created person, known in the law as a corporation,
cannot obtain license to practice law, since it is wholly incapable of acquiring the educational qualifications necessary to obtain such license, nor can it possess in its corporate name the necessary moral character required therefor."

The Court, quoting Howton v. Morrow, 106 S.W.2d 81, defined the practice of law as follows: "Practicing law is not confined to performing services in actions or proceedings in courts of justice, but includes giving advice and preparing wills, contracts, deeds, mortgages, and other instruments of a legal nature."

The Court found that the Trust Company should be enjoined from "writing deeds, wills, conveyances and other legal documents requiring expert knowledge and equipment in their phraseology so as to comport with the law relating to such matters; or engaging in preparing any instrument wherein it is designated as fiduciary to enforce and administer the provisions in same, or to hold itself out as possessing the requisite knowledge so to do. If, however, the maker of such an instrument on isolated occasions should apply without solicitation on his own volition to defendants to act as the maker's amanuensis in framing the instrument he desires to execute, and for which defendant receives no compensation, it may perform such duty, and likewise it may, for and on behalf of itself when beneficially interested in the corpus of the trust (or the estate to be administered), prepare any instrument creating such benefit to itself as a 'party'".

5. Key Ethics Opinions

a. KBA U-50 (1997)

Question: Maya financial and tax consulting firm, with lawyer and non-lawyer employees, solicit estate planning business and for a fee prepare estate planning documents for individual customers?

Answer: No.

The Opinion goes though the basic analysis that the activities would be within the definition of the practice of law and so unlicensed persons could not do it for another person. With regard to the employment of staff lawyers to do the acts, the Opinion stated: "Neither corporations nor their salaried employee attorneys may offer legal services to the public. ... Practicing attorneys who review
documents prepared by non-lawyer employees or such marketers, or who share fees with such marketers, aid the unauthorized practice of law in violation of SCR 3.130(5.5)(b) and 3.470."

b. KBA U-44 (1990)

Question: May a bank distribute forms for "living wills" and assist their customers by notarizing "living will" instruments?

Answer: Qualified yes.

In answering this question the Opinion notes: "It is the law of Kentucky that a corporation (including a bank) may not prepare legal documents for its customers or for any other party, unless the Bank has some interest in the transaction. If the bank is a party to the transaction, it may have its in-house staff prepare documents for the bank and the customer (for example, the borrower) so long as no fee is charged."

c. KBA U-32 (1981)

Question 1: May a non-lawyer (including, but not limited to, an independent "employee benefit consulting firm" or an independent "financial consulting firm") either directly or through its employees, provide services to the public relating to the establishment of pension and profit sharing plans and trusts?

Answer: No.

In reaching this conclusion, the Opinion dealt with the issue of the services being provided by a corporation as follows: "The public interest demands that the professional services of a lawyer should not be controlled or exploited by any law agency, whether personal or corporate, which intervenes between the client and the attorney. If corporations were permitted to offer as an inducement legal services for the public in connection with their business, the end result would be that all legal work other than the actual courtroom trial of cases would be performed by corporations. Advising the public as to the substance and validity of pension and retirement plans as well as the actual drafting of such documents are matters which demand legal training and constitute an important area of the practice of law."

The Opinion went on to quote and cite the case law for the position that a
corporation can use attorneys to represent itself but not others because a corporation cannot practice law. The Opinion also restated the Frazee list.

d. KBA U-31 (1981)

Question: does a real estate mortgage lender, or a title insurance company on behalf of a real estate mortgage lender, commit the unauthorized practice of law by performing the ministerial acts necessary in the closing of a real estate loan?

Answer: Qualified no.

The Opinion warned of the limits set by the case law.

e. KBA U-23 (1978)

Question: Where a bank or other financial institution employs a "legal department" which is staffed with salaried attorneys who act on behalf of the bank in telephone calls, conferences, filing papers in court, and appearing at depositions, is the bank, as a corporation, engaged in the unauthorized practice of law?

Answer: No.

After discussing the case law, the Opinion clarified the law: "By looking at the above cases, one may abstract the following test, which may be used in determining whether a corporation is practicing law through a salaried attorney: Are the legal services rendered by the attorney wholly for the corporation itself or for the public, to which the bank is making a charge for such services."

See also KBA Unauthorized Practice Opinion U-36 (1981), discussed supra section C.2. of this Outline.

D. Legal Advice Given by an Out of State Lawyer is Unauthorized Practice of Law


This Opinion stated that a nonresident attorney must be assisted by
Kentucky counsel when he represents his client and employer in an administrative hearing in Kentucky.

2. Other jurisdictions


A New York firm with no attorneys licensed in California performed legal services for a California-based client under a fee agreement stipulating that California law applied to all matters in the representation. Client eventually sued for malpractice and the firm counterclaimed for the fee. The court held that the firm had engaged in the unauthorized practice of law contrary to California law and thus the fee agreement as it related to the California activities, was unenforceable.

**The court found that the activities of the attorneys in rendering legal advice and representing the California client was within the definition of the practice of law. In dealing with whether the practice of law was “in California”, the court noted that physical presence in the state was one factor but was not in itself determinative. The court noted that one may practice “in California” “by advising a California client on California law in connection with a California legal dispute by telephone, fax, computer, or other modern technological means” although the Court noted that not every time a lawyer “virtually” enters the state is there an unauthorized practice. The Court stated that the test is

“sufficient contact with the California client to render the nature of the legal service a clear legal representation. In addition to a quantitative analysis, we must consider the nature of the unlicensed lawyer’s activities in the state. ...The primary inquiry is whether the unlicensed lawyer engaged in sufficient activities in the state, or created a continuing relationship with the California client that incuded legal duties and obligations.”

The Court took the position that the enforcement of the unauthorized practice rule against out of state counsel was in line with the rationale of unauthorized practice regulation in general. The Court noted that just because the out-of-state attorney is admitted somewhere does not mean that attorney is competent in regard to California law. Note the irony that the firm is being sued for malpractice for the California activities too.

Ms. Sachs, who lived in New York, convinced a friend, Spivak, an attorney admitted in California, to come to New York and advise her about a proposed property settlement in her divorce action. The action was in Connecticut court and Ms. Sachs had other representation. Spivak went to New York for fourteen days and advised Ms. Sachs, discussing various issues with her and reviewing the property settlement documents. Later, when Sachs refused to pay Spivak's bill, Spivak sued.

New York's highest court refused the request for payment on the basis that the activities in New York were the unauthorized practice of law. The Spivak court stated:

There is, of course, a danger that [the unauthorized practice ban] could under other circumstances be stretched to outlaw customary and innocuous practices....[R]ecognizing the numerous multi-State transactions and relationships of modern times, we cannot penalize every instance in which an attorney from another State comes into our State for conferences or negotiations relating to a New York client and a transaction somehow tied to New York. We can decide those cases when we get them but they are entirely unlike the present one.

c. Ranta v. McCarney, 391 N.W.2d 161 (N.D. 1986)

The North Dakota Supreme Court refused an attorney his fees because the fees related to the unauthorized practice of law. The attorney was admitted in Minnesota but not North Dakota. He had North Dakota clients and a Bismarck, North Dakota office. The fees related to advice Ranta gave a North Dakota resident about his North Dakota business. The advice, however, involved the federal tax law, not North Dakota law.

The court stated that a lawyer admitted in a foreign state must be treated the same as an in-state lawyer suspended from the practice. Such individuals are prohibited from the practice of law which includes "all advice to clients, and all action taken for them in matters connected with the law...."

d. Michigan's Out of State Lawyer Exception

Michigan permits out of state lawyers to provide legal advice to clients while present in the state as long as the lawyer's presence in Michigan is temporary and the advice is limited to the specific matter for which the client has retained the lawyer. Mich. Comp. Laws Ann. §600.916 (West 1995).

II. Other Professional Responsibility Issues


Question: May a former "in-house" lawyer for a corporation or other entity [see Rule 1.13] represent a client in a matter adverse to the interests of the corporation or entity if the matter is substantially related to matters handled by the lawyer when he or she worked 'in-house" for the corporation or entity?

Answer: No.

The Opinion clarifies that an in-house counsel's former employer is the attorney's former client. The Opinion then refers to rule 1.9 and 1.10, having listed those rules in the "References" section.

Rule 1.9 is the former client rule. It states:
A lawyer who has formerly represented a client in a matter shall not thereafter:
(a) Represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client consents after consultation; or

(b) Use information relating to the representation to the disadvantage of the former client except as Rule 1.6 would permit with respect to a client or when the information has become generally known.

Rule 1.10 is the imputed disqualification rule. It states:
(a) While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7, 1.8(c), 1.9 or 2.2.

(b) When a lawyer becomes associated with a firm, the firm may not knowingly represent a person in the same or a substantially related matter
in which that lawyer, or a firm with which the lawyer was associated, had previously represented a client whose interests are materially adverse to that person and about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(b) that is material to the matter.

c. When a lawyer has terminated an association with a firm, the firm is not prohibited from thereafter representing a person with interests materially adverse to those of a client represented by the formerly associated lawyer unless:

(1) The matter is the same or substantially related to that in which the formerly associated lawyer represented the client; and

(2) Any lawyer remaining in the firm has information protected by Rules 1.6 and 1.9(b) that is material to the matter.

(d) A disqualification prescribed by this rule may be waived by the affected client under the conditions stated in Rule 1.7.

The Opinion then states:

Clearly, the lawyer may not attack his or her own prior work or represent anyone in connection with a matter in which the lawyer participated personally and substantially while working “in-house.” Compare Rule 1.11(a).

This language is unfortunate and mysterious. The test of representation in an former client scenario as stated above in Rule 1.9 does not involve a determination of personal and substantial involvement. That is the test of representation in Rule 1.11 which deals with a government lawyer who moves into the private sphere. Rule 1.9 analysis looks at whether the later matter is “the same or substantially related matter in which that person’s interests are materially adverse.” The two tests require different analyses and E-387 leaves one to wonder which is correct.

B. Kentucky Supreme Court Rule 3.130(1.13)

Kentucky Supreme Court Rule 3.130 (1.13) deals with the organizational client. The Rule states:

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act
or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization. Such measures may include among others:

(1) Asking reconsideration of the matter;
(2) Advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and
(3) Referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law.

c. If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly a violation of law and is likely to result in substantial injury to the organization, the lawyer may resign in accordance with Rule 1.16.

(d) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(e) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.
UNIFORM COMMERCIAL CODE
AND
FAIR DEBT COLLECTION PRACTICES ACT
UPDATE

John T. McGarvey
Morgan & Pottinger, P.S.C.
Louisville, Kentucky

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SECTION F
UNIFORM COMMERCIAL CODE  
AND  
FAIR DEBT COLLECTION PRACTICES ACT UPDATE  

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SECTION F

**Senate Bill 352**

This Bill repeals nonsensical and surplus sections of the old Article 3. The new Article 3, effective January 1, 1997, re-codified the former 3-802(1) as 3-310, the former 803 as 3-119, and the former 3-804 as 3-309. Former sections 3-701, 3-801, 3-802(2), and 3-805 were intentionally omitted from the Revised Code. The 1996 Bill enacting the model amendments to Article 3 repealed sub parts 1-6 of the old version, but, by oversight, did not repeal sub parts 7 & 8, which were not replaced as sub parts but are not part of the revised article. Senate Bill 352 corrects that error.

**House Bill 94**

Nearly every legislative session sees a bill that would add non-uniform language to KRS 355.9-503 or KRS 355.9-504 on self help repossession and the sale of collateral. This year's bill was House Bill 94. The Bill would have required that a motor vehicle repossessed in Kentucky be sold in Kentucky. The Bill would have had an extremely adverse effect on creditors who use, and have sometimes gone to the expense of setting up, regional auctions in locations such as Clarksville Indiana, Evansville Indiana, and Nashville Tennessee. The Bill was withdrawn.

**House Bills 116 and 739**

Kentucky is the only state in the union that does not have any form of central filing system or central search system for liens perfected under the Uniform Commercial Code. Our first attempt to address the problem was at the time the Legislature adopted the model amendments of Article 9 in 1986. However, Kentucky's county clerks strongly objected to central filing on the basis that the local lien filing system produces 25% of the revenue to operate their offices.

Beginning in 1988, and each in legislative session since, there has been an attempt to establish a central search system. Under this system, liens would continue to be recorded in local clerk's offices but would also be electronically recorded in a central data base in the office of the Secretary of State. Several states, including Georgia and Louisiana have adopted the system first offered in Kentucky that combines the convenience of local filing with the efficiency of central
116 was this year's attempt to establish a central search system for Kentucky. The bill never made it out of committee.

The Bill that passed, HB-739, is described by one lobbyist as a "streamlined" version of central search. This bill establishes a central search system but does so through a system of dual filing. Financing statements, amendments, and continuation statements must, effective January 4, 1999, be filed in both the appropriate county clerk's office and in a new Kentucky Lien Information System established in the office of the Secretary of State.

As well as creating the new Kentucky Lien Information System, the bill amends existing part 4 of Article 9 to require that all UCC filings (financing statements, continuation statements, terminations, releases, amendments, and assignments) contain an identification number for the debtor. The number for a person other than an individual will be the Internal Revenue Service Taxpayer Identification Number. For individuals the number may be their Social Security number or "a number assigned in accordance with administrative regulations promulgated by the Secretary of State."

How the new law relates to the UCC perfection system will ultimately be decided by the courts. Although the bill specifies that the filing in the Secretary of State's office is for informational purposes only (an amendment added at the request of the county clerks), the Secretary of State filing is mandatory.

The Text of HB-739:

SECTION 1. A NEW SECTION OF KRS CHAPTER 14 IS CREATED TO READ AS FOLLOWS:

(1) It is the intent of the General Assembly that a statewide computerized lien information system be created to accumulate, index, and disseminate information relative to liens and related filings made with the Secretary of State according to Article 9 of KRS Chapter 355.

(2) The Kentucky Lien Information System is hereby created and established as a division within the Department of State.

(3) The Kentucky Lien Information System shall be operation beginning on January 4, 1999.

SECTION 2. A NEW SECTION OF ARTICLE 9 OF KRS CHAPTER 355 IS CREATED TO READ AS FOLLOWS:
(1) Notwithstanding a filing made to perfect a security interest in the place set forth in KRS 355.9-401, a secured party shall file a financing statement, or any amendment, assignment, continuation, release, or termination related thereto, in the Office of the Secretary of State. The financing statement, amendment, assignment, continuation, release, or termination filed under this section shall be on a form prescribed by the Secretary of State.

(2) The Secretary of State shall receive a fee of one dollar ($1) for the filing made under this section.

(3) The filing requirement of this section shall not apply when the collateral is timber to be cut or is minerals or the like, including oil an gas, other than coal, or accounts subject to subsection (5) of KRS 355.9-103, other than accounts arising out of the sale of coal, or when the financing statement is filed as a fixture filing under KRS 355.9-313 and the collateral is goods which are or are to become fixtures.

(4) The secretary of State shall index all filings made under this section for inclusion in the Kentucky Lien Information System.

(5) A filing made in accordance with this section shall be for notice purposes only.

II. Court Decisions Interpreting Kentucky's UCC after January 1, 1977.

Concrete Materials Corporation v. Bank of Danville and Trust Company, 938 S.W. 2d 254 (Ky. 1997).

Over a period of eight years, a plant manager, who had the duty of depositing checks written to his employer, converted proceeds to his own use. He would tender a deposit slip that showed cash back equal to one of the deposited checks. He would then have the teller stamp a second deposit slip that listed the net amount of the deposit. The second deposit slip was forwarded to company
headquarters. When they discovered the scheme, the company sued the Bank of Danville to recover the stolen funds represented by 547 unauthorized withdrawals.

The Kentucky Supreme Court, affirming the Court of Appeals, properly applied KRS 355.4-406 by concluding that the deposit slip reflecting unauthorized cash was an altered "item" and subject to the one year limit for reporting fraud in an account. The fraud was shown on the original deposit slip that the bank returned to the customer, however, the customer had relied on the duplicate obtained by its manager.

Although based on the former version of Article 4, the definition of "item" under the revised version, and the one year reporting limit, remain under revised Article 4. Issues not addressed by the Court include the deposit agreement that reduced the one year reporting limit to 60 days, and the question of violation of the "for deposit only" endorsement of the checks.


The central issue of this decision is who is the Bank's debtor. The note showed that the Burrus Group, Inc. was the borrower. However, no representative capacity appeared following the signatures of Harold Burrus and Janice Burrus. The Kentucky Court of Appeals correctly applied KRS 355.3-403(2)(b)[now KRS 355.3-402(2)(b)] and reversed a Summary Judgment in favor of the Bank. The court ruled that:

"... parol evidence is admissible to show that the immediate parties to the note had an understanding that the persons who signed the note would not be personally liable for debt." Id. P. 891


Tobacco Warehousemen are granted special protection under KRS 355.9-307(2). The statute provides that

"... the warehousemen selling such tobacco crop shall not be liable to the holder of such lien, unless written notice by certified mail, return receipt requested, of such lien, the name and address of the debtor and proper description of the property subject to the lien, are given to the tobacco warehousemen prior to the payment of the proceeds of sale to the owner or producer of such tobacco crop."

The question decided by the Court of Appeals was whether the warehousemen may invoke the protection of this statute when it is a lender to the tobacco farmer as opposed to a mere seller of the crop.

Farmers Bank had properly perfected its security interest through filing under the Uniform Commercial Code. Its security interest attached to the tobacco crop and the proceeds in the hands
of the warehousemen. The Court of Appeals, reversing the trial court, found that KRS 355.9-307(2) was intended to protect a warehouseman acting as a middleman seller, but not as a creditor of the debtor. The Court found the purpose of the statute was "... to protect warehousemen, who unknowingly sell tobacco subject to a security interest, from the potential of double liability - once from the farmer and again from the lender who sues them for conversion." The Court did not find that the protection extended to the warehousemen as a creditor. This was a first impression case on the issue.


The Kentucky Court of Appeals ruled that the only means to protect a security interest in a mobile home, even one affixed to real estate, is through a title lien statement and the lien appearing on a Kentucky Certificate of Title for the mobile home. A lessor claimed an interest in a mobile home under the recorded lease for the real estate to which the mobile home was affixed. Bank one had complied with the requirements of KRS Chapter 186A and perfected its security interest through the notation of its lien on the title to the mobile home. Judge Gudgel's opinion emphasized the straightforward language of KRS 186A.190(2):

> Notwithstanding the existence of any filed financing statement under the provisions of KRS Chapter 355 relating to any property registered or titled in Kentucky, the sole means of perfecting and discharging a security interest in property for which a certificate of title is required by this Chapter is by notation on such property's certificate of title.

Judge Gudgel found that both Chapter 186A and Chapter 355:

> "... clearly and unambiguously provide that, as to any property for which a Certificate of Title is required by KRS Chapter 186A, security interest in that property may be perfected or discharged only by notation in that vein on the Certificate of Title."

_Id._ at 198.


This is a significant decision for any financial institution that purchases dealer paper or expects to assert a purchase money security interest in motor vehicles. The contest between Chrysler Credit and a trustee in Bankruptcy involved the trustee's effort to avoid Chrysler's lien. Chrysler's lien was not noted on the Kentucky Certificate of Title until 38 days after its customer received possession of the vehicle. The trustee contended that this was outside the twenty-day "relation back" exception in 11 USC Section 547 (c)(3) and that the trustee could avoid Chrysler's lien. Chrysler asserted that its customer did not have rights in the collateral sufficient for the security interest to attach until the
Kentucky title was issues. However, the Court found that the term "rights in the collateral" as used in KRS 355.9-203(c) does not equate with ownership, and that possession of the vehicle was sufficient for the security interest to attach. The Court found that as a matter of law, that the belated perfection of the security interest was a preferential transfer that the trustee could avoid.

This decision was buttressed by the decision of the United States Supreme Court in Fidelity Financial Services v. Fink, Trustee, 118 S.Ct. 651 (U.S. 1998). In that case, the secured creditor mailed the perfection documents 21 days after the debtor took possession of the vehicle. A state statute allowed 30 days in which to perfect. However, the Court found that the last act to "perfect" the lien occurred more than 20 days after the customer obtained possession, and because the debtor granted the security interest within 90 days prior to the bankruptcy filing, the trustee had a good argument for setting aside the transfer as a preference.


A reminder that secured creditors should always take and perfect a security interest in general intangibles. The Bankruptcy Court correctly found that the premium refund from a canceled prepaid insurance account was a general intangible, and subject to the perfected security interest of the secured party.

III. Status of Kentucky's Uniform Commercial Code.

Except for Article 5 on Letters of Credit, Kentucky's Uniform Commercial Code tracks the model version of all articles. Kentucky enacted the model version of Article 2(a) on Leases in 1990, the model versions of Articles 3 and 4 in 1996 (effective January 1, 1997), repealed Article 6 on Bulk Transfers in 1991, and enacted the model version of Article 8 on Investment Securities in 1996. There has been no demand for adopting the new version of Article 5. It is expected that the next major UCC revision in Kentucky, most likely the new Article 2B, or revisions of Article 9, both of which are expected to be recommended to the states this year, will also update the State's version of Article 5.

IV. Uniform Commercial Code Drafting Projects.

Article 2

Article 2, on sales, was first promulgated nearly 50 years ago. A new draft is scheduled to be presented to the National Conference of Commissioners on the Uniform State Laws at its meeting in 1999. The draft will principally deal with changes in technology and business practices, such as electronic contract formation, that have taken place in the last half-century.

Article 2A, on leases, will undergo corresponding revisions to a new Article 2. Article 2A is now the law of 48 states.
Article 2B addresses the special problems presented by intangible goods such as computer programs, licenses for information, and software contracts. As with Article 2A, Article 2B relies on the backbone of Article 2, but broadens its scope to include information, financial services, products of the entertainment industry, etc. Article 2B may be approved at this year's meeting of the National Conference of Commissioners on Uniform State Laws.

Articles 3, 4 and 4A

No redrafting is currently in progress. The revised Articles 3 and 4 are now the law of 48 states. Article 4A has achieved universal enactment. Unfortunately, New York, a key player in the financial industry may be the last hold out on revised Articles 3 and 4.

Article 5

Thirty-three states have adopted the 1995 revision of Article 5. New York has also been a hold out on this Article, but is expected to adopt the revisions this year.

Article 6

Kentucky was at the forefront of the repeal of the Article on Bulk Transfers. Now, 35 additional states have repealed the article and six have enacted the slimmed down alternative.

Article 7

The permanent editorial board has recommended the appointment of a drafting committee for the Article on Documents of Title, however, no revisions are on the horizon.

Article 8

Kentucky, again, was one of the first states to adopt the 1994 revisions to the Article on Investment Securities. The 1994 revisions have proved both workable and popular and are now the law in 43 states. Additionally, the Department of the Treasury has adopted revised Article 8 as a rule in its TRADES regulations (31 C.F.R. 357).

Article 9

The American Law Institute has scheduled the revisions to the Article on Secured Transactions for a vote at its Spring 1998 meeting. The National Conference of Commissioners on Uniform State Laws will consider the revisions at its August 1998 meeting. The new Article 9 may be before the Kentucky Legislature in 2000. The revisions will address issues such as electronic filing, and the sale and securitization of payment intangibles. Matters that may be brought within the scope of Article 9 include deposit accounts, non-possessory statutory liens, and consignments. Revisions are also being considered in 9-402(7) when debtors change their names, new debtors are created, and organizational forms change.
V. Fair Debt Collection Practices Act Update.

Amendments Effective December 30, 1997

The Primary effect of the most recent amendments is to remove the requirement that all communications from a debt collector to a consumer debtor, after the initial communication, include what became known as the "Mini Miranda" ("this is an attempt to collect a debt and any information obtained will be used for that purpose"). However, all communications from a debt collector to consumer debtors must show that the communication is from a debt collector. The amendments also eliminated the need to make the disclosure in a "formal pleading" that is part of a legal action. Unfortunately, the amendments do not define the term "formal pleading". Are garnishments, judgment liens, etc., formal pleadings? Hopefully, the judicial interpretation will be that any document filed in court is a formal pleading under the amended statute.

Jenkins v. Heintz, Revisited.

The five-year saga of Jenkins v. Heintz ended on March 23, 1998. Jenkins v. Heintz first made headlines in 1994 when the 7th Circuit reversed the Northern District of Illinois and held that attorneys, even when engaging in litigation, were subject to the restrictions and requirements of the Fair Debt Collection Practices Act. The U.S. Supreme Court in 1995 affirmed the 7th Circuit. The underlying controversy, not addressed until 1996 in the Northern District of Illinois, was whether a debtor could sue an attorney for attempting to collect a debt not authorized by the contract upon which the attorney sued. The District Court granted summary judgment and ruled that the Fair Debt Collection Practices Act does not require attorneys to make an independent investigation of information provided by their client and that counsel was entitled to rely upon a Bank's representation that charges were legally valid and authorized under the contract. The 7th Circuit affirmed the summary judgment at 124 F.3d 824 (7th Cir., 1997). Cert. denied, 66 U.S.L.W. 3509 (U.S., March 23, 1998).

Bartlett v. Heibl, 128 F. 3d 497 (7th Cir. 1997).

The 7th Circuit held that a letter from an attorney that informed a debtor that, absent payment, the debtor would be sued within one week, but also told the debtor of his right to contest the debt within 30 days, was confusing and violated the FDCPA. Judge Posner found that although the debtor did not even read the letter, and did not suffer actual damages, he might be entitled to the statutory award of up to $1,000. The most conservative response for lawyers is to not demand payment or any other response from the debtor prior to the expiration of the 30-day verification period.

Pending Legislation.

HR 1059, currently before the U.S. House of Representatives, would amend the FDCPA to specifically allow a debt collector to continue collection activity during the 30-day period following the initial validation notice.
# UCC SCORECARD

50 State Survey of Adoptions of Revised Official Text of the UCC

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1. Florida and South Dakota have adopted only 1987 Official Text without the 1990 Amendments. The 1990 Amendments have been introduced in Florida as HB 1083.

2. States which have repealed Article 6 are identified by indicating "Repeal" next to the state name; states adopting the revisions suggested in Alternative B to the 1989 Official Text are identified by indicating "Revise" next to the state name.

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*Intro = Legislation introduced (bill number given where possible).*  
*Died = Died in committee or on adjournment.*

*Please note that the Enactment Date does not necessarily reflect the effective date. Please refer to the applicable statute for the relevant effective date.*

*Our thanks to John McCabe and Katie Robinson at the National Conference of Commissioners on Uniform State Laws for their help in compiling the information above. These revisions are based on the information available as of February 2, 1998.*
ELECTRONIC BANKING AND THE INTERNET

LEGAL ASPECTS OF THE ELECTRONIC DELIVERY
OF FINANCIAL SERVICES

Holli Hart Targan
Jaffe, Raitt, Heuer & Weiss, P.C.
Detroit, Michigan

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SECTION G
# ELECTRONIC BANKING AND THE INTERNET

—Legal Aspects of the Electronic Delivery of Financial Services—

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Most laws governing financial institutions were written at a time when the transfer of information and the transfer of funds took place on paper, either through the mail or in person. Today, however, financial institutions are becoming more and more involved in delivering traditional services electronically; that is, accomplishing the transmission of data and funds through open or closed computer networks. But the old laws, written for a different era, don’t always mesh with the new technology. Over the past few years in particular, the Federal banking regulators have attempted to walk a fine line: they have struggled to remold the regulations interpreting those outmoded laws so that the regulations do not inhibit innovation, while at the same time remaining mindful of fulfilling their mission to protect the safety and soundness of the banking system.

Part of the problem in promulgating definite standards with which financial institutions must comply when engaging in electronic banking is that it’s like shooting at a moving target: in many instances the technology is in its infancy and constantly changing. It follows that this is an area of the law that is still emerging and under continual change. Therefore, a financial institution thinking about initiating an electronic banking product should thoroughly examine the laws and regulations in effect at that time. Further, it is an area of the law that demands perpetual vigilance: new regulatory pronouncements are released quite often, and should be thoroughly analyzed to determine whether the new release necessitates change in existing electronic banking systems or products.

Set forth below is an analysis of the law surrounding the electronic delivery of financial services, classified in three broad categories: 1) Electronic Banking Generally, 2) Web Compliance, and 3) Smart Cards.

I. The Emerging World of Electronic Banking

The following developments by the Federal banking regulators will affect “electronic banking”, or how a bank communicates with its customers via computer, broken down into three categories: A) Regulators’ general statements about electronic banking; B) more specific regulatory advice; and C) digital certificates.

A. Regulators’ General Statements

1. FDIC Exam Guidance on Electronic Banking Activities

In March, 1997 the FDIC released its Safety and Soundness Examination Procedures related to Electronic Banking. The Exam Procedures may be found on the FDIC’s web site at: http://gopher.fdic.gov/. Examination procedures are used by examiners when conducting bank examinations. Exam procedures also set the standards to be followed by financial institutions when engaging in a specified activity.
The guidance segregates electronic capabilities of financial institutions into three categories by degree of functionality. The three categories are: information-only systems, which allow electronic access by customers only to marketing or other publicly available information; electronic information transfer systems, which provide the ability to transmit messages, documents or files among a group of users (such as a web site that allows a customer to submit an online loan or deposit account application); and electronic payment systems, which are an alternative, electronic means of providing traditional banking products.

The Exam Procedures set forth the bank roles in each system, the risks associated with each role, and specific ways to manage this risk. Most valuable to financial institutions thinking about engaging in electronic banking products is the section of the guidance that sets forth specific items for which examiners will be looking, because this sets the standards against which a bank’s electronic banking program will be measured.

2. FDIC Guidance on Security Risks Associated with the Internet

On December 18, 1997 the FDIC supplemented their Exam Procedures by issuing guidance on the security risks associated with the Internet. The Guidance may be found on the FDIC’s web site at: http://gopher.fdic.gov/. The paper offers information to financial institutions that are using or planning to use the Internet as an information resource or delivery channel. The paper does not make specific recommendations as to which technical solutions an institution should deploy, but rather points out the risks that the Internet presents to enable the institution to implement appropriate controls.

The FDIC describes five areas of concern, which relate to both transactional and system security issues. These five areas of concern are:

a. Data Privacy and Confidentiality. Any data stored on a Web server may be susceptible to compromise if proper security precautions are not taken.

b. Data Integrity. The open architecture of the Internet can allow people to modify data during a transmission; steps must be taken to ensure data is maintained in its original form.

c. Authentication. Authentication is necessary to establish the identities of all parties to a communication, because one computer can impersonate another.

d. Non-repudiation. Non-repudiation involves creating proof of the origin or data to protect the sender against false denial by the recipient that the data has been received or to protect against false denial. The FDIC points out that steps must be taken to prohibit non-repudiation.

e. Access Control/System Design. The FDIC recommends putting in place strong security measures to control access to computer systems.

The FDIC goes on to discuss the primary technologies that presently exist to manage the risks of data privacy and confidentiality, data integrity, authentication, and non-repudiation, such as encryption, certificate authorities and digital certificates. This section provides a good, basic description of such current technologies.
3. OCC Guidance on Risks Associated with Technology

In February, 1998 the Office of the Comptroller of the Currency ("OCC") issued Banking Bulletin 98-3, which provides guidance on how banks should identify, measure, monitor and control risks associated with the use of technology. The Bulletin may be found on the OCC's web site at: http://www.occ.treas.gov/. The Bulletin contains two main parts: 1) an outline of the primary risks related to bank use of technology and 2) a description of a risk management process indicating how a bank should manage these risks. This Guidance will be applied to all types of technology. The OCC defines "technology" as systems used to store, receive, transmit, process, and recover information, including computer hardware and software and telecommunications lines. The main points of the Guidance are:

a. Use of technology-related products exposes a bank to the following types of risk: transaction (due to deficiencies in system design or implementation); strategic (when management does not adequately plan for, manage, and monitor performance); reputation (when the technology generates adverse public opinion such that it impairs banks' earnings); and compliance (failure to comply with disclosure requirements, or when the bank doesn't have systems in place to ensure compliance with mandatory reporting requirements).

b. OCC expects banks to have an integrated approach to risk management to identify, measure, monitor and control risks. Technology-related risks will be reviewed with other bank risks to determine the bank's overall risk profile.

c. Bank management should rigorously analyze a technology's risk, and establish risk controls to manage risk exposures.

d. The following constitutes the elements of a risk management process: i) plan for use of technology (consider issues such as costs of development, testing and designing, ability to resume operation in the event of system failure), which should include involving the Board of Directors, ii) decide how to implement the technology, including having project management controls in place, which include proper project monitoring, clearly defined expectations, cost estimates, expected delivery dates, expertise and training, policies and procedures, testing, and contingency planning, and iii) measure and monitor risk-taking, including auditing procedures, and quality assurance.

4. OTS Statement on Retail On-Line PC Banking

On June 23, 1997 the Office of Thrift Supervision ("OTS") published a Statement on Retail On-line PC Banking, which provides guidance to thrifts in implementing personal computer banking programs. The Statement may be found at the OTS' web site at: http://www.ots.treas.gov/. In particular, the Statement points out the risks to financial institutions in engaging in PC banking, and sets forth specific controls to mitigate those risks. The risks and ways to control them follow:

a. Strategic Risk. This exists in the business decisions that a financial institution faces when new products or services are introduced. This risk may be addressed by: i) developing a business plan justifying the program, ii) ensuring that sufficient resources are available to support the program, iii) decide whether to outsource certain functions or perform them in-house, and iv) staying abreast of technological developments.

b. Legal/Regulatory Risk. This risk arises from the uncertainty of how the electronic environment will affect the legal framework, jurisdiction, and regulatory compliance. Countermeasures generally consist
of effective policies and procedures and comprehensive consumer disclosures, including detailed
contracts, and digital signatures.
c. Operational Risk. Operational risk arises from the potential that inadequate information systems,
operations problems, breaches in internal controls, fraud, or unforeseen events will result in unexpected
losses. Programs should be implemented that prevent, detect, and contain a system attack and protect
confidential data.

5. Interagency Task Force on Consumer Electronic Payments

The Consumer Electronic Payments Task Force has been formed by the Secretary of the Treasury, all of the
Federal bank regulators, and the Federal Trade Commission. The Task Force's mission is to: 1) identify
and explore issues affecting consumers raised by emerging electronic money technologies, and 2) identify
innovative responses to those issues.

The Task Force's objectives are to: 1) identify consumer issues raised by electronic money, 2) evaluate the
extent to which those issues are addressed by current laws and voluntary industry guidelines, and 3) identify
innovative, non-regulatory approaches that help the electronic money industry address consumer issues.

On May 30, 1997, the Task Force announced that it would hold public meetings on June 9, 1997 and
June 17, 1997. It also published a request for comment on issues affecting consumers raised by emerging
electronic money technologies and on non-regulatory responses to those issues. In particular, the Task
Force has asked for comments on:

a. **Privacy Issues.** What information is generated about users and transactions, what is done with
that information, what privacy concerns have customers raised, and how can these concerns be
addressed?
b. **Consumer Disclosures and Protections.** What information is currently disclosed to consumers?
Are you concerned about the potential different disclosures from different types of providers?
What information do customers most often seek, or misunderstand? What do customers most
often complain about?
c. **Access to Electronic Money.** What electronic money products are most likely to be useful to the
elderly, minorities, disabled persons and the poor? Are there impediments to access to electronic
money by these groups? What are you doing to reach these customers? Do electronic money
issuers need additional incentive to reach these customers?
d. **Financial Condition of Issuers.** If an issuer fails, what is the status of customers holding that
issuer's electronic money? What problems would customers face if an issuer failed? What types
of prudential requirements (like capital and liquidity) apply to issuers? What information is
available to consumers about issuers?

B. More Specific Action or Advice

1. Office of Thrift Supervision Notice on Electronic Banking Regulations

On April 2, 1997 the Office of Thrift Supervision ("OTS") published an Advance Notice of Proposed
Rulemaking seeking comment on electronic banking regulations. OTS is concerned that its current
electronic banking regulations do not adequately address advances in technology and may impede
innovation by thrifts. OTS received 19 comments, which suggested two broad principles to guide OTS in drafting regulations: 1) the public and institutions will best be served if statutory and regulatory restrictions are kept to a minimum, in order to not inhibit innovation, and 2) thrifts should be allowed to compete effectively with other regulated financial institutions and unregulated firms offering financial and related services.

On October 3, 1997, OTS published a Notice of Proposed Rulemaking, which would amend OTS electronic-related regulations to address advances in technology and to permit prudent innovation for the use of emerging technology by thrifts. The Proposed Rule may be found on the OTS' web site at: http://www.ots.treas.gov/. Comments were due December 2, 1997. The OTS proposed to issue a broad enabling regulation clarifying that thrifts may engage in any activity through electronic means that they may conduct through more traditional delivery mechanisms.

The Proposed Rule would eliminate existing regulations that address electronic operations (12 CFR Sections 545.138 and 545.141) and would add a new subpart B to 12 C.F.R. Section 545 to address electronic operations. Specifically, it would:

a. Allow thrifts to use electronic means or facilities to perform any authorized function or provide any authorized product or service. "Electronic means or facilities" means ATMs, automated loan machines, PCs, the Internet, the World Wide Web, and telephones. OTS will specifically clarify that none of these facilities will be deemed branches under federal law. This would allow the opening of savings or demand accounts or loan accounts through these facilities, which the existing regulations do not allow.

b. Authorize thrifts to market and sell electronic capacities and by-products to third parties. The thrift must have acquired or developed these capacities in good faith as part of providing financial services. This constraint is similar to the condition imposed by the OCC on national banks.

c. Permit a thrift to participate in electronic banking activities with an entity that is not subject to examination by a federal banking regulator, but only if that entity has agreed, in writing, to subject itself to OTS examination.

d. Require thrifts to adopt standards and policies that are designed to ensure secure operations. The regulation would also require thrifts to implement security measures adequate to prevent unauthorized access to its records and its customers' records, and to prevent financial fraud through the use of electronic facilities. In imposing such requirements, the OTS declined to specify those security measures that must be adopted by thrifts, reasoning that state-of-the-art security measures are in constant flux. OTS noted that in certain circumstances it may require specific security measures. For example, when it authorized Security First Network Bank to conduct business over the Internet, the OTS required adequate encryption, independent testing, and testing before and after implementation.

The OTS declined to exempt electronic banking from Community Reinvestment Act, Regulation E, safety and soundness regulations, and other applicable statutes and regulations, instead emphasizing that it intends to permit the new electronic technologies to develop within the existing framework of law and regulation.

It also declined to specifically regulate stored value cards or Internet banking. Rather, it chose to more broadly permit thrifts to perform any authorized function or provide any authorized product or service
through electronic means or facilities, which include stored value cards, the Internet or any other emerging electronic technologies. The proposed regulation states that once OTS gains more experience with these new products, it may issue more specific guidance. Until that time, thrifts’ exercise of this authority remains subject to existing safety and soundness requirements, consumer protection requirements, commercial law, and other applicable requirements.

2. FRB Regulation E Interim Rule on Electronic Communications

On March 17, 1998 the Federal Reserve Board ("Board") published an interim rule with request for comments amending Regulation E, (Electronic Fund Transfers) 12 C.F.R. Section 205. The Interim Rule may be found at the Board’s web site at: http://www.bog.frd.fed.us/. Regulation E implements the Electronic Funds Transfer Act ("EFTA"), and imposes disclosure, error resolution, and liability responsibilities on electronic fund transfer participants. The Interim Rule will allow depository institutions (and others subject to Regulation E) to deliver by electronic communication any of the Regulation E-mandated disclosures and other information, as long as the consumer agrees to such delivery.

The Interim Rule was effective March 20, 1998; comments must be received by May 15, 1998.

Under Regulation E, certain disclosures, like initial disclosures and periodic statements, must be given to consumers: 1) in writing, 2) in a clear and readily understandable form, and 3) in a form that the consumer may keep. On May 2, 1996 the Board published proposed amendments and requested comment on how electronic communication relates to such requirements.

The Interim Rule states that although it will allow financial institutions to provide Regulation E disclosures electronically, those disclosures remain subject to applicable timing, format, and other requirements of the Regulation. The Interim Rule will allow financial institutions to implement systems to provide EFTA information electronically while proposed rules are being considered to allow the electronic delivery of disclosures under other laws.

In conjunction with the Interim Rule, the Board stated:

a. The term “financial institution” is broadly defined in Regulation E to include persons that directly or indirectly hold accounts belonging to consumers or that issue an access device and agree to provide EFT services.

b. The term “electronic communication” is limited to a communication in a form that can be displayed as visual text; thus, communication by telephone voicemail does not qualify.

c. There may be various ways that a financial institution and a consumer could agree to the electronic delivery of disclosures. Whether such an agreement exists is determined by applicable state law. The regulation does not preclude a financial institution and a consumer from entering into an agreement electronically nor does it prescribe a formal mechanism for doing so.

d. Disclosures must be "sent", and not merely be made available, to a consumer electronically. Posting information on an Internet site without notice and instructions about how the consumer may obtain the required information would not satisfy the requirement. Financial institutions have flexibility in how they may deliver disclosures, including sending disclosures to an e-mail address designated by the consumer or designating a location on a web site where the consumer might enter a PIN to access required information.
e. Electronic communication remains subject to timing requirements. For example, the change-in-terms notice must be sent 21 days in advance. The Board solicits comment on whether further guidance is needed on how to comply with the timing requirements when a notice is posted on an Internet website.

f. The disclosure must be “clear and readily understandable”. The Board emphasized that whatever technology is used, the communication must be clear and readily understandable. Financial institutions are not required to ensure that the consumer has the equipment to read the disclosures.

g. The requirement that the disclosures must be in a form the consumer can keep will be satisfied if the disclosure can be printed or downloaded by the consumer.

h. The Interim Rule does not require financial institutions to provide a paper copy upon request, as the proposal would have required. The Board expects that financial institutions will accommodate a consumer’s request for a paper copy.

i. Financial institutions may request paper confirmation in cases where they can currently require written confirmation (stop-payments and confirmation of oral notices of error), but they must clearly identify to the consumer the information subject to paper confirmation and must provide the address where written confirmation must be sent.

3. FRB Proposed Regulations on Electronic Delivery of Disclosures

On March 17, 1998 the Federal Reserve Board published Proposed Regulations that would allow financial institutions to deliver by electronic communication disclosures required by a number of regulations, including Regulation B (Equal Credit Opportunity), 12 C.F.R. Section 202; Regulation M (Consumer Leasing), 12 C.F.R. Section 213; Regulation Z (Truth in Lending), 12 C.F.R. Section 226; and Regulation DD (Truth in Savings), 12 C.F.R. Section 230, if the consumer agrees to such delivery. The Proposed Regulations may be found on the Board’s web site at: http://www.bog.frd.fed.us/.

The Board proposes to amend all of these regulations to permit financial institutions to use electronic communication where each regulation calls for information to be provided in writing. The content of each proposed revised regulation is much the same as that described in Number 3, immediately above. Comments on each proposal are due by May 15, 1998.

4. FRB—Home Banking Authorizations for Pre-Authorized EFTs

In 1996, the Federal Reserve Board revised Regulation E, 12 C.F.R. Section 205, to specifically allow an electronic authorization to qualify as a "written authorization", under the requirement that preauthorized EFTs from a consumer's account may be authorized by the consumer only in writing. This was intended to address developments in electronic banking services such as home banking. This change would, for example, allow preauthorized transfers in an electronic payment system to be authenticated by a digital signature algorithm, PIN, or other code. To qualify, the electronic agreement would have to be displayed on a computer screen that enables the consumer to read the communication. The person that obtains the authorization must provide an electronic or hard copy to the consumer.

5. FRB Transaction Limits on Electronic Banking Activity

In June, 1997 the Federal Reserve Board released a November 1, 1996 opinion on the monthly transaction limits under Regulation D (Reserve Requirements) applicable to home banking and ATM activity.
a. **Via Telephone or Home Banking.** The FRB stated that a savings account depositor could instruct a bank by telephone or home banking data transmission to make payments directly from the account to a third party no more than 6 times per month. Likewise, the 6 transaction limit applies if the customer instructs the institution to transfer funds from the savings account to a transaction (DDA) account, and then from the DDA to a third party.

b. **Via ATM.** If the instruction to pay a third party directly from a savings account comes from the customer via ATM, the 6 transaction limit applies. However, if the customer tells the institution via ATM to transfer funds from the savings account to a transaction account at the same institution, the transfer does not count against either the 3 or 6 transaction limit.

c. **Instructions from a Third Party.** Instructions from a third party, such as Checkfree, to a bank are subject to the 3 transaction limit.

C. **Digital Certificates**

Digital certificates are used to electronically authenticate the sender of an electronic message, like a notary verifying the signature of an individual in a physical setting. The certificate process also enables subscribers to be sure that communications received have not been altered during transmission. There has been much talk in the industry about whether financial institutions are authorized to (and should, from a risk standpoint) take part in the digital certificate process.

1. **OCC Zions Application Approval**

On January 12, 1998, the Office of the Comptroller of the Currency approved the application of a national bank to offer digital signature products to its customers. The Approval Letter may be found at the OCC’s web site at: http://www.occ.treas.gov/. The approval permits Zions First National Bank ("Bank") to establish an operating subsidiary to act as a certification authority to enable subscribers to generate digital signatures that verify the identity of a sender of an electronic message.

Initially the Bank intends to offer digital certificates to attorneys in Utah who submit court filings electronically, and those involving corporate and government contracts. The Bank must get OCC’s approval before offering the product to the public.

The Bank has agreed to provide clear consumer disclosures regarding general rights and responsibilities, as well as privacy, error resolution procedures, and fees. The approval is conditioned on the Bank’s submission to the OCC of its final information system, and on the Bank’s maintenance of sufficient capital to support the activity.

The OCC reasoned that the Bank is authorized to conduct the activity as part of the business of banking because the service resembles verification and identification services, such as notary services, already performed by banks. Both functions require the bank to verify identity and provide a basis for authenticating a signature (or its digital equivalent) based on either personal knowledge of the party signing or satisfactory evidence that the signature is of the party to whom it is attributed. Further, verification of identity and authentication of transactions electronically are a logical outgrowth of the core bank competencies of special identification and authentication.
The approval letter indicates that the OCC is developing a supervisory issuance on national bank certificate authority activities, which will provide basic information and general risk analysis for banks that are considering investing in, providing services to, or operating a certification authority.

2. Legislation

On February 4, 1998 Senator Bob Bennett (R-Utah) introduced the Digital SEAL (Signature and Electronic Authentication Law) which would allow the financial services industry to provide “consumer friendly” technology for conducting financial transactions. The bill would specifically authorize financial institutions to participate in the area of electronic authentication, allowing them to verify the sender's identity and ensure the message was not altered.

II. Web Page Compliance

A number of regulatory requirements come into play when transacting the business of banking on the Internet. The relevant requirements will depend on what the bank’s Internet capabilities are, from merely posting information on the web to actually transferring funds, setting up accounts, and transmitting disclosures. Set forth below is a brief explanation of the relevant Federal bank regulations which should be examined and the web issue within each regulation. This is an area under constant change, and therefore a financial institution should update the list at the time it is developing the Web pages, and whenever new issuances are released by the Federal bank regulators.

A. FDIC Official Advertising Statement.

Twelve C.F.R. Section 328 requires financial institutions to display an official advertising statement in all of its advertisements, with a few, non-relevant, exceptions. The advertising statement must be of such size and print to be clearly legible. Institutions may use the words “Member of the Federal Deposit Insurance Corporation” or “Member FDIC” or a reproduction of the FDIC symbol.

In a February 11, 1997 Notice of Proposed Rulemaking, which has not been finalized, the FDIC stated:

The staff is of the view that every institution’s home page is to some extent an advertisement and accordingly should contain the official statement to the extent required by the rule. Whether subsidiary web pages contain advertisements will vary depending upon the content of the information within the particular web page. The staff is of the view that each such subsidiary web page that contains an advertisement should include the official statement, unless such advertisement is subject to one of the exceptions in Section 328.3(c).

Therefore, all Web pages that may be construed as advertisements should contain the FDIC Official Advertising Statement.
B. Office of Thrift Supervision Statement on Retail On-Line Personal Computer Banking

On June 23, 1997, the Office of Thrift Supervision ("OTS") published a Statement on Retail On-Line Personal Computer Banking, which provided advice to institutions engaging in PC banking. See supra.

OTS stated in that issuance that thrift management should ensure that customers are fully informed of the risks associated with their participation in a PC banking program. Consumer disclosures should explain the circumstances under which their account data may be at risk and the security methods employed by the financial institution. Further, customers must be informed of their rights and responsibilities in the event of unauthorized access.

C. Regulation DD, Truth in Savings, Consistency of Terms Requirement.

The Official Staff Commentary of Regulation DD (Truth in Savings), 12 C.F.R. Section 230, states that institutions must use consistent terminology to describe terms or features required to be disclosed. The Official Staff Commentary explains that periodic statement and change-in-terms notices must use the same terminology so that consumers can readily identify the fee. Consistent terminology should be used in each communication with a customer, including Web pages.

D. Equal Housing Lender Symbol

The Fair Housing Act, 42 U.S.C. 3601, and its implementing regulation, 24 C.F.R. Section 109.30, requires mortgage lenders to place the “Equal Housing Lender” symbol on communications with consumers about mortgage loans. The symbol consists of a house with an equal sign inside of it.

The equal housing lender symbol should be placed on Web pages that discuss mortgage loans.

E. Regulation E Preauthorized Transfers Requirements.

Regulation E (Electronic Fund Transfers), 12 C.F.R. Section 205, permits financial institutions to enable a customer to use electronic means to "pre-authorize" an electronic fund transfer. Regulation E provides that preauthorized electronic fund transfers from a consumer’s account may be authorized only by a writing signed or similarly authenticated by the consumer. The Regulation E Official Staff Commentary explains that a consumer's authorization via a home banking system qualifies as "similarly authenticated". To satisfy the requirements of Reg E, there must be some means to: 1) identify the consumer (such as a security code) and, 2) make available a paper copy of the authorization (automatically or upon request). The text of the electronic authorization must be displayed on a computer screen or other visual display which enables the consumer to read the communication.

The person that obtains the authorization must provide a copy to the consumer.

Regulation E also provides that a consumer may stop payment of a preauthorized electronic fund transfer from the consumer’s account by notifying the financial institution orally or in writing at least 3 business days before the scheduled date of the transfer.
If the transfer will vary in amount, the financial institution must inform the consumer of the right to receive notice of all varying transfers, but may give the consumer the option of receiving notice only when a transfer falls outside a specified range of amounts or only when a transfer differs from the most recent transfer by more than an agreed-upon amount.

F. Regulation E and Regulation DD Initial Disclosures Requirements.

Regulation E (Electronic Fund Transfers), 12 C.F.R. Section 205, requires that certain disclosures be made to consumers at the time a consumer contracts for an electronic fund transfer service or before the first electronic fund transfer is made involving the consumer’s account.

Further, Regulation DD (Truth in Savings), 12 C.F.R. Section 230, requires a financial institution to provide account disclosures before an account is opened or a service in provided, whichever is earlier. If the consumer is not present when the account is opened, the institution must mail the disclosures no later than 10 business days after the account is opened or the service is provided, whichever is earlier.

Certain web pages may trigger these disclosure requirements which should comply with the requirements set forth in the Board’s Interim Rule published March 17, 1998. See supra. If the financial institution has the means to do so, it may provide Regulation E and Regulation DD disclosures and other information electronically, pursuant to the Board’s interim rule published March 17, 1998. See supra.


The FDIC Electronic Banking Safety and Soundness Examination Procedures, supra, require that an institution include in their operating policies and procedures that customers submit a signed authorization for each payee included in bill payment, funds transfer and similar programs. Further, financial institutions must verify the legitimacy of each payee, and whether the financial institution has adopted reasonable guidelines for adding payees.

H. Privacy Policy Disclosure.

The Clinton Administration has urged companies with web pages to disclose how the companies will use information it gathers from consumers through the web site. In March, 1998, the American Banker reported that the FTC will be looking at 1,200 Web sites to see if companies are complying with this directive, and will report to Congress on June 1, 1998 on its results. Predictions are that if this “self-regulation” (i.e., voluntary compliance) is not taking place, legislation will follow. At this point, no company will be penalized for the absence of a policy. The “privacy policy” disclosure should consist of the financial institution’s policies on what it does with customer information, such as “we collect information for business purposes only, we limit employee access to such information, we do not reveal customer information to third parties, we try to maintain accurate information.”

I. Jurisdiction.

OCC mentions, in its Banking Bulletin 98-3 on technology risks, see supra, that banks face compliance risk when conducting Internet transactions with regard to jurisdictional authority over the transactions,
giving no answer to the question, but merely raising it as an issue financial institutions should be concerned about.

III. Smart Cards

Set forth below are the issues that should be examined when participating in a smart card project. The legal issues may be broadly categorized, and are discussed, in the following three subject areas: 1) Federal statutes and regulation, 2) state laws, and 3) private contracts between the parties.

A. Federal Statutes and Regulation

The following Federal laws should be examined when participating in a stored-value project, and are discussed below:

1. The Board of Governors of the Federal Reserve System’s Regulation E (Electronic Fund Transfers).
3. The Federal Deposit Insurance Corporation’s General Counsel Opinion on the Insurability of Stored Value Products.
4. The Office of Thrift Supervision’s bulletins on electronic banking.
5. The Department of Treasury’s Financial Crimes Enforcement Network (“FinCEN”) requirements relating to the Bank Secrecy Act.

1. Regulation E

The Board recognizes that Regulation E (Electronic Fund Transfers), 12 C.F.R. Section 205, in its current form does not perfectly address the new technology of stored-value systems. Therefore in May, 1996 the Board published a proposed amendment to Regulation E specifically addressing stored-value. “Proposed” is the operative word here. The Board laid out its thoughts on how Regulation E should handle stored value, and asked the industry to comment on what it said. The point here is that what is discussed below is the proposal; nothing the Board has said about Regulation E has the force of law at this point.

While examining specific requirements, the Board also proposed to broadly exempt all stored value cards worth less than $100 with one huge caveat: when stored-value cards are used to access a deposit account (like during reloading), all Regulation E requirements apply. The exceptions to the existing Regulation E requirements, therefore, relate to transactions in which value stored on a card is drawn down to obtain cash or purchase goods or services.

To analyze the issue, the FRB categorized stored value systems as follows:

1. On-line System. The Board calls this the “On-line Stored-Value System”, which is characterized by the following: access to a database for purposes of transaction authorization and data capture, on-line authorizations with data stored in a central database. Further, the balance of funds in on-line systems are not recorded on the card itself, but maintained in the data base.
2. **Off-line System.** The Board calls this the “Off-line Unaccountable Stored-Value System”, which has the following characteristics: the record of value is recorded on the card and not maintained in a central data base, transaction data is recorded on the card and captured at merchant terminals, the merchant aggregates transaction data and transmits it in batches to the financial institution, and the record of value is not drawn from a deposit account during the life of the smart card.

3. **Hybrid System.** The Board calls this the “Off-line Accountable Stored-Value System”. In these systems, the record of value is recorded on the card and maintained in a central data base, no on-line authorization of transaction data takes place, transaction data is periodically transmitted to and maintained by a data facility, and the consumer has the right to draw from a deposit account.

In its proposal, the Board stated that off-line systems would be totally exempt from Regulation E requirements, and that certain requirements would apply to on-line and hybrid systems, as explained below.

a. **Unsolicited Issuance Rules.** Regulation E prescribes the conditions under which an issuer may distribute unsolicited EFT access devices. The proposal would exempt off-line system cards from these restrictions, but on-line and hybrid systems would presumably be subject to these restrictions.

b. **Initial Disclosures.** Regulation E mandates that certain disclosures be made to consumers when the consumer contracts for an EFT service or before the first transfer is made. The Board stated that on-line systems would be subject to all initial disclosure requirements and that off-line systems would be subject to no initial disclosure requirements. Further, for hybrid systems, only the following Regulation E-required initial disclosures would apply: 1) consumer liability for unauthorized transactions, with the disclosure stating that the consumer bears full responsibility or any limits on liability; 2) the types of transfers available; 3) transaction charges, and 4) error resolution procedures.

c. **Periodic Statement Requirement.** Regulation E requires a financial institution to send an account statement to consumers for each monthly cycle in which an EFT has occurred or quarterly if no transfer has occurred. The Board said that on-line systems are not subject to this requirement, but the account balance and transaction history must be provided to the cardholder upon request. Further, off-line systems and hybrid systems would not be subject to this requirement.

d. **Annual Reminder of Error Resolution Procedures.** Regulation E requires financial institutions to annually remind consumers of the Regulation E-required error resolution procedures. Alternatively, institutions may include on periodic statements an abbreviated notice of error resolution procedures. None of the three categories of systems would be subject to this requirement.

e. **Change in Terms Notice Requirement.** Under Regulation E, if terms required to be disclosed (like transaction fees) change from those initially in effect, the institution must notify the consumer at least 21 days before the effective date of the change. None of the three stored value system categories would be subject to this requirement.

f. **Transaction Receipt Requirement.** Regulation E requires an institution to make a transaction receipt available to a consumer for an EFT initiated at an ATM or POS terminal. The Board stated that on-line systems must comply with transaction receipt requirements, but that off-line systems and hybrid systems are not subject to this requirement.

g. **Liability Limits to Consumers.** Regulation E generally limits a consumer’s losses for unauthorized EFT debits to a maximum of $50. If the consumer doesn’t notify the financial institution of the loss or theft of the access device within 2 days of learning of it, the consumer’s potential liability rises to $500. If the consumer doesn’t notify the institution of unauthorized transfers appearing on a periodic
statement within 60 days, the consumer's liability for any further unauthorized transfers is unlimited. The Board stated that for on-line systems, the liability limits required by Regulation E would apply to cards with a maximum value of more than $100. However, off-line systems and hybrid systems would not be subject to this requirement.

h. Error Resolution Procedures. Regulation E requires institutions to investigate and resolve claims of error made by consumers within specified times—generally, no later than 10 days after receiving the consumer's notice of error, or 45 days after the notice if the institution provisionally credits the consumers account within 10 days. The Board stated that on-line systems and off-line systems and hybrid systems would not be subject to this requirement, although the Board requested comment on whether minimal error resolution procedures should be required, and if no error resolution procedures are required, whether consumers should be notified of this in the initial disclosures.

A 1996 law required the Federal Reserve Board to evaluate whether Regulation E could be applied to stored-value products without adversely affecting the cost, development, and operation of such products. The fact that this law passed is evidence that the Board is under political pressure to closely examine the effects of regulation before imposing requirements on stored value systems. The 79-page report that resulted from the study analyzes and evaluates regulatory and nonregulatory options for addressing risks faced by consumers in using stored-value cards. Alternatives examined include: the existing legal framework; taking steps short of regulation, such as policy statements or consumer education programs; and selective application of Regulation E, such as only requiring initial disclosures.

The study concluded that it is unlikely that one set of Regulation E consumer protections would be appropriate for all of the various types of existing and planned stored-value products. The study also pointed out that it is difficult to predict whether the benefits to consumers from regulation would outweigh the costs of compliance, given the limited experience with stored-value products.

2. Office of the Comptroller of the Currency's Banking Bulletin on Stored Value Systems

On September 10, 1996 the Office of the Comptroller of the Currency ("OCC") joined the flurry of Federal regulatory activity surrounding stored value systems by releasing a 10 page Banking Bulletin ("Bulletin") on stored value card systems. The Bulletin describes emerging stored value card systems, and outlines attendant risks so that bankers can make informed decisions about whether and how to become involved in those systems.

The Bulletin contains the following: 1) a description of stored value card systems, 2) an outline of the various roles that banks can play in stored value card systems, 3) a description of the risks banks may face when participating in stored value card systems, and 4) a list of items that banks should disclose to consumers using such systems.

The Bulletin emphasizes the importance of adequately informing consumers of their rights and responsibilities when using stored value cards. To do so, banks are advised to keep informed of regulatory developments in this area. The OCC states that the following issues should be disclosed to consumers using stored value products:

1. How to use the card.
2. Where and how the consumer can increase the value on the card.
3. Whether the electronic cash earns interest.
4. Fees connected with obtaining or using the card.
5. The name of the issuer and its obligation to redeem the electronic cash.
6. Whether the consumer is protected if the card is lost or stolen.
7. Whether the monetary value is FDIC insured.
8. Where the liability lies if a transaction is not properly consummated.
9. What happens to electronic cash that is abandoned or expires.
10. Dispute resolution procedures.
11. The circumstances under which information on a consumer’s electronic cash transactions may be disclosed to third parties.

3. FDIC General Counsel Opinion on FDIC Insurance Coverage of Funds Represented on Stored-Value Cards

On August 2, 1996 the Federal Deposit Insurance Corporation ("FDIC") released an opinion from the FDIC General Counsel on whether funds underlying stored value cards are covered by Federal deposit insurance.

The FDIC General Counsel looked at whether the funds represented by electronic value reside in a deposit account covered by the Federal Deposit Insurance Act to determine if those funds are FDIC insured. After a lengthy analysis of the Federal Deposit Insurance Act, the General Counsel made the following conclusions:

a. Funds in Bank Primary--Customer Account Systems are covered by FDIC insurance. These are systems where stored value is created by a bank, and funds remain in a customer's account until the value is transferred to a merchant, who collects the funds from the customer's bank.
b. Funds in Bank Primary--Reserve Systems are not covered by FDIC insurance. These are systems where stored value is created by a bank. As value is downloaded onto a card, funds are withdrawn from a customer's account and paid into a reserve account at the bank to pay merchants.
c. Funds in Bank Secondary--Pre-Acquisition Systems are not covered by FDIC insurance. In Bank Secondary Systems the electronic value is created by a merchant and the funds are ultimately held by that merchant. In Bank Secondary-Pre-Acquisition systems the bank exchanges its own funds for electronic value from the merchant and in turn exchanges electronic value for funds with its customers.
d. Although funds in Bank Secondary--Advance Systems are not covered by FDIC insurance for the cardholder, FDIC insurance may be provided to the merchant. Here, the electronic value is created by the merchant and is provided to the bank by the merchant to have available for its customers. As customers exchange funds for electronic value, the funds are held by the bank for a short period of time and then forwarded to the merchant. It is those funds held in a depository account for the merchant that may be FDIC insured.

One of the most interesting parts of the General Counsel opinion is a statement that the FDIC will expect institutions to clearly and conspicuously disclose to their customers the insured or non-insured status of their stored value products, as appropriate. Thus, banks participating in stored value systems must disclose this information.
This General Counsel Opinion has been amplified by the FDIC in an Opinion Letter dated May 12, 1997. FDIC 97-4, 1998 Fed. Banking L. Reporter §82-204. The letter opines that electronic cash held in a customer's individual account constitutes a deposit, and therefore is covered by FDIC insurance.

4. FDIC Electronic Banking Exam Procedures

In March, 1997 the FDIC released procedures relating to electronic banking, including stored value systems, to be followed by its bank examiners when conducting safety and soundness examinations of financial institutions.

The exam guidelines outline the different ways banks may become involved in electronic banking, including electronic payment systems. The guidelines lay out specific risks to banks in participating in these systems. In general, the following areas will be reviewed by examiners: operating policies and procedures, audit, legal and regulatory, administration and system operations, and vendors and outsourcing.

For example, in the legal and regulatory area, the FDIC cites as concerns the uncertain enforceability of digital contracts, user privacy issues, uncertain legal jurisdiction regarding taxation, criminal and civil laws, the uncertain regulatory environment, and the uncertain applicability of reserve requirements to electronic money.

In the guidance to examiners conducting a safety and soundness exam on a bank, the guidelines require examiners to look at whether the underlying agreements covering payment systems reasonably address claims of lost or stolen value among the bank, its customers, and third parties. Further, examiners must verify that appropriate procedures have been established to ensure compliance with financial recordkeeping and Bank Secrecy Act requirements, including Know Your Customer guidelines. Examiners also must determine whether the bank has entered into formal contracts with vendors. The examiner guidelines state that the contracts should contain provisions that address control of customer and other confidential information, provide for disaster recovery services, and allow the bank to review independent audits.

5. Office of Thrift Supervision

On October 3, 1997, the Office of Thrift Supervision ("OTS") published a Notice of Proposed Rulemaking, which would amend OTS electronic-related regulations to address advances in technology and to permit prudent innovation for the use of emerging technology by thrifts. The Proposed Rule may be found at the OTS’ web site at: http://www.ots.treas.gov/. Comments were due December 2, 1997. The OTS proposed to issue a broad enabling regulation clarifying that thrifts may engage in any activity through electronic means that they may conduct through more traditional delivery mechanisms. See supra.

The OTS declined to specifically regulate stored value cards. Rather, it chose to more broadly permit thrifts to perform any authorized function or provide any authorized product or service through electronic means or facilities, which include stored value cards, the Internet or any other emerging electronic technologies. The Proposed Regulation states that once OTS gains more experience with these new products, it may issue more specific guidance. Until that time, thrifts' exercise of this authority remains
subject to existing safety and soundness requirements, consumer protection requirements, commercial law, and other applicable requirements.

6. Bank Secrecy Act and Treasury’s Financial Crimes Enforcement Network (“FinCEN”) Requirements

On May 21, 1997 the Department of Treasury’s Financial Crimes Enforcement Network (“FinCEN”) released a Notice of Proposed Rulemaking that would subject “any business engaged in the transfer of funds” to the requirements of the Bank Secrecy Act (“BSA”), 31 C.F.R. Section 103. This would specifically include issuers, sellers, or redeemers of stored value. This proposal eliminates any doubt that offerors and operators of advanced electronic payment systems are subject to the BSA.

FinCEN’s Proposed Rule would require “Money Services Businesses” to register with the Department of Treasury and maintain a current list of their agents in a central location for examination by law enforcement agencies. The proposed rule would define “money services businesses” to explicitly include issuers, sellers or redeemers of stored value. Under the proposal, most offerors of stored value products would be treated as “money services businesses” for purposes of the Bank Secrecy Act. Thus, those involved in stored value projects would be required to register with Treasury and maintain a list of their agents, which could be inspected by law enforcement agencies upon request.

While including stored value products in the registration requirements of the Bank Secrecy Act, Treasury also proposed to exempt stored value products from the suspicious activity reporting rules, at least for now. The proposed rules would require a money services business that engages in activities other than those related to stored value to file a form within 30 days of becoming aware of a “suspicious transaction”, or transmissions of between $750 and $10,000 to any person outside of the United States, and to maintain records about such transactions.

Comments on the proposal were due in August, 1997, and as of March, 1998, final rules had not been released.

B. State Law Considerations

A stored value participant should examine the following types of laws in the states in which it will conduct business:

1. Money transmitter laws.
2. Escheat laws.
3. Electronic commerce laws.

In addition, knowledgeable counsel should be consulted to determine whether any other law particular to the relevant jurisdiction applies to the stored value participant’s activities.
1. Money Transmitter Laws

Many states have laws that regulate "money transmitters." Money transmitters are entities other than financial institutions that perform certain activities usually conducted by financial institutions, such as cashing checks.

State laws typically define money transmitters as businesses (other than regulated financial institutions), that sell payment instruments, exchange foreign currency, cash checks, or transmit funds. It is the "transmitting funds" activity that may be the hook that reels in smart card issuers within the purview of the law. Therefore, a non-financial institution issuing stored value cards should examine the money transmitter laws in the state in which the issuer is accepting funds.

Some state money transmitter laws do not on their face appear to apply to stored value, because the definition of money transmitter doesn't explicitly include electronic transmission. Other state laws are more clear cut. For example, the Florida money transmitters' code defines a "money transmitter" as a person who engages in the receipt of money for the purpose of transmission by any means, including transmissions by electronic transfer.

In Florida, money transmitters must file reports and maintain records for 5 years regarding transmissions in excess of $10,000 or if they suspect that the transaction involves the proceeds of an illegal activity. Money transmitters must register with the State, must have a minimum net worth of at least $100,000, must maintain specified net worth requirements, and must maintain a corporate surety bond or collateral deposits. In addition, money transmitters must hold permissible investments in the amount of the aggregate face amount of all funds transmitted and outstanding payment instruments issued.

One legal question that is raised by stored value systems and is yet to be settled may be answered by money transmitter laws. An issue in contracts between stored value participants should be who is ultimately liable to the consumer for the funds represented on the cards. Some state money transmitter laws answer that question by mandating that the money transmitter is liable for all funds it transmits.

Disclosure to consumers is another area of concern in the stored value arena that may partially be addressed by money transmitter laws. Some state laws require that each payment instrument issued by a registrant must "bear the name of the registrant clearly imprinted thereon." This would require that the name of the stored value issuer be printed on a smart card. Another part of the money transmitter law would require issuers to disclose information about how the user could get in touch with the issuer. In addition, the Florida law states that the money transmitter must provide each consumer a toll-free telephone number or the address and telephone number of the department of banking.

Money transmitter codes may also subject licensees to Bank Secrecy Act requirements. The Indiana code requires money transmitters to comply with all state and federal money laundering statutes and regulations.

Some in the industry maintain that the existing money transmitter laws are a perfect vehicle for regulating non-financial institutions engaged in stored value systems. Such laws should be carefully examined.
2. Escheat

Another legal issue relating to smart card systems is whether, and how, the state laws of escheat apply to the monetary value represented on stored value cards. Escheat laws require that abandoned property, including intangible property such as money, be turned over to the state after a prescribed period of dormancy.

The holder of the property must turn the property over to the state upon expiration of a mandated dormancy period. The state then publishes notice of its custody and, after a certain length of time, keeps or sells the property.

Not surprisingly, the escheat laws do not specifically prescribe a period of dormancy for the monetary value represented on stored value cards. So are issuers of stored value cards required to turn over to the state monetary value on cards that have been lost or stolen?

The answer depends in part on the type of stored value system being used. Stored value systems in which the funds reside in a consumer's account, and the cards merely tap the account much like a debit card, would be covered by the 1981 Uniform Unclaimed Property Act ("Act") because the deposit account itself is covered. Stored value systems in which funds are pulled out of the consumer's account and aggregated with and placed in a "holding account" are a harder call. If the pool of money is constantly being tapped and funded, the account would never be abandoned in the first place, and the monetary value represented on lost or unused cards would presumably revert to the financial institution.

In systems where the funds are taken from an account and placed on the card itself the issue has not been resolved, and there are arguments on both sides. Issuers can point to the fact that the Act does not specifically enumerate the dormancy period for stored value cards, and therefore such vehicles do not come within the purview of the Act. Moreover, presumably in these types of systems, the money no longer resides with the financial institution. Thus, the issuer no longer "holds" the money, and has nothing to transfer to the state. The state can analogize the value on stored value cards to one of the enumerated types of property, such as money or credit balances, and apply the requirements to that monetary value.

The new Uniform Unclaimed Property Act, published in 1995 ("1995 Act"), appears to clear up this confusion. The 1995 Act has been enacted in Maine, Montana, New Mexico and West Virginia, and has been introduced in the legislatures of Minnesota, Mississippi, Oklahoma, Texas, and the District of Columbia.

The 1995 Act states in the drafter's notes, which are read to assist practitioners in interpreting the Act, that the definition of property under the 1995 Act is intended to be all-inclusive. The drafters notes explain that the descriptions set forth in the Act are examples that are not limiting, "but are stated to help holders identify kinds of property interest which otherwise may be overlooked. Thus, 'property' is not the check, note, certificate or other document that evidences the property interest, but the underlying right or obligation". Stored value would fall squarely within this concept - the drafters are explaining that it is the underlying stored monetary value that is escheatable, and not the card itself.
An issuer and any other entity holding stored value funds participating in a stored value project should carefully review the escheat laws to determine whether, and under what circumstances, stored monetary value must be escheated. And to be absolutely certain, it wouldn’t hurt to ask the state escheat division, and see what their interpretation is.

3. Electronic Commerce Laws

If the stored value system is connected with the Internet, then state certificate authority or other electronic commerce laws may come into play. The certificate authority laws are intended to minimize the incidents of fraud in electronic commerce by use of “certificate authorities”, and primarily address security issues for stored value participants. Basically, certificate authority laws designate entities that act as authenticators of electronic transactions, by holding and distributing private keys. The laws list the conditions that must be met before the certificate authority can issue a certificate, and set forth the conditions under which certificate authorities may be liable.

Some states have also passed digital signature laws, which in essence qualify electronic signatures as the real, written thing for purposes of state law. For example, Florida and Virginia law states that an electronic signature may be used to sign a writing and will have the same force as a written signature.

Stored value system participants using stored value in conjunction with the Internet should examine the state law to determine if these, or other, electronic commerce laws apply.

C. Contract Issues

If Federal or state law or regulation does not address an issue, and no court cases exist to sort things out, then the parties usually can decide for themselves how to allocate rights, obligations, and liabilities. And the way to do this is by entering into contracts that spell out, in as much detail as possible, who is responsible for what.

There are many players in a smart card transaction: the consumer, the card issuer, the processor, the financial institution at which the funds are held, the acquiring bank, and the merchant. Contracts should be entered into between these players to set forth each party’s rights, obligations, and liabilities. Many provisions, such as those addressing liability and system-wide rules, will be passed along from party to party to ensure stored value system consistency.

Set forth below is a discussion of the various contracts between the parties, and issues that should be covered in each contract.

1. Issuer/Consumer Contract

This is the relationship of most concern to consumer groups and legislators. Many are worried that because stored value is so new, it will not be explained adequately to consumers. A few of the issues that should be covered in these contracts follow.

a. Who the issuer is. The contract must be clear about who is liable to pay the consumer for the monetary value contained on the card. Further, the roles of the various players whose names appear
on the storage device should be explained to the consumer. This disclosure will protect those entities from an allegation by the consumer that those entities should be liable under a theory of agency on the monetary obligation.

b. When contract amendments will be effective. With technology changing all the time, it may be necessary to change the terms entered into between the consumer and the issuer. The issuer will have to be able to notify users of such changes. Normally, changes to a contract must be agreed to by both parties before being effective, and therefore a unilateral change by the issuer may not be binding on the user. Include a provision in the contract stating that the consumer’s use of the card after the effective date of an amendment will be deemed acceptance by the user of the change. This means, of course, that those changes to the contract will only be effective for transactions occurring after the notice.

c. Expiration of the card. A stored value participant may want to impose an expiration date on smart cards to periodically upgrade security or technology features of the cards, similar to credit cards. Or an issuer may want to require that all value represented on the card be used by a certain date. (This gets tricky with reloadable cards, where it may be difficult to ascertain the date on which a certain monetary value is loaded.) Users should be made aware of the applicable expiration date and how to redeem any remaining value on the card.

d. Whether the card or the monetary value is transferable. If for some reason the issuer does not want the card or the value to be transferred (as in the case of frequent buyer programs), the contract between the issuer and the user must clearly disclose that fact.

e. Implied warranty disclaimer. Although it may be debatable as to whether smart cards would qualify as a “sale of goods” (and therefore whether this implied warranty would apply), an issuer should clearly and conspicuously disclaim the warranty of merchantability in its contract with users, just in case.

f. Finality. The contract should clearly state when the obligation represented by the monetary value on the card is discharged. Is the consumer off the hook to a merchant when the monetary value is presented to the merchant from the user (like cash and cashier’s checks), or rather when the merchant actually receives the money from the acquiring institution (like a check)? Eventually a body of law or system rules will be put in place to impose a uniform rule, but until that time, the contracts between the parties will govern.

g. For consumers to get comfortable with using smart cards, it is vital that users know at what point in time their obligation to a merchant has been satisfied. The American Bar Association’s analysis of commercial law issues associated with stored value systems concludes that the most appropriate rule would finally discharge the user’s monetary obligation when the merchant’s terminal accepts the stored obligation, like cashier’s checks. This rule seems to fit in best with consumer’s expectations and how consumers will be using smart cards.

h. Unauthorized use disclaimer. One section of the contract should address the conditions under which the card can be used. For example, you could state that the card may only be used when properly authorized by a central database (if appropriate), that the card may not be used beyond its expiration date, and that the value of the card is limited to the value validly transferred onto the card by you. This will protect the issuer from liability in situations where the consumer has used the card in an unauthorized way.

i. Limitation of liability. Normally an issuer could be held liable if something went wrong in a smart card transaction, because the issuer controls the technology. For example, the technology could go haywire and erroneously authorize a transaction, resulting in the transfer to merchants of more
monetary value than was loaded onto the card. The contract should limit this liability to a reasonably foreseeable amount and should disclaim special consequential and incidental damages.

2. Acquiring Institution/Processor Contract

The acquirer/processor contract should obligate the acquirer to enter into agreements containing certain provisions with merchants. Such provisions should include any system-wide requirements for accepting cards. These may include, for example, a prohibition on establishing minimum transaction amounts as a condition for honoring cards and a prohibition on imposing a surcharge on the cards. Another system-wide rule included in these contracts is one establishing when the debt owed by a user is extinguished, such as one determining that the acceptance of the card immediately extinguishes the consumer's debt to the merchant.

The processor, or system operator, will also want to make clear that the processor is not the issuer of the card. The contract should specifically state that monetary value loaded onto cards using the processors' facilities (like ATMs) are not obligations of the system, but rather of the issuer.

Further, the settlement process should be set forth, with an indication of, for example, how merchants will transmit data to the acquiring bank or the processor. This would also be a good place for the processor to disclaim liability for reimbursing merchants for monetary value on a card, clarifying that it is the issuer, and not the processor, that is primarily liable to reimburse merchants. The contract should also contain limitations on liability and indemnification provisions. Other important provisions include mutual obligations to keep proprietary information confidential, and the conditions under which the acquirer may use the processor's trademarks.

3. Acquiring Institution/Merchant Contract

This agreement should pass along to the merchant all stored value system requirements imposed by the issuer, the processor, and the acquiring member, similar to the credit and debit card processing world. The following issues should be covered in the contract.

a. Liability. Unlike the credit card processing world, where merchants are responsible to the acquiring institutions for all losses related to the acceptance of the card, merchants may balk at taking on liability for stored value transactions. This is particularly true before stored value systems become ubiquitous and are in the early, pilot stages of development. In any event, the contract should make clear who is primarily liable to the consumer (if anyone) for lost or stolen cards, and who is liable for technological mishaps that may occur with stored value technology. Consequential damages should be specifically disclaimed by the acquiring bank.

b. Settlement. The contract should set forth in detail what the merchant can expect in terms of settlement availability and the settlement process. If a settlement account or reserve account will be utilized, the procedures for funding and maintaining those accounts should be covered, as well as authorizations for debiting those accounts. What steps must the merchant take to obtain funds represented on stored value cards? Will funds be transferred immediately to the merchant upon card presentation or, rather, within a certain amount of time after the batch transmission is made?
c. Finality. The contract with the merchant should carry forward the system's rules regarding when a payment by a consumer becomes final. As explained above, the American Bar Association's analysis of commercial law issues associated with stored value systems concludes that the most appropriate rule would finally discharge the user's monetary obligation when the merchant's terminal accepts the stored obligation, like cashier's checks.

It may be tempting to include contractual provisions stating that the credit given to merchants by processors is provisional and subject to the risk of collection back through the system, similar to the rule relating to credit cards that has arisen from chargeback rights. But this type of rule is only practical, and should only be applicable, where the system is fully auditable. Otherwise, it will be impossible to trace the purchaser back through the system, and therefore be able to charge back an item. A provision requiring cash in exchange for returned items and not allowing charge back rights will take care of this.

4. Confidentiality and trademark. It's also important to make sure that merchants protect any proprietary information obtained by virtue of their participation in the stored value system. Proprietary information should be defined. Confidentiality obligations also should be included in the agreement.

Also important in this agreement are trademark issues. The agreement should spell out what the merchant's obligations are with regard to displaying trademarks, and who has rights in any trademarks displayed to indicate to customers that the stored value cards will be accepted at the merchant's location.

5. Issuer/Processor Contract

Because the issuer controls the technology governing stored value systems, it is most likely that the issuer will be held accountable to the consumer and the merchant if something goes wrong in a smart card transaction, such as if a cardholder or merchant unintentionally accepts a fraudulent obligation. Of course, the buck does not stop there: the issuer could then go back against the manufacturer if they were negligent in designing or producing the system, and against person who perpetuated the fraud, if the loss was due to fraud. But as between the issuer and other stored value participants, it's likely that the issuer will probably be held accountable (particularly if the contracts do not allocate responsibility otherwise). Thus, the contract should clearly explain which party will be liable in certain situations.

If the processor is also the promoter of the system, it may want to impose certain other obligations on issuers, to ensure that the system operates uniformly among all participants. Such requirements may include that the issuer disclose certain information to consumers.

Other key provisions in the issuer/processor contract are those relating to confidentiality of information and use of customer information, disaster recovery requirements, any applicable limitations on liability, and a discussion of the transaction flow, so that both parties clearly understand who is responsible for what.

6. Conclusion

During this, the infancy of stored value in the United States, more questions are raised by an inquiry into the legal obligations and responsibilities of the parties than are answered. It's most likely that stored value payment law will be an evolutionary process, drawing from Federal, State and commercial law,
and ultimately decided upon by the courts. The prudent stored value participant will closely examine relevant law and then protect itself as much as possible with carefully crafted agreements between the parties.
BANKRUPTCY CASES OF INTEREST TO FINANCIAL INSTITUTIONS and RECOMMENDATIONS OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION

Lea Pauley Goff
Stoll, Keenon & Park, LLP
Louisville, Kentucky

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SECTION H
# BANKRUPTCY CASES OF INTEREST TO FINANCIAL INSTITUTIONS

AND

RECOMMENDATIONS OF THE NATIONAL BANKRUPTCY

REVIEW COMMISSION

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I. INTRODUCTION

Bankruptcy continues to be an important factor in the professional lives of those who are either directly affiliated with financial institutions or who represent them. This outline is intended to bring the reader up to date on selected developments in bankruptcy case law during approximately the last year. This material concentrates on developments of interest to lenders, particularly U.S. Supreme Court, Sixth Circuit and Kentucky decisions. This includes the continued development of the law on subjects such as discharge litigation, property valuation, "lien stripping" and redemption rights, which are of particular interest to financial institutions today.

Bankruptcy legislation develops more slowly than the case law. However, the National Bankruptcy Review Commission has now issued an extensive report proposing changes in the present bankruptcy code. This material notes certain of the proposals which may be of particular interest to the banking community and addresses the present status of the Commission's work.

II. BANKRUPTCY CASES OF INTEREST TO FINANCIAL INSTITUTIONS

A. Discharge of Debt

The development of case law regarding exceptions to discharge continues to be fueled by a rapidly changing, and increasingly technology-oriented, consumer credit industry. Discharge exceptions are narrowly construed and many of the decisions are adverse to lenders.

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1Many thanks to my partners Joseph M. Scott, Jr. and Laura Day Delcotto for their thoughts and advice regarding this presentation, and to our associate Gregory L. Taylor for his research and drafting assistance.
The Bankruptcy Code provides for the discharge of debts under 11 U.S.C. §§ 727, 1141, 1228 and 1328. Debts excepted from discharge include, among other things, certain tax-related debts, debts for fraud or defalcation while acting in fiduciary capacity, debts for domestic obligations and debts arising from willful injuries. The exceptions which probably are of most interest to the banking community are the exceptions to discharge for debts incurred as a result of borrower misrepresentation. 11 U.S.C. §523(a) excepts from discharge debts including that:

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by -

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor’s or an insider’s financial condition;

(B) use of a statement in writing -

(i) that is materially false;

(ii) respecting the debtor’s or an insider’s financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive; or

(C) for purpose of subparagraph (A) of this paragraph, consumer debts owed to a single creditor and aggregating more than $1,000 for “luxury goods or services” incurred by an individual debtor on or within 60 days before the order for relief under this title, or cash advances aggregating more than $1,000 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within 60 days before the order for relief under this title, are presumed to be nondischargeable; “luxury goods or services” do not include goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor; an extension of consumer credit under an open end credit plan is to be defined for purposes of this subparagraph as it is defined in the Consumer Credit Protection Act;
In re Christie is an unpublished decision by the Hon. Joe Lee, of the Bankruptcy Court for the Eastern District of Kentucky, entered October 9, 1997 (Case No. 96-50823, A.P. No. 96-5073). The court held that use of a credit card itself is not a representation of ability to pay. In 1995, creditor First Card mailed to debtor Joseph M. Christie a Visa card invitation with a pre-approved credit line. The application sought only a small amount of information including identification of his employer, his social security number, date of birth and telephone numbers. First Card reserved the right to obtain and act upon a credit report. However, Mr. Christie apparently had good credit then and was issued the card. At that time, he was 23 years old and had take-home pay of less than $900 per month. He obtained five credit cards that year with an aggregate limit of $17,000. He quickly reached the limit on all of the cards, in large part as a result of cash advances used to fund gambling activity. The debtor then filed his bankruptcy proceeding.

First Card sought a determination that the debt was nondischargeable under both § 523(a)(2)(A) and § 523(a)(2)(B). The court characterized claims under § 523(a)(2)(A) as largely involving oral misrepresentations by borrowers and § 523(a)(2)(B) as involving written misrepresentations. The court rejected both claims. It noted that none of the meager application information provided by the debtor himself was actually false - - and that other information "published" about the debtor’s financial condition was published by someone other than the debtor, such as a credit bureau. The court further held that the debtor’s mere signing of a credit slip when the card is used is not a representation of ability to repay the debt. If there is any representation, it is of intent to repay. In reaching this conclusion, the court followed a Ninth Circuit decision, In re Anastas, 94 F.3d 1280 (9th Cir. 1996). The court finally held:

There must be a showing of actual or positive fraud, not merely fraud implied by law. The fact that a debtor is hopelessly insolvent and was unable to repay First Card, and that he had a gambling addiction is not sufficient to support a finding of the type of malicious and bad faith intent that is necessary for a finding of actual fraud under § 523(a)(2)(A).

Id. at 6 (emphasis in original).

Anastas is another case in which the credit card debt was incurred as a result of a claimed gambling addiction. The bankruptcy court found the debt to be nondischargeable, noting that since debtor’s expenses exceeded his income he could not have had a realistic hope of repaying the debt. The Ninth Circuit Bankruptcy Appellate Panel affirmed, but the Ninth Circuit Court of Appeals reversed. The court held that the representation made by a cardholder in a transaction is the intent, rather than ability, to pay. It further held that the hopeless condition of the debtor’s finances is not a substitute for an actual finding of bad faith.

In In re Moody, 203 B.R. 771 (Bankr. M.D. Fla. 1996), a Florida bankruptcy court rejected the approach adopted by the Ninth Circuit in Anastas for determining whether to except credit card debt from discharge as "overly narrow." Although the court did not dispute that a mere inability to meet the minimum charge on a card, or a balance exceeding the credit card limit, alone would not
be sufficient to except the debt under § 523(a)(2)(A), it would take such circumstances into account on a case by case basis. Under the facts and circumstances in this instance, the court concluded that there was no evidence in the record which warranted finding that the debtor engaged in a fraudulent financial scheme or "loaded up" his credit card debt having already decided to seek relief in bankruptcy.

In In re Feld, 203 B.R. 360 (Bankr. E.D. Pa. 1996), a Pennsylvania bankruptcy court noted that Congress did not intend to insulate a debtor who fraudulently uses a credit card. It applied the common law elements of fraudulent misrepresentation to credit card transactions in determining dischargeability under § 523(a)(2)(A). The Court found that each use of the card constitutes a representation of intent to pay. However, unlike Anastas, the court found that each use of the card was not a separate contract, but was rather the anticipated performance of the contract created when the card was issued. Finding that an inability to pay, by itself, is insufficient to show an intent to defraud, the court found the debt to be dischargeable for lack of evidence of reliance on the debtor's misrepresentations.

The requirement of 11 U.S.C. § 523(a)(2)(B) that misrepresentations of the debtor's financial condition must be in writing in order to be grounds for a declaration that the debt is nondischargeable have generated still more litigation strictly construing the requirement for a writing. In In re Kaspar, 125 F.3d 1358 (10th Cir. 1997), the Tenth Circuit noted that it was addressing the issue whether "modern technology and business practices grounded in convenience will prevail over the strict language of statutory law." The court held they would not. The court found that the lender's internal written summaries of information obtained from the debtor by telephone did not constitute a "writing" under §§523 (a)(2)(B). In Kaspar, the debtors telephoned Belleo First Federal Credit Union and applied for credit by telephone, giving oral answers to requests for information, including about their financial condition. Belleo then summarized the information in a computer-generated form which the debtors did not see or sign. The debtors incurred debt and filed a chapter 7 bankruptcy proceeding. Belleo filed a complaint alleging that the information provided by the debtors was untrue and sought to have the debt declared nondischargeable under both §§523(a)(2)(A) and (B). The parties stipulated the dismissal of the § 523(a)(2)(A) claim and litigated the other - - based on the issue of whether the debtors' oral statements and Belleco's computer generated form constituted a "writing." The court rejected the holding of a 1990 Florida bankruptcy court which denied dischargeability based on the court's equation of an oral application with one which the debtor "caused to be made or published." (Chevy Chase Federal Savings Bank v. Graham 122 B.R. 447 (Bankr. M.D. Fla. 1990)). The court held that the statute unequivocally requires a writing prepared by or adopted by the Debtor and that while

... the law lags behind technology and custom ... We will not undertake to rewrite the express language of a statute merely to accommodate the commercial conveniences attributable to modern technology.

Id. at 1362.
If the creditor brings and loses a nondischargeability action concerning consumer debt under § 523(a)(2), there is a statutory provision which may result in an award to the debtor of his or her attorney fees. 11 U.S.C. § 523(d) provides:

(d) If a creditor requests a determination of dischargeability of a consumer debt under subsection (a)(2) of this section, and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, the proceeding if the court finds that the position of the creditor was not substantially justified, except that the court shall not award such costs and fees if special circumstances would make the award unjust.

The provision was enacted in response to concern that some creditors were filing poorly-grounded nondischargeability actions in the hope of forcing a settlement and extracting some payments from the debtors.

Within the Sixth Circuit, one Tennessee bankruptcy court decision illustrates the risk to lenders of nondischargeability actions under § 523(a)(2) and expresses skepticism of the "implied representation" theory advanced by the creditor. 

In re Stockard, 216 B.R. 237 (Bankr. M.D. Tenn. 1997), was rendered December 16, 1997. The debt at issue resulted from Amy Stockard's use of a credit card obtained as a result of her response to lender Providian Bancorp's unsolicited "30 - Second Response Certificate." Within approximately six months, Ms. Stockard exceeded the limit on the card and all payments were late. However, Providian did not send a warning or revoke the card. The Stockards filed a bankruptcy proceeding. Providian brought an action alleging the nondischargeability under § 523(a)(2) of Ms. Stockard's debt in the amount of approximately $5000. In the nondischargeability action, the debtor sought discovery of matters including the lender's credit criteria and guidelines. The lender resisted the discovery, claiming that the information constituted trade secrets. On the day of the hearing on the motion to compel discovery, counsel for both parties announced that the action would be dismissed by stipulation. Days after the stipulation was filed, the debtor sought award of her attorney fees in the amount of $1,950. Providian objected.

The court in Stockard noted that it must award costs and reasonable attorney fees under 11 U.S.C. § 523(d) if the following four elements are satisfied:

1. The creditor requested a "determination of dischargeability of a consumer debt under subsection (a)(2)" of 11 U.S.C. § 523;

2. The debt was discharged;

3. The creditor's position throughout the litigation was not "substantially justified"; and

4. "Special circumstances" do not exist that "would make the award unjust."
In the attorney fee litigation, the parties agreed that the only contested issue was whether or not Providian’s position was “substantially justified” under § 523(a)(2)(A) (debts incurred by false pretenses, false representations or actual fraud other than a statement respecting the debtor’s financial condition). Providian had the burden of proving that the debtor obtained the money or credit through material misrepresentation, which the debtor knew was false or made with gross recklessness as to the truth, that the debtor made the misrepresentation with the intent to deceive, and that the Providian justifiably relied on the misrepresentation and that it caused the loss. Providian argued for an “implied representation” theory of nondischargeability under which, with each use of the credit card, the holder makes an implied representation that he or she has the intent to pay the charges incurred, citing Anastas.

The bankruptcy court in Stockard noted that the Sixth Circuit had not yet adopted an “implied representation” theory of nondischargeability. However, the Court did not address that issue because it held that Providian had failed another prong of the test — it could not prove that it justifiably relied on the alleged implied misrepresentation regarding intent to pay. Providian argued that it would have proved at trial that its reliance on the implied misrepresentation was justifiable because its criteria for issuing the credit card “was so dependable and predictive that it supplied the necessary justifiable reliance element of proof.” Id. at 243. However, the court noted that Providian had refused in discovery to reveal the criteria and guidelines on which it claimed to rely. It also noted that Providan’s diligence or not at the time that the card was issued does not demonstrate its subsequent reliance each time that each charge was incurred. The Court concluded:

A credit card company may not bring a nondischargeability action with the knowledge and intent that it will not produce discoverable information central to the issues and then, when threatened with having to do so, dismiss the action. It is this sort of abuse that § 523(d) is designed to redress.

Id. at 243. The Court not only awarded the debtor all of the $1,950 in attorney fees sought, but ordered the debtor’s counsel to submit an affidavit detailing the additional fees for the prosecution of the § 523(d) action itself.

The Second Circuit reached a creditor-friendly conclusion regarding the timing of discharge litigation. In In re Emery, 132 F.3d 892 (2d Cir. 1998), the court held that a creditor may seek a revocation of the debtor’s discharge based upon the creditor’s discovery of the debtor’s fraud after the deadline for objecting to discharge but before the date of discharge. The debtor filed a Chapter 7 proceeding in 1991. The deadline for filing a complaint objecting to discharge was September 10, 1991 and no complaint was filed. The debtor received the actual discharge on November 29, 1991. Creditor Citibank was still investigating the debtor’s conduct by the date of the discharge but later sought to revoke the discharge for the debtor’s fraud during the bankruptcy proceeding. The bankruptcy court dismissed the complaint holding that Citibank had constructive knowledge of the fraud prior to the discharge and should have sought an extension of time in which to object. The district court reversed and the Second Circuit affirmed it. The court held that there was nothing
indicating congressional intent to give a debtor immunity for the “gap” period between the bar date and the discharge itself.

A recent Kentucky bankruptcy court decision by the Hon. William S. Howard illustrates the risk to a debtor of a state court default judgment prior to a bankruptcy filing. In In re Brown, 215 B.R. 844 (Bankr. E.D. Ky. 1998), creditors obtained a default judgment against a chapter 7 debtor in state court on claims of common law fraud and under the Ohio Consumer Sales Practices Act. They then brought a complaint to have the debt excepted from discharge by 11 U.S.C. § 523(a)(2)(A), and argued that the default judgment was entitled to collateral estoppel effect. The Court, looking to state law on the preclusive effect of default judgments, found that the judgment was entitled to such effect on the common law fraud grounds, but not as to the Ohio act. The Court found that the elements of common law fraud in Ohio--a false representation, reasonable reliance and injury--were such that there was an express adjudication of the issue involved in the fraud exception to discharge. However, the Ohio Consumer Sales Practices Act merely proscribes certain unfair or deceptive acts. It required neither a showing of reasonable reliance nor proximate cause, and thus did not relate to and would not support summary judgment for the fraud made nondischargeable under section 523(a)(2)(A).

B. Plan Confirmation

1. Property Valuation, including “Lien Stripping”

In Associates Commercial Corp. v. Rash, _____ U.S._____, 117 S. Ct. 1879, 138 L. Ed.2d 148 (1997), the U.S. Supreme Court resolved a conflict among the circuits regarding the appropriate valuation of collateral for “cram down” purposes in a chapter 13. In 1989, Elray Rash bought a tractor truck for $73,700. He made a down payment and agreed to pay the balance over 60 months and pledged the truck as collateral for that unpaid balance. The seller assigned the loan and lien to Associates Commercial Corporation ("Associates"). In March 1992 Rash and his wife filed a petition and repayment plan under chapter 13. At that time, the balance due on the truck was approximately $41,000. Pursuant to 11 U.S.C. §506(a), the lender’s claim was secured only to the extent of the value of the collateral. In order to have their plan confirmed, the Rashes had to (a) gain the secured creditor’s acceptance of the plan; (b) surrender the collateral; or (c) invoke the cram down power. In a cram down, the debtor keeps the property over the objection of the creditor, with the creditor retaining the lien and the debtor paying to that creditor the present value of the allowed secured claim over the life of the plan. The allowed secured claim is the present value of the collateral, and the source of the dispute in this case.

The Rashes proposed a plan valuing the truck at $28,500 and Associates objected, arguing that it should be deemed an allowed claim for the full $41,000. The Rashes argued that the proper valuation is the net amount that Associates would realize if it repossessed and sold the truck, which its expert estimated to be approximately $31,000. Associates argued that the proper valuation was the amount that the Rashes would have to pay to purchase a similar vehicle, which its expert estimated to be $41,000.
The bankruptcy court agreed with the Rashes and approved the plan based on the lower "foreclosure value" amount. The district court affirmed. A panel of the Fifth Circuit reversed but, on rehearing en banc, then affirmed the district court. The Fifth Circuit held that a higher replacement value standard would result in the creditor's receipt of an amount in excess of what it would realize pursuing its state court remedies. The U.S. Supreme Court, in a decision by Justice Ginsburg, noted that, in contrast to the Fifth Circuit's foreclosure value approach, some circuits had followed a replacement value approach and others had held that a bankruptcy court has discretion to value property at the mid-point between foreclosure and replacement value. The Court granted certiorari in order to resolve the conflict. It reversed the Fifth Circuit, holding that the proper measure of value is the replacement value (i.e. fair market value, not the cost of a new replacement item). The Court noted that §506(a) requires valuation "in light of the purpose of the valuation and of the proposed disposition or use of such property . . ." It held that this dictated a valuation based upon the debtor's choice to retain and use the property -- the debtor derived value from the collateral equal to its replacement value. The Court concluded that "the value of property retained because the debtor has exercised the §1325(a)(5)(B) 'cram down' option is the cost the debtor would incur to obtain a like asset for the same 'proposed . . . use'." Id. at 1886.

Property valuation also plays an important role in determining the extent to which a creditor is able to protect its real estate mortgage when the debtor files for bankruptcy protection. Based on the valuation, the debtor may be able to avoid the creditor's interest by "stripping" the creditor's lien. Lien stripping continues to be an area of interest to lenders. Kentucky debtors were recently successful in stripping away a second mortgage-holder's claim and leaving the creditor without recourse for the debt, in In re Courtney, an unpublished decision by the Hon. Joe Lee, No. 96-5116 (Bankr. E.D. Ky. Oct. 9, 1997). The Bankruptcy Code provides that a creditor's claim is secured to the extent of the value of the collateral for such claim. 11 U.S.C. § 506(a). If the value of the collateral is less than the indebtedness, the balance of the creditor's claim is treated as unsecured. Thus, based on the value of the property at issue, debtors have attempted to "strip" away and avoid paying all or portions of a creditor's secured claim.

The Supreme Court of the United States has twice addressed the issue of "lien stripping" with respect to consensual mortgage liens. Briefly, in Dewsnup v. Timm, 502 U.S. 410, 112 S. Ct. 773, 116 L.Ed.2d 903 (1992), the Court held that a chapter 7 debtor could not "strip down" a mortgagee's lien to the judicially determined value of the collateral. In Nobelman v. Am. Savings Bank, 508 U.S. 324, 113 S. Ct. 2196, 124 L.Ed.2d 228 (1993), a chapter 13 debtor attempted to separate the secured and unsecured portions of a home mortgage and reduce the mortgage on the residence to the lower amount reflected by its fair market value. Nobelman resolved a split of authority among the courts of appeal, and held that it would not allow the debtor to split secured creditors' claims based on the property valuation and thereby modify the creditors' rights as reflected in the mortgage instrument. These decisions, however, did not purport to resolve the issue of lien stripping in all contexts.

In In re Courtney, the bankruptcy court discussed lien stripping in the context of wholly unsecured claims. The debtors filed a chapter 7 petition listing two mortgages as encumbrances on their residence. They estimated the value of their residence as $60,000 and claimed a $10,000 exemption in the property. Courtney at *1. This was the only evidence in the record as to the value
of the property. *Id.* at n.3. The debtors filed a statement of intent to retain the residence by reaffirming with the first mortgage-holder and avoiding the lien of the second. The first mortgage-holder filed a secured claim for just over $60,000. After the second mortgage-holder also filed a secured claim for approximately $12,000, the chapter 7 trustee filed a notice of abandonment of the estate’s property, including the residence. *Id.* at *2. The Debtors had not objected to the second mortgage-holder’s claim. However, they did not move to avoid the lien of the second mortgage-holder under 11 U.S.C. § 506(d). The motions was overruled based on *Dewsnup* because the creditor’s claim was, at that point, still deemed secured and had been fully allowed. *Id.* at *3.

After an order of discharge was entered, the debtors did object to allowance of the second mortgage-holder’s claim. They argued that, based on the fair market value of the residence, the claim should be unsecured because there was no equity to which it could attach. *Id.* Judge Lee found that the value of the second mortgage-holder’s claim secured by a lien on property in which the estate had an interest was zero. *Id.* at *5. Thus, the claim was completely “underwater” and totally unsecured. *Id.* at *6. Judge Lee reconciled this ruling with *Dewsnup* by noting that it stated that liens pass through bankruptcy unaffected where the claim is deemed “allowed” and secured by a lien with recourse to the underlying collateral. The Court held the second mortgage-holder’s claim was not enforceable against the debtors’ residence, but would be allowed as an unsecured claim. However, because of the debtors’ discharge, the second mortgage-holder was barred from collecting its claim as a personal liability of the debtors. *Id.* at *9.

Finally, valuation plays an important role in determining a debtor’s solvency. In *In re Trans World Airlines*, 134 F.3d 188 (3d Cir. 1998), Chapter 11 debtor TWA sought to recover a prepetition deposit made to stay enforcement of a judgment as a preferential transfer. The issue before the court was whether TWA was solvent on the date of the deposit. The debtor’s solvency depended on the method used to value its assets and liabilities, either fair market value or face value. The Third Circuit agreed with the bankruptcy court that the debtor was insolvent on the date of the deposit. Because liquidation was not clearly imminent, the court found that a “fair valuation” was achieved by using a going concern basis. In valuing the assets, the court noted that the amount that can be realized from their sale is a function of the time period over which they must be sold. A fair valuation of assets contemplates a conversion of assets into cash during a reasonable period of time. The court found that a reasonable time should be an estimate of the time that a typical creditor would find optimal, in this case 12 to 18 months. Lastly, the court addressed whether the debtor’s liabilities should be measured at face value or market value. It found that a fair valuation of TWA’s debt was its face value under a going concern analysis.

2. New Value and Absolute Priority Rule

The Seventh Circuit Court of Appeals recently followed the Ninth Circuit by concluding, in a single asset real estate case, that a “new value corollary” to the absolute priority rule still exists. The absolute priority rule provides generally that the members of one class of creditors cannot be paid until claims of a senior objecting class have been paid. “[A] dissenting class of unsecured creditors must be provided for in full before any junior classes can receive or retain any property under a reorganization plan.” *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202, 108 S.Ct.
963, 966, 99 L.Ed.2d 169 (1988) (internal quotations and brackets omitted). Thus, ordinarily, if unsecured creditors are not being paid in full, equity owners cannot retain their interest. The "new value corollary" to this rule provides that the equity owners can retain their interest if they contribute new and "reasonably equivalent" value in the form of money or "money's worth." There has been considerable discussion in the case law about whether this exception to the absolute priority rule still exists. The Sixth Circuit has impliedly acknowledged the new value corollary. In re U.S. Truck, 800 F.2d 581, 588 (6th Cir. 1986).

The Seventh Circuit confirms its recognition of the new value corollary in Matter of 203 N. LaSalle Street Partnership, 126 F.3d 955 (7th Cir. 1997). LaSalle is a limited partnership which owns certain office space encumbered by a lien in favor of Bank of America. LaSalle owed Bank of America over $93 million, secured by a non-recourse mortgage. Bank of America was significantly undersecured and elected to split its claim, to be treated as a secured claim and an unsecured claim under 11 U.S.C. § 1111(b). Over the Bank of America's objection, the bankruptcy court approved a plan which paid Bank of America's secured claim valued at $55.8 million over the course of a seven to ten year plan period, amortized over thirty years. If the property were sold or refinanced, the secured claim would be paid and any additional amounts would be applied towards Bank of America's over $38 million unsecured claim. The debtor's partners were permitted to retain their interest during this period of time in exchange for contribution of new capital in the amount of $3 million at the time of confirmation and five annual installments of $625,000. In exchange, the partners deferred or saved the immediate tax recapture in the amount of $38 million and they retained an interest in property in the event that it increased over the term of the plan. The bankruptcy court also confirmed the plan notwithstanding Bank of America's argument that the plan was not feasible because the debtor's own projections anticipated cash flow shortfalls in years seven and eight of the plan.

3. Debtor Redemption Rights

A recent Sixth Circuit Bankruptcy Appellate Panel decision addressed the debtor's redemption rights in a vehicle. In In re Elliott, 214 B.R. 148 (6th Cir. BAP 1997), the BAP held that an automobile which had been repossessed by a secured creditor prior to the bankruptcy filing continued to be property of the bankruptcy estate where the repossessed property had not been sold, and the debtors' rights of redemption extinguished, prior to the date of bankruptcy. The Court denied the secured creditor relief from stay in a chapter 13 case even though the car had been repossessed prior to the bankruptcy filing and the bank had obtained a repossession title for purposes of selling the vehicle at public auction. Under Ohio law, the debtor's statutory redemption rights were not extinguished until the repossessed collateral was sold. Kentucky law has similar provisions. KRS 355.9-506. The Sixth Circuit BAP recognized the bankruptcy court's ability to determine whether the right of redemption continued to exist as an equitable interest which was "property of the estate" under the Bankruptcy Code. The Court denied the bank relief from the stay and allowed the debtor to cure the defaults, obtain possession of the vehicle from the bank, and pay the bank over time under the chapter 13 plan. Elliott reminds creditors with secured claims that, even if collateral has been repossessed and the bank has possession of the property, an order of relief
from the stay should be sought from the bankruptcy court prior to the secured creditor taking any steps involving the collateral. Otherwise, a risk of a stay violation exists for the lender.

4. Set Off

In *In re Continental Airlines*, 134 F.3d 536 (3d Cir. 1998), after chapter 11 plans submitted by Continental Airlines and its affiliates had been confirmed, the U.S. government moved to set off its claim against funds owed to Continental and deposited with the court pursuant to unrelated litigation. Pursuant to the confirmed plans, various federal agencies were to be treated as general unsecured creditors and recover a small percentage of their total claims. In separate litigation, the government had been ordered to return money it had wrongfully withheld from several airlines, including $4.8 million to Continental which it deposited with the bankruptcy court. The Third Circuit affirmed the ruling that the government’s set-off rights, if any, were extinguished by confirmation of the plan. In doing so, the court distinguished *Citizens Bank of Maryland v. Strumpf*, 516 U.S.16 (1995), and followed instead its earlier decision in *United States v. Norton*, 717 F.2d 767 (3d Cir. 1983) (holding that a creditor’s withholding of funds subject to a set-off violated the automatic stay and adopting the view that set-off is not permitted after confirmation of the plan). Comparing the funds deposited with the court to the res of a trust, the court found that the government’s set-off rights were affected by confirmation of the plan because the government no longer retained an interest in them.

C. Security Interests

1. Purchase Money Security Interests

In *Fidelity Fin. Serv., Inc. v. Fink*, _U.S._, 118 S. Ct. 651, 139 L. Ed.2d 571 (1998), the U.S. Supreme Court permitted a chapter 13 debtor to avoid a purchase money security interest in a vehicle as a result of the creditor’s delay in perfecting the lien. 11 US.C. § 547 prohibits the trustee from avoiding otherwise preferential transfers to the extent they result from a contemporaneous exchange for new value, and to the extent that a security interest is perfected within twenty days of the debtor taking possession of the collateral. Under 11 US.C. § 547(c)(3)(B), a bankruptcy trustee (or chapter 13 debtor) may not avoid a purchase money security interest if, among other things, that security interest is "perfected on or before twenty days after the debtor receives possession of such property." In *Fidelity* the creditor perfected its security interest more than twenty days after the debtor’s receipt of the property but within a relation-back or grace period provided by state law. The Court held that the perfection was not timely and permitted the avoidance of the lien.

In 1994, Diane Beasley purchased an automobile and gave Fidelity Financial Services Inc. ("Fidelity") a promissory note for the price, secured by the vehicle. Twenty-one days later, Fidelity mailed the application necessary to perfect its security interest, addressed to the Missouri Department of Revenue. Two months later, Beasley filed a chapter 7 proceeding. After that proceeding was converted to a chapter 13, Richard Fink, the trustee of the bankruptcy estate, moved to set aside Fidelity’s security interest as an avoidable preference because Fidelity had failed to protect that interest within 20 days after Beasley’s receipt of the car. Fidelity argued that the
applicable state law -- that of Missouri -- treated a lien on a motor vehicle as having been perfected on the date of its creation if the debtor filed the necessary documents within 30 days after the debtor takes possession.

The bankruptcy court held that the lien was an avoidable preference, concluding that Missouri's relation back provision could not extend the twenty-day perfection period imposed by § 547(c)(3)(B). The district court and the Eighth Circuit each affirmed, with the latter holding that a transfer is perfected "when the transferee takes the last step required by state law to perfect its security interest." *Fidelity Fin. Serv v. Fink*, 102 F.3d 334, 335 (8th Cir. 1996) (internal quotation marks omitted), aff'd, 118 S. Ct. 651 (1998). The U.S. Supreme Court noted that it granted certiorari in order to resolve a conflict among the circuits over the question of when a transfer was perfected. In an opinion by Justice Souter, the Court affirmed the Eighth Circuit.

Although the creditor lost in *Fidelity* based upon the federal twenty day period, a Kentucky creditor recently succeeded, based on that federal period. In *In re Smallwood*, 204 B.R. 519 (Bankr. E.D. Ky. 1997), the bankruptcy trustee filed a complaint seeking to avoid the bank's lien on the debtors' automobile as a preferential transfer. The bank filed its lien sixteen days after debtors purchased and took possession of the vehicle. Thirty-one days after the bank perfected its lien, debtors filed for bankruptcy. The trustee claimed that the bank's lien was perfected outside the 10-day relation back period provided by state statute. KRS 186A.195(5). The Court concluded that federal law prevailed in determining the time of perfection and that the bank's lien was not avoidable.

2. Other Security Interests

The bankruptcy court of the Eastern District of Kentucky has also recently addressed the scope of a security interest in "general intangibles" as it relates to the right to a refund of unearned insurance premiums. In *In re MegaMarket of Lexington, Inc.*, 207 B.R. 527 (Bankr. E.D. Ky. 1997), the chapter 7 trustee filed a notice of abandonment of the estate's interest in certain bank accounts, on the ground that the accounts were over-encumbered by the consensual lien of an entity now known as Fleming Companies, Inc., the statutory liens of wage claimants and a tax lien. The debtor objected, challenging the validity of Fleming's security interest.

The debtor had executed a loan and security agreement in which it gave to Fleming's predecessor a security interest in then-owned or after-acquired property including "general intangibles" and proceeds. Approximately one month post petition, the debtor's insurance carrier paid the debtor approximately $80,000 which was a refund of unearned premiums on two workers compensation insurance policies. Both policies terminated prior to the bankruptcy filing. The court, in an opinion by Judge Lee, concluded that the debtor had a right to the refund prior to the commencement of the case but had received the money after commencement. The court concluded that the refund constituted "proceeds" of the collateral, and "proceeds" as used in § 552(b) "is not limited to the technical definition of that term in the U.C.C., but covers any property into which property subject to the security interest is converted." *Id.* at 532 (quoting legislative history). The court found that a prepaid insurance account is a current asset, is "easily convertible to cash upon
expiration or cancellation of the policy." The court concluded that a prepaid insurance account is a "chose in action" which falls under the category of a "general intangible." The court noted that Fleming had a properly perfected security interest in the debtor’s intangibles, the policies expired or were canceled prior to the bankruptcy, making the right to receive the refund property which the debtor acquired prepetition, and the refund itself proceeds of the collateral.

D. Secured Claims Issues

A recent Sixth Circuit Court of Appeals BAP decision discussed the claims of an oversecured creditor where the debtor objected to substantial portions of the attorney fee and other components of the secured claim. In Re Brunswick Apartments of Trumbull County, Ltd., 215 B.R. 520 (6th Cir. BAP 1998). 11 U.S.C § 506(b) is the provision by which oversecured creditors are entitled to interest and the "reasonable" charges permitted by their loan documents. It provides as follows:

(b) to the extent that an allowed secured claim is secured by property the value of which, after any recover under subsection (c) of this section [trustee’s ability to recover from property securing an allowed secured claim the reasonable and necessary expenses of preserving or disposing of the property], is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, cost, or charges provided for under the agreement under which such claim arose."

In Brunswick, the debtor executed a promissory note to Cardinal Industries Mortgage Company in 1989 in the amount of approximately $1.3 million. The note was later assigned to First Bank of Ohio by the F.D.I.C. The debtor eventually defaulted, and filed its chapter 11 petition. It was apparently undisputed that the bank was oversecured, which entitled it to interest, attorney fees and other costs. The debtor and the bank disputed the proper amount of those charges. The bankruptcy court fixed the bank’s secured claim in the amount of approximately $1.3 million, disallowing a service charge claimed by the bank, a significant portion of the bank’s attorney fee claim, and other charges. The appellate panel affirmed, noting the significant deference given the bankruptcy court’s determination regarding the “reasonableness standard” of § 506(b).

The note given by Brunswick provided for a 5% service charge to be levied on any delinquent "installment" payment. The bank sought to include in its claim that 5% charge on installments including the final payment due. That final payment was actually a "balloon" payment on the matured principal balance, as opposed to a periodic installment payment under the note. The bankruptcy court and BAP construed the loan document as permitting a service charge only on the regular installments and not the final balloon. The bank also included in its claim the fees of its principal counsel in the amount of approximately $63,000. The bankruptcy court allowed only approximately $11,000 of this amount. The bankruptcy court noted that the claim included fees for services to enforce a purported compromise which the Court found had never been reached. The Court also found that the bank had filed a lengthy and detailed objection to a plan under which it was not impaired, and had failed to pursue that objection at the actual hearing. The bankruptcy court
found the bank's efforts to have been unnecessary to protect its interest, and the BAP agreed. The bank had also included in its claim the fees of a consultant who sat on the bank's board and portions of the regular salaries of the bank's in-house employees who spent time on the matter, all of which was disallowed.

E. Fraudulent Conveyances

In In re Taylor, 133 F.3d 1336 (10th Cir. 1998), the Tenth Circuit found a fraudulent conveyance in a debtor's pre-bankruptcy conversion of a jointly-held asset to an individually-held asset. Here, Mr. and Mrs. Taylor traded a jointly-titled vehicle for a vehicle which was titled only in Mrs. Taylor's name. Mr. Taylor filed a bankruptcy proceeding approximately two weeks later. The Court held that the trustee was entitled to judgment against Mrs. Taylor for one-half of the value of the Taylors' interest in the vehicle that was traded pre-petition. The Court also held that the debtor concealed the transfer by not identifying the trade.

Continued development has occurred with respect to the issue of a bankruptcy trustee's ability to recover debtors' pre-petition transfers to churches. 11 U.S.C. § 548 provides that a trustee may avoid, or recover, certain pre-bankruptcy transfers for which the debtor received less than "reasonably equivalent value." In In re Young, 82 F.3d 1407 (8th Cir. 1996), the Eighth Circuit held that a bankruptcy court could not recover funds that the debtors had tithed to their church. The appellate court agreed that the transfers would ordinarily be avoidable transfers but concluded that permitting the recovery of the money would violate the Religious Freedom Restoration Act, as a substantial burden on the debtor's free-exercise of religion without furthering a compelling governmental interest. In 1997, the U.S. Supreme Court vacated and remanded Young in light of its decision in City of Boerne v. Flores, ___ U.S. ___, 117 S.Ct. 2157 (1997), reversing a Fifth Circuit decision that RFRA is constitutional. See Christians v. Crystal Evangelical Free Church, __, U.S. __, 117 S. Ct. 2502, 138 L. Ed.2d 1007 (1997).

F. Jurisdiction Issues

The United States Supreme Court's 1996 decision regarding a gaming issue for a Native American tribe continues to have an impact on bankruptcy law. See Seminole Tribe of Florida v. Florida, 517 U.S. 44, 116 S. Ct. 114, 134 L. Ed.2d 252 (1996). In Seminole Tribes the Court held that Congress could not abrogate states' Eleventh Amendment immunity except under the Fourteenth Amendment. The Third Circuit Court of Appeals recently concluded that 11 U.S.C. § 106, which purports to abrogate sovereign immunity in bankruptcy proceedings, is unconstitutional. See In re Sacred Heart Hospital of Norristown, 133 F.3d 237 (3d Cir. 1998). The Honorable William Howard, of the Bankruptcy Court for the Eastern District of Kentucky, has held similarly in In re Tri-City Turf Club, 203 B.R. 617 (Bankr. E.D. Ky. 1996).
G. **Reaffirmation**

Bankruptcy courts throughout the country continue to look at reaffirmation agreements in Chapter 7 cases and the practices surrounding them. Much of their effort is directed against Sears. A California bankruptcy court found that Sears engaged in the unauthorized practice of law by sending a non-lawyer account representative to negotiate a reaffirmation agreement with an unrepresented couple. A New York bankruptcy judge reviewed all the reaffirmation agreements filed in his court in 1997 to which Sears was a party. In 30 cases he required the debtor’s attorneys to explain why the agreements were in the debtors’ best interests. He sanctioned counsel in one case for failing to adequately counsel the debtors. Sears has been sanctioned for obtaining reaffirmation agreements, deliberately not submitting them to the court, but enforcing them anyway. *In re Latanowich*, 207 B.R. 326 (Bankr. Mass. 1997). In addition to the sanction, the court reported the matter to the U.S. Attorney for potential criminal investigation.

H. **Miscellaneous Cases of Interest**

The bankruptcy court for the Western District of Kentucky recently sanctioned a creditor for filing a criminal complaint for the purpose of collecting a discharged debt. *In re Brown (Brown v. Foley)*, 213 B.R. 317 (Bankr. W.D. Ky., 1997). In 1995, Everett F. Brown closed his vehicle parts business and turned over the inventory to the seller who had financed the acquisition of the business. In early 1996, he filed for bankruptcy protection. Brown listed one of his suppliers, Southern Kentucky Rebuilders, Inc., as a creditor. The supplier’s principal, Mike Foley, acknowledged receipt of the bankruptcy notice but did not otherwise participate in the bankruptcy proceeding.

After receiving Brown’s bankruptcy notice, Foley filed a criminal complaint against Brown, resulting in a grand jury indictment of Brown on May 24, 1996, for felony theft by failure to make required disposition. On June 6, 1996, he received his bankruptcy discharge. On June 20, 1996, he was arrested on the theft charge. Brown’s counsel inquired of the Commonwealth Attorney about Foley’s intent in bringing the complaint and Foley’s subsequent correspondence with the Commonwealth’s Attorney indicated that Foley had no objection to deferring the charges if he was paid the money owed.

Brown then filed an adversary proceeding seeking to enjoin further criminal proceedings and be awarded damages for violation of the discharge injunction and the automatic stay. The Honorable David T. Stosberg immediately enjoined Foley and the Commonwealth Attorney from pursuing the criminal proceedings, which the Commonwealth Attorney then dismissed with prejudice. Foley defended the damages complaint on the grounds that he acted solely as agent for his corporation and that the goods disposed of by Brown were held on “consignment.” The court concluded that the transaction did not exhibit characteristics of a consignment, that Foley’s conduct would not be excused by “allowing him to belatedly hide behind a rather thin corporate veil,” that Foley had not bothered to investigate the closing of the business and the disposition of the property and that he was unremorseful regarding his actions. The court further noted Foley’s willingness to accept the money and defer the criminal prosecution as evidence of his true motive for seeking the indictment - - to collect the debt. The Court awarded Brown compensatory damages in the amount of approximately
$3,500 and held "as a deterrent, we award Brown punitive damages in the amount of $6,300, which is triple the amount which Foley sought to recover from Brown through the criminal proceeding." *Id.* at 321.

In *In re Miller*, 215 B.R. 970 (Bankr. E.D. Ky. 1997), a chapter 13 bankruptcy, the debtor brought an adversary proceeding to challenge various practices of the defendant check cashing service, specifically a fee that it charged when the debtor's check was returned for insufficient funds. The fee was charged as a renewal of the transaction for another two week period. The debtor claimed that this fee violated both federal and state consumer credit disclosure requirements. The check cashing service characterized the fee as a service charge, and thus not required to be disclosed as a finance charge. On a motion to dismiss, the court, in an opinion by Judge Howard, found that the debtor's complaint stated a cause of action under both the federal Truth in Lending Act, Regulation Z, and the Kentucky credit disclosure statute.

In *In re Travel Professionals Int'l*, 213 B.R. 669 (Bankr. E.D. Ky. 1997), the court, in another opinion by Judge Howard, addressed its jurisdiction over estate counterclaims that are otherwise not related to bankruptcy. Prior to the institution of this involuntary chapter 7 bankruptcy, the bank brought a collection action in state court. The state court action was removed to an adversary proceeding in the bankruptcy and the debtors filed lender liability counterclaims. In deciding a motion for abstention, the Court found that it had jurisdiction to conduct a jury trial on all the claims asserted in the action, given consent by the parties and a special designation by the district court. The Court refused to abstain from hearing the action because it involved claims litigation, noting that counterclaims may be the largest assets of an estate. For the same reason, because the matter was a core proceeding involving claims litigation, the Court found that it was not required to abstain under 28 U.S.C. § 1334(c)(2) (requiring abstention of state law causes of action not arising under title 11).

III. RECOMMENDATIONS OF NATIONAL BANKRUPTCY REVIEW COMMISSION

A. Formation and Activities of the NBRC

The National Bankruptcy Review Commission ("Commission") issued its final report on October 20, 1997. The approximately 1,300 page report is entitled *Bankruptcy: The Next Twenty Years*, and includes 172 recommendations to Congress. Although the Report makes recommendations, it does not include draft legislation and there is not yet noticeable activity in Congress with respect to all or a portion of the recommendation. This outline notes selected recommendations which may be of the most interest to the banking community. The full text of the recommendations is attached as an exhibit. The entire report is available on the Internet at http://www.nrbc.gov. The section references below are to the recommendations themselves.
B. Business Bankruptcy Recommendations

The Commission recommends amendment or clarification of numerous aspects of the Code with respect to partners and partnerships. Under the Commission’s proposal, the bankruptcy court would have the power to decide who is a partnership and determine rights among general partners. Section 2.3.3. The Commission recommends that the estate should have a claim against a general partner to the extent that he or she would be personally liable for a deficiency under applicable non-bankruptcy law, with the amount not being reduced on account of any right of contribution or indemnity among the general partners. Section 2.3.4. The Court would also be able to order a partner to provide the partnership estate with assurance of payment of, or indemnity for, any deficiency recoverable from the general partner, or order him not to incur obligations or transfer property. Section 2.3.5.

The Commission recommends that 11 U.S.C. § 558 be amended to provide that, except in certain specified circumstances, prepetition waivers, restrictions and conditions or other modifications of a debtor’s rights are unenforceable. Section 2.4.5.

The Commission proposes that 11 U.S.C § 1129(b)(2)(B)(ii) should be amended to provide that the Court may find that a plan is fair and equitable (which is a confirmation requirement) even though it permits members of a junior class of claims or interests to purchase new interest in the reorganized debtor. However, under these circumstances, a party in interest could request that the court terminate the period in which the debtor has the exclusive right to propose a plan if the debtor moves to confirm a non-consensual plan.

The Commission proposes a new category of debtors to be known as a “small business debtor.” This would be any chapter 11 debtor which has aggregate non-contingent liquidated secured and unsecured debts as of the petition date or order for relief in the amount of $5 million or less and any single asset real estate debtor as defined in 11 U.S.C. § 101(51b), regardless of the amount of such debtor’s liability. These debtors would be subject to a streamlined reorganization process. This proposal would require debtors in small business chapter 11 cases to file a plan within 90 days and require confirmation within 150 days except as otherwise permitted. Section 2.5.5. The Commission also recommend expanding the grounds for appointment of a chapter 11 trustee. Under the recommendation, a trustee could be appointed for reasons including substantial or continuing loss to the estate, failure to maintain insurance, and failure to comply with orders of the court. Section 2.5.9.

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2The Commission recommends eliminating the $4 million debt ceiling from the definition of “single asset real estate” debtor. Section 6.2.1
C. Consumer Bankruptcy Recommendations

The consumer bankruptcy recommendations which will probably be of primary interest to lenders include recommendations regarding the increased standardization of exemptions, the use of reaffirmation agreements, credit card debt discharge and chapter 13 plan requirements and valuations.

First, the Commission proposes the elimination of state’s ability to “opt out” of the federal exemptions scheme. At this time, 11 U.S.C § 522(d) lists the type and amount of value of property that a debtor can claim exempt under the federal bankruptcy law. However, states are permitted to “opt out,” in which case the debtor may claim exemptions in property only pursuant to the state’s exemption scheme. Kentucky is one of many states which has opted out. See KRS 427.170. The federal exemption scheme is generally more favorable to the debtor than is Kentucky’s. For example, the federal homestead exemption at present is $15,000. 11 U.S.C § 522(d)(1). Kentucky’s homestead exemption is $5,000. KRS 427.080. The Commission then recommends that the debtor be able to exempt an interest in real property used as a principal residence in the amount determined by the law of the state in which the debtor resides, but no event should that interest be less than $20,000 no more than $100,000. All exemptions except the homestead exemption would apply separately to each debtor in a joint case - - i.e. depending on the state of residence, a married couple in a bankruptcy proceeding would be able to claim at least $20,000 homestead exemption. See Section 1.2.3.

With respect to property of the estate not exempted by other provisions, the Commission recommends that the debtor be permitted to retain up to $20,000 in value in any form. The debtor who claims no homestead exemption would be permitted to exempt an additional $15,000 of property in any form. Section 1.2.3.

The Commission recommends that 11 U.S.C § 524(c) be amended to propose additional requirements for reaffirmation agreements. The Commission recommends that reaffirmation be permitted with court approval, if the amount of debt the debtor seeks to reaffirm does not exceed the allowed secured claim, the lien is not avoidable, no attorney fees cost or expenses have been added to the principal amount of the debt being reaffirmed and the reaffirmation meets other requirements. The Commission recommends an amendment of § 524(d) to provide that an actual hearing is not required only when the debtor was represented by counsel in negotiations on the agreement, the counsel signs an affidavit making required representations and no one has requested a judicial valuation of the collateral which is the subject of the agreement. The court could still hold a hearing in its discretion and the court’s approval of the agreement would signify its determination that the agreement is in the best interest of the debtor and the debtor’s dependants and does not impose on due hardship on them. The Commission also recommends adding an additional subsection of 11 U.S.C. § 524 which will require the court to award costs, attorney fees and treble damages against a creditor who seeks to collect a debt which has been discharged and is not reaffirmed. Section 1.3.2.
The Commission recommends amending 11 U.S.C. § 522(f) to provide that a creditor claiming a purchase money security interest in exempt property held for personal or household use of the debtor or a dependant of the debtor must petition the bankruptcy court for continued recognition of the security interest and the court must hold a hearing to value each item covered by the petition. If the value of the item is less than $500, the petition will not be granted. If the value is $500 or greater the security interest would be recognized and treated as a secured loan in Chapter 7 or Chapter 13 matter. Section 1.3.4

The Commission recommends that the code be amended to provide that, except for credit card debts excepted from discharge under § 523(a)(2)(B) (for materially false written statements respecting the debtor’s financial condition) and § 523(a)(14) (debts incurred to pay non-dischargeable taxes to the United States), debts incurred on a credit card that did not exceed the debtor’s credit limit would be dischargeable unless incurred with 30 days before the order for relief. The Commission further recommends repealing § 523(a)(8) to make student loans once again dischargeable. Section 1.4.5. The Commission further recommends that creditors who do not receive notice of a bankruptcy get an extension of time in order to object to or seek revocation of a discharge. Section 1.4.8.

The Commission recommends that § 1322(b)(2) be amended to provide that the rights of a holder of a claim secured only by a junior lien on real estate that is the debtor’s principal residence may not be modified to reduce the secured claim to less than the appraised value of the property at the time that security interest was given. The Commission also proposes that the creditor’s claim secured by personal property be determined by the property’s wholesale value, and a claim secured by real property be determined by that real property’s fair market value less the hypothetical cost of sale. Section 1.5.2.

The Commission proposes payments on unsecured debt be determined by guidelines based upon the debtor’s income, without being less than the value of what the creditors would receive in a chapter 7. Section 1.5.4. The Commission also proposes some additional restrictions on multiple filings, Section 1.5.5.

D. Administrative Recommendations

The Commission recommended establishment of a national consumer filing system which would identify bankruptcy filings with the debtors’ social security numbers or other identifying numbers. Section 1.1.1. The Commission also recommends the increased use of random audits of debtors’ schedules. Section 1.1.2.
THE REPORT OF THE
NATIONAL BANKRUPTCY REVIEW COMMISSION

Final Report
October 20, 1997
# BANKRUPTCY: THE NEXT TWENTY YEARS
National Bankruptcy Review Commission
Final Report

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Chapter 1: Consumer Bankruptcy - System Administration

1.1.1 National Filing System

A national filing system should be established and maintained that would identify bankruptcy filings using social security numbers or other unique identifying numbers.

1.1.2 Heightened Requirements for Accurate Information

The Bankruptcy Code should direct trustees to perform random audits of debtors’ schedules to verify the accuracy of the information listed. Cases would be selected for audit according to guidelines developed by the Executive Office for United States Trustees.

1.1.3 False Claims

Courts should be authorized to order creditors who file and fail to correct materially false claims in bankruptcy to pay costs and the debtors’ attorneys’ fees involved in correcting the claim. If a creditor knowingly filed a false claim, the court could impose appropriate additional sanctions.
1.1.4 **Rule 9011**

The Commission endorses the amended Rule 9011 of the Federal Rules of Bankruptcy Procedure, to become effective on December 1, 1997, which will make an attorney's presentation to the court of any petition, pleading, written motion, or other paper a certification that the attorney made a reasonable inquiry into the accuracy of that information, and thus will help ensure that attorneys take responsibility for the information that they and their clients provide.

1.1.5 **Financial Education**

All debtors in both Chapter 7 and in Chapter 13 should have the opportunity to participate in a financial education program.

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**Chapter 1: Consumer Bankruptcy - Property Exemptions**

1.2.1 **Elimination of Opt Out**

A consumer debtor who has filed a petition for relief under the Bankruptcy Code should be allowed to exempt property as provided in section 522 of the Code. Subsection (b)(1) and (2) of section 522 should be repealed.

1.2.2 **Homestead Property**

The debtor should be able to exempt the debtor's aggregate interest as a fee owner, a joint tenant, or a tenant by the entirety, in real property or personal property that the debtor or a dependent of the debtor uses as a residence in the amount determined by the laws of the state in which the debtor resides, but not less than $20,000 and not more than $100,000. Subsection (m) of section 522 should be revised to reflect that all exemptions except for the homestead exemption shall apply separately to each debtor in a joint case.

1.2.3 **Nonhomestead Lump Sum Exemption**

With respect to property of the estate not otherwise exempt by other provisions, a debtor should be permitted to retain up to $20,000 in value in any form. A debtor who claims no homestead exemption
should be permitted to exempt an additional $15,000 of property in any form.

1.2.4 All professionally-prescribed medical devices and health aids necessary for the health and maintenance of the debtor or a dependent of the debtor should be exempt.

1.2.5 Rights to Receive Benefits and Payments

All funds held directly or indirectly in a trust that is exempt from federal income tax pursuant to sections 408 or 501(a) of the Internal Revenue Code should be exempt.

1.2.6 Rights to Payments

Rights to receive future payments (e.g., social security benefits, life insurance) should be exempt, and the debtor’s right to receive an award under a crime victim’s reparations law or payment for a personal bodily injury claim of the debtor or the debtor’s dependent should be exempt.

Chapter 1: Consumer Bankruptcy - Reaffirmation Agreements and the Treatment of Secured Debt

1.3.1 11 U.S.C. § 524(c) should be amended to provide that a reaffirmation agreement is permitted, with court approval, only if the amount of the debt that the debtor seeks to reaffirm does not exceed the allowed secured claim, the lien is not avoidable under the provisions of title 11, no attorney fees, costs, or expenses have been added to the principal amount of the debt to be reaffirmed, the motion for approval of the agreement is accompanied by underlying contractual documents and all related security agreements or liens, together with evidence of their perfection, the debtor has provided all information requested in the motion for approval of the agreement, and the agreement conforms with all other requirements of subsection (c).

Section 524(d) should be amended to delineate the circumstances under which a hearing is not required as a prerequisite to a court approving an agreement of the kind specified in section 524(c): a hearing will not be required when the debtor was represented by counsel in negotiations on the agreement and the debtor’s attorney has signed the affidavit as provided in section 524 (c), and a party in
interest has not requested a judicial valuation of the collateral that is the subject of the agreement. If one or more of the foregoing requirements is not met, or in the court's discretion, the court shall conduct a hearing to determine whether an agreement that meets all of the requirements of subsection (c) should be approved. Court approval of an agreement signifies that the court has determined that the agreement is in the best interest of the debtor and the debtor's dependents and does not impose undue hardship on the debtor and the debtor's dependents in light of the debtor's income and expenses.

The Commission recommends that the Advisory Committee on Bankruptcy Rules of the Judicial Conference prescribe a form motion for approval of reaffirmation agreements that contains information enabling the court and the parties to determine the propriety of the agreement. Approval of the motion would not entail a separate order of the court.

1.3.2 An additional subsection should be added to section 524 to provide that the court shall grant judgment in favor of an individual who has received a discharge under section 727, 1141, 1228, or 1328 of this title for costs and attorneys fees, plus treble damages, from a creditor who threatens, files suit, or otherwise seeks to collect any debt that was discharged in bankruptcy and was not the subject of an agreement in accordance with subsections (c) and (d) of section 524.

1.3.3 No Ride-Through

Section 521(2) should be amended to clarify that a debtor with consumer debts that are secured, as determined by the provisions of title 11, by property of the estate must redeem the property or obtain court approval of an agreement under section 524(c) of title 11 in order to retain the property postdischarge, except for a security interest in real or personal property that is the debtor's principal residence.

1.3.4 Security Interests in Household Goods

Household Goods Worth Less Than $500

Section 522(f) should provide that a creditor claiming a purchase money security interest in exempt property held for personal or household use of the debtor or a dependent of the debtor in household furnishings, wearing apparel, appliances, books, animals, crops, musical instruments, jewelry, implements, professional books, tools of the trade or professionally prescribed health aids for the debtor or a
member of the debtor’s household must petition the bankruptcy court for continued recognition of the security interest. The court shall hold a hearing to value each item covered by the creditor’s petition. If the value of the item is less than $500, the petition shall not be granted; if the value is $500 or greater, the security interest would be recognized and treated as a secured loan in Chapter 7 or Chapter 13.

1.3.5 Characterization of Rent-to-Own Transactions

Consumer rent-to-own transactions should be characterized in bankruptcy as installment sales contracts.

Chapter 1: Consumer Bankruptcy - Discharge, Exceptions to Discharge and Objections to Discharge

1.4.1 Credit Card Debt

Except for credit card debts that are excepted from discharge under section 523(a)(2)(B) (for materially false written statements respecting the debtor’s financial condition) and section 523(a)(14), (debts incurred to pay nondischargeable taxes to the United States), debts incurred on a credit card issued to the debtor that did not exceed the debtor’s credit limit should be dischargeable unless they were incurred within 30 days before the order for relief under title 11.

1.4.2 Debts Incurred to Pay Nondischargeable Federal Tax Obligations

Section 523(a)(14) should remain unchanged to except from discharge debts incurred for federal taxes that would be nondischargeable under section 523(a)(1).

1.4.3 Criminal Restitution Orders

Section 523(a)(13) should be expanded to apply to all criminal restitution orders.

1.4.4 Family Support Obligations

Sections 523(a)(5), (a)(15), and (a)(18) should be combined. The revised 523(a)(5) should provide that all debts actually in the nature of support, whether they have been denominated in a prior court order as alimony, maintenance, support, property settlements, or otherwise,
are nondischargeable. In addition, debts owed under state law to a state or municipality in the nature of support would be nondischargeable in all chapters.

1.4.5 Dischargeability of Student Loans

Section 523(a)(8) should be repealed.

1.4.6 Issue Preclusive Effect of True Defaults

For complaints to establish nondischargeability on grounds set forth in section 523(c), the Bankruptcy Code should clarify that issues that were not actually litigated and necessary to a prior judgment shall not be given preclusive effect.

1.4.7 Vicarious Liability

Section 523(c) should be amended such that intentional action by a wrongdoer who is not the debtor cannot be imputed to the debtor.

1.4.8 Effect of Lack of Notice on Time to Bring Objection to Discharge

Creditors that did not receive notice of a bankruptcy should get an extension of time to file an objection to or seek revocation of a discharge.

1.4.9 Settlement and Dismissal of Objections to Discharge

Section 727 should be amended to provide that (a) any complaint objecting to discharge may be dismissed on motion of the plaintiff only after giving notice to the United States trustee, the case trustee and all creditors entitled to notice, advising them of an opportunity to substitute as plaintiff in the action; (b) any motion to dismiss a complaint objecting to discharge must be accompanied by an affidavit of the moving party disclosing all consideration given or promised to be given by the debtor in connection with dismissal of the complaint; and (c) if the debtor has given or promised to give consideration in connection with dismissal of the complaint, the complaint may not be dismissed unless the consideration benefits the estate generally.
Chapter 1: Consumer Bankruptcy - Chapter 13 Repayment Plans

1.5.1 Home Mortgages

A Chapter 13 plan could not modify obligations on first mortgages and refinanced first mortgages, except to the extent currently permitted by the Bankruptcy Code. Section 1322(b)(2) should be amended to provide that the rights of a holder of a claim secured only by a junior security interest in real property that is the debtor's principal residence may not be modified to reduce the secured claim to less than the appraised value of the property at the time the security interest was made.

1.5.2 Valuation of Collateral

A creditor's secured claim in personal property should be determined by the property's wholesale price.

A creditor's secured claim in real property should be determined by the property's fair market value, minus hypothetical costs of sale.

1.5.3 Payments on secured debts that are subject to modification should be spread over the life of the plan, according to fixed criteria for interest rates.

1.5.4 Unsecured Debt

Payments on unsecured debt should be determined by guidelines based on a graduated percentage of the debtor's income, subject to upward adjustment to meet the section 1325(a)(4) requirement that creditors receive at least the present value of whatever they would have received in a Chapter 7. The trustee or an unsecured creditor should be authorized to file an objection to any plan that deviates from the guidelines, and a court would determine whether the deviation was appropriate in light of all the circumstances.

1.5.5 Consequences of Incomplete Payment Plans

The Bankruptcy Code should provide that a case under Chapter 13 that otherwise meets the standards for dismissal shall be converted to Chapter 7 after notice and a hearing unless a party in interest objects on the basis that the debtor had been granted a discharge in a Chapter
7 case commenced within six years of the date on which the conversion would take place, in which case the Chapter 13 case will be dismissed. In addition, the debtor may object to conversion without grounds, in which case the Chapter 13 case will be dismissed. The standards for modification, dismissal, and discharge in Chapter 13 would not otherwise change.

Section 362 should be amended to provide that the filing of a petition by an individual does not operate as a stay if the individual has filed two or more petitions for relief under title 11 within six years of filing the instant petition for relief and if the individual has been a debtor in a bankruptcy case within 180 days prior to the instant petition for relief. On the request of the debtor, after notice and a hearing, the court may impose a stay for cause shown, subject to such conditions and modifications as the court may impose.

1.5.6 In Rem Orders

Section 362 should be amended to provide that the filing of a petition by an individual does not operate as a stay with respect to property of the estate transferred by that individual to another individual who was a debtor under title 11 within 180 days of the filing of the instant petition, unless the court grants a stay with respect to such property after notice and a hearing on request of the debtor.

After notice and a hearing, a bankruptcy court should be empowered to issue in rem orders barring the application of a future automatic stay to identified property of the estate for a period of up to six years when a party could show that the debtor had transferred such real property or leasehold interests or fractional shares of property or leasehold interests to avoid creditor foreclosure or eviction. A subsequent owner of the property or tenant of the leasehold who files for bankruptcy (or the same owner or holder in a subsequent filing) should be permitted to petition the bankruptcy court for the imposition of a stay to protect property of the estate, which the court would be required to grant to protect innocent parties who were not a part of a scheme to transfer the property to hinder foreclosure or eviction.

1.5.7 Retention of the “Superdischarge”

Congress should retain 11 U.S.C. § 1328(a), which permits a debtor who completes all payments under the plan to discharge all debts
provided for by the plan or disallowed under section 502 of title 11 except for those listed in section 1328(a)(1) - (3).

1.5.8 Debtors who choose Chapter 13 repayment plans should have their bankruptcy filings reported differently from those who do not. Debtors who complete voluntary debtor education programs should have that fact noted on their credit reports.

1.5.9 Trustees should be encouraged to establish credit rehabilitation programs to help provide better, cheaper access to credit for those who participate in repayment plans.

Chapter 2: Treatment of Mass Future Claims in Bankruptcy

2.1.1 Definition of Mass Future Claim

A definition of “mass future claim” should be added as a subset of the definition of “claim” in 11 U.S.C. § 101(5). “Mass future claim” should be defined as a claim arising out of a right to payment, or equitable relief that gives rise to a right to payment that has or has not accrued under nonbankruptcy law that is created by one or more acts or omissions of the debtor if:

1) the act(s) or omission(s) occurred before or at the time of the order for relief;
2) the act(s) or omission(s) may be sufficient to establish liability when injuries ultimately are manifested;
3) at the time of the petition, the debtor has been subject to numerous demands for payment for injuries or damages arising from such acts or omissions and is likely to be subject to substantial future demands for payment on similar grounds;
4) the holders of such rights to payments are known or, if unknown, can be identified or described with reasonable certainty; and
5) the amount of such liability is reasonably capable of estimation.

The definition of “claim” in section 101(5) should be amended to add a definition of “holder of a mass future claim,” which would be an entity that holds a mass future claim.
2.1.2 Protecting the Interests of Holders of Mass Future Claims

The Bankruptcy Code should provide that a party in interest may petition the court for the appointment of a mass future claims representative. When a plan includes a class or classes of mass future claims, the Bankruptcy Code should authorize a court to order the appointment of a representative for each class of holders of mass future claims. A mass future claims representative shall serve until further order of the bankruptcy court.

The Bankruptcy Code should provide that a mass future claims representative shall have the exclusive power to file a claim or claims on behalf of the class of mass future claims (and to determine whether or not to file a claim), to cast votes on behalf of the holders of mass future claims and to exercise all of the powers of a committee appointed pursuant to section 1102. However, a holder of a mass future claim may elect to represent his, her, or its own interests and may opt out of being represented by the mass future claims representative.

The Bankruptcy Code should provide that prior to confirmation of a plan of reorganization, the fees and expenses of a mass future claims representative and his or her agents shall be administrative expenses under section 503. Following the confirmation of a plan of reorganization, and for so long as holders of mass future claims may exist, any continuing fees and expenses of a mass future claims representative and his or her agents shall be an expense of the fund established for the compensation of mass future claims.

The Bankruptcy Code should provide that a mass future claims representative shall serve until further orders of the bankruptcy court declare otherwise, shall serve as a fiduciary for the holders of future claims in such representative's class, and shall be subject to suit only in the district where the representative was appointed.

2.1.3 Determination of Mass Future Claims

Section 502 should provide that the court may estimate mass future claims and also may determine the amount of mass future claims prior to confirmation of a plan for purposes of distribution as well as allowance and voting. In addition, 28 U.S.C. § 157(b)(2)(B) should specify that core proceedings include the estimation or determination of the amount of mass future claims.
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2.1.4 **Channeling Injunctions**

Section 524 should authorize courts to issue channeling injunctions.

2.1.5 **Plan Confirmation and Discharge; Successor Liability**

Sections 363 and 1123 should provide that the trustee may dispose of property free and clear of mass future claims when the trustee or plan proponent has satisfied the requirements for treating mass future claims. Upon approving the sale, the court could issue, and later enforce, an injunction to preclude holders from suing a successor/good faith purchaser.

Chapter 2: Transnational Insolvency

2.2.1 Adoption of the UNCITRAL Model Law for Cross-Border Insolvencies

2.2.2 Retention of provisions for additional relief

2.2.3 Amendment of title 28 to add jurisdiction over the Model Law provisions

2.2.4 Conforming amendments to the definitions of foreign proceeding and foreign representative in section 101(23)-(24)

2.2.5 Exclusion from the application of the Model Law of consumers resident in the United States if their debts are within the limits for Chapter 13

2.2.6 Recognition *vel non* of foreign tax claims to be left to evolving caselaw and treaty negotiations

2.2.7 28 U.S.C. § 1410 should be amended to provide that the various bases for venue may be used in the alternative as a matter of choice, *i.e.*, the word “only” should be deleted from the section; additionally there should be a catch-all venue choice related to the interest of justice and convenience of the parties

Chapter 2: Partnerships
2.3.1  *Defining the term “General Partner”*

A “general partner” should be defined under 11 U.S.C. § 101 as any entity that as a result of an existing or former status as an actual or purported general partner in an existing, former, predecessor, or affiliated partnership, is liable under applicable nonbankruptcy law for one or more debts of the partnership.

2.3.2  *Consent of Former Partners*

The Bankruptcy Code and Rules should be amended to clarify that, notwithstanding Recommendation 1 (defining “general partner”), a former general partner of a partnership is not, absent a specific court order to the contrary, required to consent to a voluntary petition by a partnership, to be served with a petition or summons in an involuntary case against a partnership, or to perform the duties of disclosure or procedural duties imposed on a general partner of a debtor partnership.

2.3.3  *Bankruptcy Court Jurisdiction*

The court in which a partnership case is pending should have jurisdiction under 28 U.S.C. § 1334(b) to determine who is or may be liable as a general partner for the debts of the partnership and may determine the rights among the general partners with respect to the debts of the partnership. Such matters should constitute core proceedings under 28 U.S.C. § 157(b).

2.3.4  *Liability of General Partner for Deficiency in Partnership Case*

If there is a deficiency of property of the partnership estate to pay in full all allowed claims in a case under title 11, the estate should have a claim against each general partner to the extent that, under applicable nonbankruptcy law, such general partner is personally liable for such deficiency. The amount of the deficiency claim should not be reduced on account of any right of contribution or indemnity among general partners. The claim should be estimated if its determination would unduly delay the administration of the case. Any action or proceeding to enforce liability under this section should be commenced no later than four years after the entry of the order for relief in the case concerning the partnership.
2.3.5  Power of the Court to Assure Payment of the Deficiency

Renumbered section 723(b) of the Bankruptcy Code should be amended to provide that the court in a partnership case may, after notice and a hearing, order any general partner that is not a debtor in a case under this title to provide the estate, in such amount as the court shall determine to be appropriate under the circumstances, with indemnity for, or assurance of payment of, any deficiency recoverable from such general partner, or (2) not to incur obligations or transfer property except under specified circumstances.

2.3.6  Trustee's Recovery against the Estate of a Debtor General Partner

Renumbered section 723(c) of the Bankruptcy Code should be amended to provide that notwithstanding section 728(c), the trustee of a partnership has a claim against the estate of each general partner in such partnership that is a debtor in a case under title 11 for (1) the full amount of all claims allowed in the case concerning the partnership for which such general partner would otherwise be personally liable as a general partner under applicable nonbankruptcy law; and (2) administrative claims which have been assessed against such general partner. Notwithstanding section 502 of this title, there shall not be allowed in such partner’s case a claim against the partner on which both the general partner and the partnership are liable, except to the extent that such claim is allowable and secured only by property of such general partner and not by property of such partnership.

2.3.7  Repeal of the “Jingle Rule” in All General Partner Bankruptcy Cases

Chapter 5 of the Bankruptcy Code should be amended in order to provide that the claim of a trustee of a partnership debtor, or the claim of a creditor of a nondebtor partnership, is entitled to share in the distribution in a general partner’s bankruptcy case in the same manner and to the same extent as any other claim of the same class of a creditor of such general partner.

2.3.8  Allocation of Expenses of Administration of a Partnership Case

Chapter 5 of the Bankruptcy Code should be amended to provide that the expenses of administration of a partnership case under section 503 of the Bankruptcy Code may be assessed against general partners or paid from the property constituting recoveries from general partners under this section and from other property of the estate in such
proportions as the court shall determine are fair and reasonable after notice and hearing.

2.3.9 Distribution of Recoveries from General Partners

Renumbered section 723 of the Bankruptcy Code should be amended to provide that notwithstanding section 726 of the Bankruptcy Code (except as provided in Recommendation 2.3.8 above), the trustee should apply any recovery obtained from a general partner or the estate of a general partner only to the payment of deficiencies on claims for which such general partner is personally liable as a general partner under applicable nonbankruptcy law. Any property constituting recoveries from general partners or the estates of general partners under this Recommendation not applied to the proper deficiencies as herein provided or to administration expenses (as provided in Recommendation 2.3.8 above), should be equitably distributed by the trustee to such general partner or to such general partners’ estates as may be ordered by the court after notice and hearing.

2.3.10 Distribution of Property of the Partnership Estate

Renumbered section 723 of the Bankruptcy Code should be amended to provide that notwithstanding section 726 of the Code, and except as set forth in Recommendation 2.3.8 above (treatment of expenses of administration), the trustee should distribute property of the partnership estate which is not recovered from general partners or the estates of debtor general partners to allowed claims against the partnership in accordance with otherwise applicable provisions of this title without considering distributions of property from general partners or general partners’ estates.

2.3.11 Trustee’s Power to File Involuntary Cases

Section 303(b)(3) of the Bankruptcy Code should be amended to permit the trustee of a partnership in a case commenced under title 11 to file an involuntary petition against a general partner without regard to the number of creditors, nature of the claims or dollar amount of the claims otherwise required under section 303(b)(1) and (2).

2.3.12 Appointment of Committee of General Partners

Chapter 11 of the Bankruptcy Code should be amended to provide that, on request of a party in interest, the court may authorize the
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United States trustee to appoint a committee of general partners that is fairly representative of the interests of all general partners.

2.3.13 General Partner Liability on Nonrecourse Partnership Debt under 11 U.S.C. § 1111(b)

Section 1111(b) of the Bankruptcy Code should be amended to clarify that, except as otherwise provided in a confirmed plan of a partnership debtor or the order confirming the plan, a general partner is not liable on a nonrecourse claim against the partnership except to the extent that the general partner is personally liable on such claim under applicable nonbankruptcy law.

2.3.14 ‘Temporary’ Injunction of Proceedings or Acts against Nondebtor General Partners

The Bankruptcy Code should be amended to permit the court for cause, upon motion of a party in interest and after notice and hearing, to temporarily enjoin actions of creditors or general partners of a debtor partnership against nondebtor general partners or their property on account of partnership obligations. No injunction should be granted under this Recommendation unless the nondebtor general partner (1) consents to the jurisdiction of the bankruptcy court; (2) makes or undertakes to make the disclosures required by Recommendation 2.3.18 below; and (3) the order granting the injunction precludes the protected general partner from incurring obligations or transfers of property except under specified circumstances.

2.3.15 Relief from the Temporary Injunction

The Bankruptcy Code should be amended to provide that the court, upon request of a party in interest and after notice and hearing, may, for cause, grant relief from the temporary injunction provided pursuant to Recommendation 2.3.14. The relief available would include the termination, annulment, modification or conditioning a continuation of the injunction.

2.3.16 ‘Postconfirmation’ Injunction of Proceedings or Acts against Nondebtor General Partners Who Contribute to Plans

The Bankruptcy Code should be amended to permit the court, in connection with the confirmation of a plan of reorganization in a partnership case, to enjoin partnership creditors and general partners
from actions or proceedings against a general partner or its property to collect on partnership-related claims where the general partner has contributed or made an enforceable commitment to contribute an amount to the payment of debts in accordance with the plan or the order confirming the plan. The court, after notice and hearing, must determine that the plan complies with otherwise applicable requirements for confirmation in light of the personal assets of the nondebtor contributing partners and that the injunction will not discriminate unfairly or inequitably with respect to creditors of the partnership or the claims of the general partners for contribution or indemnity.

2.3.17 Revocation of Injunction

The Bankruptcy Code should be amended to provide that the injunction issued with respect to any nondebtor general partner under Recommendation 2.3.16 above should be terminated or revoked on the request of a party in interest if, after notice and hearing, the court determines (1) that the protected nondebtor general partner has failed to perform a material commitment under the plan; (2) that the order confirming the plan in which the injunction was issued is revoked under sections 1144 or 1230 of the Code; or (3) that the nondebtor general partner has procured the injunction by fraud. The Bankruptcy Code should be further amended to provide that a request for revocation for fraud under provision (3) should be made at any time within two years after the date of the entry of the confirmation order.

2.3.18 Duty of Disclosure by Nondebtor General Partners

The Bankruptcy Code should be amended to provide that, unless otherwise ordered by the court for cause, each nondebtor general partner shall, within 30 days after the entry of the order for relief in a partnership case or within such time as the court shall fix, produce information concerning such partner's financial condition and affairs similar to that provided by a debtor, together with such additional information and periodic reports as may be required by the court from time to time.

2.3.19 Access to Disclosed Information

The Bankruptcy Code should be amended to provide that the trustee, debtor in possession or other entity designated by the court in a partnership bankruptcy case should maintain and promptly provide
to parties in interest in the case, on reasonable request, certain important information regarding the nondebtor general partners of the debtor partnership.

2.3.20 **Treatment of LLC Member or LLC Manager Under the Bankruptcy Code**

Debtor LLC members in member-managed LLCs should be treated like general partners under the Bankruptcy Code. Similarly, debtor managers of manager-managed LLC’s should be treated like general partners under the Bankruptcy Code. This treatment should be limited to three aspects of the LLC member or LLC manager relationship: (1) continuity of LLC after LLC member’s or manager’s bankruptcy filing; (2) transferability of LLC ownership interest; and (3) management rights in the LLC.

2.3.21 **Exclusion of a Partnership or LLC Relationship from Treatment under 11 U.S.C. § 365**

The Bankruptcy Code should be amended to exclude partnership and LLC governing documents and relationships from treatment under 11 U.S.C. § 365. A new section concerning partnership and LLC governing documents and relationships should be added to the Bankruptcy Code.

2.3.22 **Ipso Facto Provisions in Partnership or LLC Governing Documents Rendered Unenforceable**

*Ipso facto* provisions relating to partnerships, LLCs, and the rights or interests of partners or LLC members or managers should not be enforceable under the Bankruptcy Code. *Ipso facto* provisions include any provision in a partnership agreement, LLC operating agreement, or applicable nonbankruptcy law that operates to terminate or modify the rights of a partner or LLC member based on insolvency, financial condition, commencement of a voluntary or involuntary case under title 11, or appointment of a trustee or custodian. Non-*ipso facto* provisions that limit a partner’s or LLC member’s rights, relationship, interest, or permit expulsion on the basis of something other than insolvency, financial condition, commencement of a voluntary or involuntary case under title 11, or the appointment of a receiver would remain enforceable.
2.3.23 Property of the Estate, Transferability, and Valuation of a Partnership or LLC Interest

"Property of the estate" for a partner or LLC member should include all rights attendant with the partnership or LLC interest, including management rights, voting rights, and economic rights (including goodwill, the right to share in profits and losses, and any other right to payment). Except as provided below, the Recommendation does not alter the effect of section 541(a)(6), to the extent it is applicable. In the case of an individual partner or LLC member who (1) continues employment (in whatever capacity) with the partnership or LLC after the order for relief, and (2) whose estate receives or is more likely than not going to receive the "buyout price" as defined below, all partnership or LLC interest amounts arising, accruing, or payable after the order for relief are deemed to be on account of personal services rendered by the partner or LLC member and do not become property of the estate. There should be a presumption, in a case of an individual debtor, that the estate is more likely than not going to receive the "buyout price," upon which presumption the parties should be entitled to rely and function until the court orders to the contrary, after notice and hearing, on motion of the trustee or any party in interest.

The court should have the power to authorize a sale under section 363 of the partnership or LLC interest and order the admission of the buyer to the partnership or LLC with all rights and duties the debtor had, except that if the governing documents preclude transfer under a non-\textit{ipso facto} provision, the anti-transfer clauses will be given effect, but only if the partnership or LLC pays the "buyout price" to the estate. The court should retain the power to (1) fashion reasonable payment terms which balance the needs of the estate for receipt of cash as rapidly as possible with the needs of the entity for liquidity and working capital to conduct its operations in a prudent manner; and (2) ensure receipt of the buyout price by the estate.

The "buyout price" means the highest price (including a calculation or appraisal method), if any, provided in the governing documents in the case of a buyout of an interest not on account of the bankruptcy of, insolvency of, financial condition of, commencement of a voluntary or involuntary case under title 11 for, or appointment of a trustee or custodian for, a partner or LLC member or manager. If no such price is provided, the court should determine a fair buyout value.
2.3.24 Treatment of Partnership and LLC Management Rights

During any period when an estate administered in a bankruptcy case includes a partnership or LLC interest, the management and voting rights of the partner or LLC member are to be exercised as follows:

- A debtor in possession under Chapter 11 or a debtor under either Chapter 12 or Chapter 13 should exercise all management and voting rights, subject to the applicable non-ipso facto provisions of the partnership or LLC governing documents and applicable nonbankruptcy law, and the other applicable provisions of the Bankruptcy Code;

- Where (a) there is more than one general partner or LLC managing entity and at least one of such partners or entities is not a debtor in a case under the Bankruptcy Code, and (b) a Chapter 7 or Chapter 11 trustee has been appointed, then the trustee should not exercise any management rights except to the extent necessary to constitute a quorum or to meet a minimum majority required by the governing documents or applicable nonbankruptcy law;

- In all other cases where a Chapter 7 or Chapter 11 trustee has been appointed, the trustee shall exercise all management and voting rights.

Regardless of the foregoing, in all cases where (1) an individual debtor continues to function as a partner or member after the order for relief, and (2) the estate receives or is more likely than not going to receive, the “buyout price,” then the individual should have the sole power to exercise management and voting rights attributable to periods after the order for relief.

2.3.25 11 U.S.C. § 523 and Imputed Conduct or Liability

11 U.S.C. § 523 should be amended to provide that nothing in this section shall preclude the discharge of a general partner from a debt (otherwise nondischargeable in a copartner’s or agent’s bankruptcy case) arising solely as a result of imputing to the general partner the conduct or liability of a copartner or agent.
2.3.26 Subordination of Claims Arising from the Purchase or Sale of a Partnership Interest

11 U.S.C. § 510(b) should be amended to subordinate the claims “arising from the rescission of a purchase or sale” of their partnership interests or “for damages arising from the purchase or sale” of their partnership interests to all claims and interests that are senior or equal to the claim or interest represented by such security or other interest in the bankruptcy case of a general partner.

Chapter 2: General Issues in Chapter 11

2.4.1 Clarifying the Meaning of “Rejection”

The concept of “rejection” in section 365 should be replaced with “election to breach.”

Section 365 should provide that a trustee’s ability to elect to breach a contract of the debtor is not an avoiding power.

Section 502(g) should be amended to provide that a claim arising from the election to breach shall be allowed or disallowed the same as if such claim had arisen before the date of the filing of the petition.

2.4.2 Clarifying the Option of “Assumption”

“Assumption” should be replaced with “election to perform” in section 365.

2.4.3 Interim Protection and Obligations of Nondebtor Parties

A court should be authorized to grant an order governing temporary performance and/or providing protection of the interests of the nondebtor party until the court approves a decision to perform or breach a contract.

Section 503(b) should include as an administrative expense losses reasonably and unavoidably sustained by a nondebtor party to a contract, a standard based on nonbankruptcy contract principles, pending court approval of an election to perform or breach a contract.
if such nondebtor party was acting in accordance with a court order governing temporary performance.

2.4.4 **Contracts Subject to Section 365; Eliminating the "Executory" Requirement**

Title 11 should be amended to delete all references to "executory" in section 365 and related provisions, and "executoriness" should be eliminated as a prerequisite to the trustee's election to assume or breach a contract.

2.4.5 **Prebankruptcy Waivers of Bankruptcy Code Provisions**

Section 558 of the Bankruptcy Code should provide that except as otherwise provided in title 11, a clause in a contract or lease or a provision in a court order or plan of reorganization executed or issued prior to the commencement of a bankruptcy case does not waive, terminate, restrict, condition, or otherwise modify any rights or defenses provided by title 11. Any issue actually litigated or any issue resolved by consensual agreement between the debtor and a governmental unit in its police or regulatory capacity, whether embodied in a judgment, administrative order or settlement agreement, would be given preclusive effect.

2.4.6 **Prepackaged Plans of Reorganization; Section 341 Meeting of Creditors**

Section 341 should provide that upon the motion of any party in interest in a Chapter 11 case that entails a prepackaged plan of reorganization, the court may waive the requirement that the U.S. trustee convene a meeting of creditors.

2.4.7 **Authorization for Local Mediation Programs**

Congress should authorize judicial districts to enact local rules establishing mediation programs in which the court may order non-binding, confidential mediation upon its own motion or upon the motion of any party in interest. The court may order mediation in an adversary proceeding, contested matter, or otherwise in a bankruptcy case, except that the court may not order mediation of a dispute arising in connection with the retention or payment of professionals or in connection with a motion for contempt, sanctions, or other judicial disciplinary matters. The court should have explicit statutory authority to approve the payment of persons performing mediation functions pursuant to the local rules of that district's mediation
program who satisfy the training requirements or standards set by the local rules of that district. The statute should provide further that the details of such mediation programs that are not provided herein may be determined by local rule.

2.4.8 Court Review of Appointments to Creditors’ Committees

Subsection (a)(2) of 11 U.S.C. §1102, “Creditors’ and equity security holders’ committees,” should be amended to read as follows:

(2) On request of a party in interest and after notice and a hearing, the court may order a change in membership of a committee appointed under subsection (a) of this section if necessary to ensure adequate representation of creditors or of equity security holders. On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The United States Trustee shall appoint any such committee.

2.4.9 Employee Participation in Bankruptcy Cases

Changes to the Official Forms, the U.S. Trustee program guidelines and the Federal Rules of Bankruptcy Procedure, are recommended to the Administrative Office of the U.S. Courts, the Executive Office of the U.S. Trustee, and the Rules Committee, as appropriate, in order to improve identification of employment-related obligations and facilitate the participation by employee representatives in bankruptcy cases. The Official Forms for the bankruptcy petition, list of largest creditors, and/or schedules of liabilities should solicit more specific information regarding employee obligations. The U.S. Trustee program guidelines for the formation of creditors’ committees should be amended to provide better guidance regarding employee and benefit fund claims. The appointment of employee creditors’ committees should be encouraged in appropriate circumstances as a mechanism to resolve claims and other matters affecting the employees in a Chapter 11 case.
2.4.10 Enhancing the Efficacy of Examiners and Limiting the Grounds for Appointment of Examiners in Chapter 11 Cases

Congress should amend section 327 to provide for the retention of professionals by examiners for cause under the same standards that govern the retention of other professionals.

The Advisory Committee on Bankruptcy Rules of the Judicial Conference should consider a recommendation that Federal Rule of Bankruptcy Procedure 2004(a) be amended to provide that “On motion of any party in interest or of an examiner appointed under section 1104 of title 11, the court may order the examination of any entity.”

Congress should eliminate section 1104(c)(2), which requires the court to order appointment of an examiner upon the request of a party in interest if the debtor’s fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes or owing to an insider, exceed $5,000,000.

2.4.11 Valuation of Property

A creditor’s secured claim in personal property should be determined by the property’s wholesale price.

A creditor’s secured claim in real property should be determined by the property’s fair market value, minus hypothetical costs of sale.


Congress should make clear that bankruptcy courts can authorize sales of property of the estate free of creditors’ interests regardless of the relationship between the face amount of any liens and the value of the property sold.

2.4.13 Release of Claims Against Nondebtor Parties

Congress should amend sections 1123 and 524(e) to clarify that it is within the discretion of the court to allow a plan proponent to solicit releases of nondebtor liabilities. Creditors that agree in a separate document to release nondebtor parties will be bound by such releases, whereas creditors that decline to release their claims against nondebtor parties will not be bound to release their claims.
2.4.14 Exclusion of Payroll Deductions from Property of the Estate

Congress should amend 11 U.S.C. § 541(b) to clarify that funds deducted from paid wages within 180 days prior to the date of the commencement of a case under title 11, held by a debtor/employer, and owed by employees to third parties, other than a federal, state or local taxing authority, do not fall within the definition of “property of the estate.”

2.4.15 Absolute Priority and Exclusivity

11 U.S.C. § 1129(b)(2)(B)(ii) should be amended to provide that the court may find a plan to be fair and equitable that provides for members of a junior class of claims or interests to purchase new interests in the reorganized debtor.

11 U.S.C. § 1121 should be amended to provide that on the request of a party in interest, the court will terminate exclusivity if a debtor moves to confirm a non-consensual plan that provides for the participation of a holder of a junior claim or interest under 1129(b)(2)(B) but does not satisfy the condition set forth in section 1129(b)(2)(B)(i).

2.4.16 Classification of Claims

Section 1122 should be amended to provide that a plan proponent may classify legally similar claims separately if, upon objection, the proponent can demonstrate that the classification is supported by a “rational business justification.”

2.4.17 Prepetition Solicitation for a Prepackaged Plan of Reorganization

The standards and requirements provided in the Bankruptcy Code for postpetition solicitation should be applicable to solicitation for a plan of reorganization within 120 days prior to filing a Chapter 11 petition by a company that is subject to and in compliance with the public periodic reporting requirements of the Securities Exchange Act of 1934. Notice of such prepetition solicitation should be served on the Securities and Exchange Commission. If a company solicits for a plan of reorganization but does not file for bankruptcy, the bankruptcy requirements and standards should be applicable if the company does not complete an exchange offer or any other transaction on the basis of such solicitation.
2.4.18 Postpetition Solicitation for a Prepackaged Plan of Reorganization

Section 1125(b) should be amended to provide that the acceptance or rejection of a plan may be solicited after the commencement of a case under title 11 but before the court approves a written disclosure statement from those classes that were solicited for the plan prior to the filing of the bankruptcy petition.

2.4.19 Elimination of Prohibition on Nonvoting Equity Securities

Congress should amend section 1123(a)(6) to eliminate the requirement that the charter of the reorganized corporate debtor prohibit the issuance of nonvoting equity securities. Section 1123(a)(6) should otherwise remain unchanged.

2.4.20 Postconfirmation Plan Modification

11 U.S.C. § 1127(b) should be amended to permit modification after confirmation of a plan until the later of 1) substantial consummation or 2) two years after the date on which the order of confirmation is entered. All other restrictions on postconfirmation plan modification in section 1127(b) should remain unaltered.

Chapter 2: Small Business Proposals

2.5.1 Defining the term "Small Business"

A "small business debtor" is any debtor in a case under Chapter 11 (including any group of affiliated debtors) which has aggregate noncontingent, liquidated secured and unsecured debts as of the petition date or order for relief of five million dollars ($5,000,000) or less and any single asset real estate debtor as defined in 11 U.S.C. § 101(51B), regardless of the amount of such debtor's liabilities.

2.5.2 Flexible Rules for Disclosure Statement and Plan

Give the bankruptcy courts authority, after notice and hearing, to waive the requirements for, or simplify the content of, disclosure statements in small business cases where the benefits to creditors of fulfillment of full compliance with Bankruptcy Code § 1125 are
outweighed by cost and lack of meaningful benefit to creditors which would exist if the full requirements of § 1125 were imposed;

The Advisory Committee on Bankruptcy Rules of the Judicial Conference ("Rules Committee") shall be called upon to adopt, within a reasonable time after enactment, uniform safe-harbor standard forms of disclosure statements and plans of reorganization for small business debtors, after such experimentation on a local level as they deem appropriate. These forms would not preclude parties from using documents drafted by themselves or other forms, but would be propounded as one choice that plan proponents could make, which, if used and completed accurately in all material respects, would be presumptively deemed upon filing to comply with all applicable requirements of Bankruptcy Code §§ 1123 and 1125. The forms shall be designed to fulfill the most practical balance between (i) on the one hand, the reasonable needs of the courts, the U.S. Trustee, creditors and other parties in interest for reasonably complete information to arrive at an informed decision and (ii) on the other hand, appropriate affordability, lack of undue burden, economy and simplicity for debtors; and

Repeal those provisions of 11 U.S.C. § 105(d) which are inconsistent with the proposals made herein, e.g., those setting deadlines for filing plans.

Amend the Bankruptcy Code to expressly provide for combining approval of the disclosure statement with the hearing on confirmation of the plan.

2.5.3 Reporting Requirements

To create uniform national reporting requirements to permit U.S. Trustees, as well as creditors and the courts, better to monitor the activities of Chapter 11 debtors, the Rules Committee shall be called upon to adopt, with a reasonable time after enactment, amended rules requiring small business debtors to comply with the obligations imposed thereunder. The new rules will require debtors to file periodic financial and other reports, such as monthly operating reports, designed to embody, upon the basis of accounting and other reporting conventions to be determined by the Rules Committee, the best practical balance between (i) on the one hand, the reasonable needs of the court, the U.S. Trustee, and creditors for reasonably complete information and (ii) on the other hand, appropriate affordability, lack of undue burden, economy and simplicity for debtors. Specifically, the
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Rules Committee, shall be called upon to prescribe uniform reporting as to:

a. the debtor's profitability, i.e., approximately how much money the debtor has been earning or losing during current and relevant recent fiscal periods;

b. what the reasonably approximate ranges of projected cash receipts and cash disbursements (including those required by law or contract and those that are discretionary but excluding prepetition debt not lawfully payable after the entry of order for relief) for the debtor appear likely to be over a reasonable period in the future;

c. how approximate actual cash receipts and disbursements compare with results from prior reports;

d. whether the debtor is or is not (i) in compliance in all material respects with postpetition requirements imposed by the Bankruptcy Code and the Bankruptcy Rules and (ii) filing tax returns and paying taxes and other administrative claims as required by applicable nonbankruptcy law as will be required by the amended statute and rules and, if not, what the failures are, how and when the debtor intends to remedy such failures and what the estimated costs thereof are; and

e. such other matters applicable to small business debtors as may be called for in the best interests of debtors and creditors and the public interest in fair and efficient procedures under Chapter 11.

2.5.4 Duties of the Debtor in Possession

The debtor is required to:

a. append to the voluntary petition or, in an involuntary case, to file within three days after the order for relief, either (A)(i) its most recent balance sheet, statement of operations and cash-flow statement and (ii) its most recent federal income tax return or (B) a statement made under penalty of perjury that no such financial statements have been prepared or that no federal income tax return has been filed or (C) both;
b. attend meetings, at which the debtor is represented by its senior management personnel and counsel, scheduled by the court, the U.S. Trustee, or the Bankruptcy Administrator including, but not limited to initial debtor interviews, court-ordered scheduling conferences, and meetings of creditors convened under 11 U.S.C. § 341;

c. file all schedules and statements of financial affairs for small business debtors within the limits set by the Bankruptcy Rules, unless the court, upon notice to the U.S. Trustee and a hearing, grants an extension, which extension or extensions shall not, in any event, exceed thirty (30) days after the order for relief absent extraordinary and compelling circumstances;

d. comply with postpetition obligations, including but not limited to the duties to: file tax returns, maintain appropriate and reasonable current insurance as is customary and appropriate to the industry, and timely pay all administrative expense tax claims, except those being contested by appropriate proceedings being diligently prosecuted;

e. create within ten (10) business days of the entry of order for relief (or as soon thereafter as possible in case all banks contacted during the first ten (10) business days decline the business) separate deposit accounts with a bank or banks in which the debtor shall be required to timely deposit, until a plan is confirmed or the case is dismissed or converted or a trustee is appointed, after receipt, all taxes collected or withheld by it for governmental units. In compelling circumstances, the court may dispense with these requirements after notice and a hearing;

f. allow the U.S. Trustee or its designated representative to inspect the debtor's business premises, books and records at reasonable times on reasonable prior written notice to the debtor.

2.5.5 Deadlines for Plan Filing and Confirmation

In small business cases only, require that the disclosure statement, if any, and plan must be filed within 90 days after the entry of order for relief, unless extended as permitted below. During this 90-day period, only the debtor may file a plan unless on request of a party in interest made during this period and after notice and a hearing, the court, for cause, orders otherwise. In small business cases only, require the plan
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to be confirmed within 150 days after the entry of order for relief, unless extended as permitted below.

2.5.6 Burden of Proof for Extensions of Deadlines

Permit extensions of the deadlines for filing and approving disclosure statements, if any, and filing and confirming plans of reorganization only if the debtor, having duly noticed and appeared at the necessary extension hearing conducted and ruled upon prior to the expiration of the deadline, if any, and having carried the burdens of coming forward and persuasion, demonstrates by a preponderance of the evidence that it is more likely than not to confirm a plan of reorganization within a reasonable time. No such deadline may be extended unless a new deadline is imposed at the time the extension is granted. The Bankruptcy and Judicial Codes will require the U.S. Trustee, as the case may be, to be a recipient of notice of extension hearings and to participate actively therein, in order to assure, to the maximum extent feasible, that the interests of the public are protected when determinations are made as to whether small business debtors receive extensions and have proven by a preponderance of the evidence that it is more likely than not that they will confirm a plan within a reasonable time.

2.5.7 Scheduling Conferences

Require the bankruptcy court to promptly conduct at least one on-the-record scheduling hearing, on notice to the U.S. Trustee and the debtor's 20 largest unsecured creditors to be sure that the deadlines discussed above are met except that no such hearing is required if an agreed order is filed by the debtor and U.S. Trustee and approved by the court after notice and hearing. The court shall also conduct such other scheduling hearings and status conferences as it deems fit and proper. Whenever possible, these hearings shall be schedules in conjunction with other mandatory events so as to minimize to the most reasonable practicable extent, the time of debtor personnel spent in court and at official meetings.

2.5.8 Serial Filer Provisions

Provide in the Bankruptcy Code that, with respect to any debtor (or any entity which has succeeded to substantially all the debtor's assets or business) which files a second case while another case is pending in which such debtor is the (or one of the) debtor(s) or in the event that it again becomes a debtor in a Chapter 11 case within two years after
an order of dismissal of a Chapter 11 case in which it was the debtor has become a final order or a Chapter 11 plan has been confirmed, shall not be entitled to the section 362(a) stay unless, after it has become a debtor, it bears the burdens of coming forward and of persuasion, by a preponderance of the evidence, that (1) the new case has resulted from circumstances beyond the control of the debtor not foreseeable at the time the first case was filed and (2) it is more likely than not that it will confirm a feasible plan, but not a liquidating plan, within a reasonable time. In cases involving such debtors when the owners have transferred the business to a new legal entity, owned and arranged by them, the section 362(a) stay would apply on filing but would be lifted on a verified, ex parte motion of the U.S. Trustee, with the right to have it reimposed upon a showing of (1) and (2) above. The Federal Rule of Civil Procedure governing injunctions applies to the court’s award of a stay to the debtor.

2.5.9 Expanded Grounds for Dismissal or Conversion and Appointment of Trustee

a. Modify section 1112 to read as follows:

(b)(1) Except as provided in subsection (c) of this section or in section 1104(a)(3) of this title, on request of a party in interest or the U.S. Trustee, and after notice and a hearing, the court shall convert a case under this chapter to a case under Chapter 7 of this title or shall dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, where movant establishes cause, except that such relief shall not be granted if the debtor or another party in interest objects and establishes both:

(A) that it is more likely than not that a plan will be confirmed within a time as fixed by this title or by order of the court; and

(B) if the cause is an act or omission of the debtor:

(i) that there exists a reasonable justification for the act or omission; and

(ii) that the act or omission will be cured within a reasonable time fixed by the court not to exceed 30 days after the court decides the motion unless the movant expressly consents to a continuance for a specific period of time or there are compelling circumstances beyond the control of the debtor which justify an extension.
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(2) For purposes of this subsection, cause includes:

(A) substantial or continuing loss to or diminution of the estate;
(B) gross mismanagement of the estate;
(C) failure to maintain appropriate insurance;
(D) unauthorized use of cash collateral harmful to one or more creditors;
(E) failure to comply with an order of the court;
(F) failure timely to satisfy any filing or reporting requirement established by this title or by applicable rule;
(G) failure to attend the section 341(a) meeting of creditors or an examination ordered under Bankruptcy Rule 2004;
(H) failure timely to provide information or attend meetings reasonably requested by the U.S. Trustee or;
(I) failure timely to pay taxes due after the order for relief or to file tax returns due after the order for relief;
(J) failure to file or confirm a plan within the time fixed by this title or by order of the court; and
(K) failure to pay any fees or charges required under Chapter 123 of title 28.

(3) The court shall commence the hearing on any motion under this subsection within 30 days after filing of the motion, and shall decide the motion within 15 days after commencement of the hearing, unless the movant expressly consents to a continuance for a specific period of time or compelling circumstances prevent the court from meeting the time limits established by this paragraph.

b. Additional Grounds for Appointment of Trustee

Add the following new section to 11 U.S.C. § 1104:

(a)(3) where grounds exist to convert or dismiss the case under section 1112 of this title, but the court determines that the appointment of a Chapter 11 trustee is in the best interests of creditors and the estate.

2.5.10 Enhanced Powers of the United States Trustee and Bankruptcy Administrator

Add a new subclause (e) to 11 U.S.C. § 341, and amend 28 U.S.C. § 586 (the general statute governing the powers and duties of the U.S.
Trustee) and the Manual for Bankruptcy Administrators, (governing the duties of Bankruptcy Administrators) to require U.S. Trustees in every small business debtor case (except where they, in their reasonable discretion determine that the conduct enumerated below is not advisable in the circumstances):

(1)(a) to conduct an initial debtor interview ("IDI") with the debtor as soon as practicable after the entry of order for relief but prior to the first meeting scheduled under Bankruptcy Code § 341(a). At the IDI, the U.S. Trustee shall, at a minimum, begin to investigate the debtor's viability, inquire about the debtor's business plan, explain the debtor's obligations to file monthly operating reports and other required reports, attempt to develop an agreed scheduling order, and inform the debtor of other Chapter 11 obligations;

(b) when determined by the U.S. Trustee to be appropriate and advisable, to visit the appropriate business premises of the debtor and ascertain the general state of the debtor's books and records and verify that the debtor has filed its tax returns. This visit should take place in connection with or reasonably promptly after the IDI (wherever possible, these events shall be combined with other events so as to minimize to the most reasonable practicable extent the amount of time of debtor personnel spent in court and at official meetings); and

(c) to review and monitor diligently on a continuous basis each debtor's activities, with a view to identifying as promptly as possible those debtors which do not pass the test of being more likely than not to be able to confirm a Chapter 11 plan within a reasonable time; and

(2) in cases where, upon the basis of continuing review, monitoring or otherwise, the U.S. Trustee finds material grounds for any relief under Bankruptcy Code § 1112, to move the court promptly for relief.
Chapter 2: Single Asset Proposals

2.6.1 Change the Present Statutory Definition of “Single Asset Real Estate” in two ways.

First, the $4 million debt limit should be eliminated from the definition of “single asset real estate” debtor subject to section 362(d)(3).

Second, the definition of “single asset real estate” should be more carefully worded to exclude cases in which the real property is used by a debtor in an active business.

The definition, as proposed, incorporating both concepts, would read as follows:

undeveloped real property or other real property constituting a single property or project other than residential real property with fewer than 4 residential units on which is located a single development or project which property or project generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor, or by a commonly controlled group of entities substantially all of which are concurrently Chapter 11 debtors, other than the business of operating the real property and activities incidental thereto.

2.6.2 Amend Code Section 362(d)(3) in Three Particulars

a. Make clear that payments required by section 362(d)(3) may be made from rents generated from the property.

b. Provide that the interest rate with respect to which payments are calculated shall be the nondefault contract rate.

c. Amend the statute to provide that the payments must be commenced or a plan filed on the later of 90 days after the petition date or 30 days after the court determines the debtor to be subject to section 362(d)(3).
2.6.3 Require Substantial Equity in order to Confirm a Lien-Stripping Plan Using the New Value Exception

In cases where the secured creditor has not made the election under section 1111(b)(1)(a)(i), a plan must satisfy the following requirements to be confirmed under the new-value exception following rejection by a class that includes the unsecured portion of a claim secured by real property: (1) The new value contribution must pay down the secured portion of the claim on the effective date of the plan so that, giving effect to the confirmation of the plan, sufficient cash payments on the secured portion of the claim shall have been made so that the principal amount of debt secured by the property is no more than 80 percent of the court-determined fair market value of the property as of the confirmation date; (2) the payment terms for the secured portion of the claim must both (i) satisfy all applicable requirements of section 1129 of the Code, and (ii) satisfy then-prevailing market terms in the same locality regarding maturity date, amortization, interest rate, fixed-charge coverage and loan documentation; and (3) the new value contribution must be treated as an equity interest that is not convertible to or exchangeable for debt.

Chapter 3: Jurisdiction

3.1.1 Establishing the Bankruptcy Court under Article III of the Constitution

The bankruptcy court should be established under Article III of the Constitution.

3.1.2 Transition to an Article III Bankruptcy Court

As of the enactment of legislation to establish an Article III bankruptcy court, sitting bankruptcy judges should be permitted to finish their current fourteen year terms. As vacancies are created through attrition (including expiration of current statutory term, appointment as an Article III judge, resignation, retirement prior to end of term for any reason, or death), Article III bankruptcy judges should be appointed by the President upon the advice and consent of the Senate to fill those positions. Sitting bankruptcy judges should be permitted to apply for any Article III judgeship positions while remaining on the bench.
Nothing in the Recommendation will affect the length of the current term, salary, retirement benefits, or other attributes of sitting bankruptcy judges.

During the transition period, bankruptcy jurisdiction should be treated in the following manner: as Article III bankruptcy judges are appointed, the jurisdiction provisions under 28 U.S.C. §§ 1334 and 157 should be transferred on a district-by-district basis to the Article III bankruptcy judge sitting in that district. Consequently, bankruptcy jurisdiction would reside in the Article III bankruptcy judge, including the power to refer and withdraw cases and proceedings. While a district is without an Article III bankruptcy judge, the Judicial Council for that circuit should be authorized to: (1) determine the need for an Article III bankruptcy judge in that district, and (2) if necessary, designate an Article III bankruptcy judge from another district (within the circuit) to sit in that district. In the event the judicial council determines a need for an Article III bankruptcy judge and one has not yet been appointed to sit within that circuit, the Chief Justice, upon receiving a certificate of necessity from the chief judge of the circuit, should be authorized to designate an Article III bankruptcy judge from another circuit to fulfill the request.

3.1.3 Bankruptcy Appellate Process

The current system which provides two appeals, the first either to a district court or a bankruptcy appellate panel and the second to the U.S. Court of Appeals, as of right from final orders in bankruptcy cases should be changed to eliminate the first layer of review.

3.1.4 Interlocutory Appeals of Bankruptcy Orders

28 U.S.C. § 1293 should be added to provide, in addition to the appeal of final bankruptcy orders, for the appeal to the courts of appeals of interlocutory bankruptcy court orders under the following circumstances: (1) an order to increase or reduce the time to file a plan under section 1121(d); (2) an order granting, modifying, or refusing to grant an injunction or an order modifying or refusing to modify the automatic stay; (3) an order appointing or refusing to appoint a trustee, or authorizing the sale or other disposition of property of the estate; (4) where an order is certified by the bankruptcy judge that (x) it involves a controlling issue of law to which there is a substantial difference of opinion, and (y) immediate appeal of the order may materially advance resolution of the litigation, and leave to appeal is
granted by the court of appeals; and (5) with leave from the court of appeals.

3.1.5 Venue Provisions under 28 U.S.C. § 1408

28 U.S.C. § 1408(1) should be amended to prohibit corporate debtors from filing for relief in a district based solely on the debtor's incorporation in the state where that district is located.

The affiliate rule contained in 28 U.S.C. § 1408(2) should be amended to prohibit a corporate filing in an improper venue unless such debtor's corporate parent is a debtor in a case under the Bankruptcy Code in that forum. Section 1408(2) should be amended as follows:

(2) in which there is pending a case under title 11 concerning such person's affiliate, as defined in section 101(2)(A) of title 11, general partner, partnership, or a partnership controlled by the same general partner.

The court's discretionary power to transfer venue in the interest of justice and for the convenience of the parties should not be restricted.

Chapter 3: Procedure

3.2.1 Minimum Amount to Commence a Preference Action under 11 U.S.C. § 547

11 U.S.C. § 547 should provide that $5,000 is the minimum aggregate transfer to a noninsider creditor that must be sought in a nonconsumer debt preference avoidance action.

3.2.2 Venue of Preference Actions under 28 U.S.C. § 1409

28 U.S.C. § 1409 should be amended to require that a preference recovery action against a noninsider seeking less than $10,000 must be brought in the bankruptcy court in the district where the creditor has its principal place of business. The Recommendation applies to nonconsumer debts only.
3.2.3 **Ordinary Course of Business Exception Under 11 U.S.C. § 547(c)(2)(B)**

11 U.S.C. § 547(c)(2)(B) should be amended to provide a disjunctive test for whether a payment is made in the ordinary course of the debtor’s business if it is made according to ordinary business terms. The ordinary course of business defense to a preference recovery action under section 547(c)(2) should provide as follows:

(2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee and such transfer was—
(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
(B) made according to ordinary business terms[.]

3.2.4 **Ad Valorem Tax Priority under 11 U.S.C. § 724(b)**

11 U.S.C. § 724(b) should be amended to exempt from subordination properly perfected, nonavoidable liens on real or personal property of the estate arising in connection with an ad valorem tax. Section 724(b) should also require the trustee to marshal unencumbered assets of the bankruptcy estate and surcharge secured claims, if warranted by the circumstances, under section 506(c) prior to subordinating any tax liens under the statute.

3.2.5 **Burden of Proof for Tax Proceedings**

The Bankruptcy Code should be amended to clarify that the burden of proof/persuasion rules and concomitant presumptions in tax controversies which would be applicable under nonbankruptcy law are equally applicable in bankruptcy court proceedings to determine tax liabilities under 11 U.S.C. §§ 502 and 505.

3.2.6 **Exception of Tax Refunds Setoffs under 11 U.S.C. § 362(b)**

11 U.S.C. § 362(b) of the Bankruptcy Code should be amended to allow a governmental unit to setoff an income tax refund that arose prior to the commencement of a Chapter 7 or Chapter 13 case against an ‘undisputed’ income tax liability of an individual debtor that arose prior to the commencement of the case.
Chapter 3: Administration

3.3.1 United States Trustee Program

The Director of the Executive Office for United States Trustees should hold the position of Assistant Attorney General.

The United States Trustee regions should match the number, size and configuration of the federal judicial circuits.

3.3.2 Personal Liability of Trustees

Trustees appointed in cases under Chapter 7, 11, 12 or 13 of the Bankruptcy Code should not be subject to suit in their individual capacity for acts taken within the scope of their duties as delineated in the Bankruptcy Code or by order of the court, as long as the applicable order was issued on notice to interested parties and there was full disclosure to the court.

Chapter 7, 12 and 13 trustees only should be subject to suit in the trustee's representative capacity and subject to suit in the trustee's personal capacity only to the extent that the trustee acted with gross negligence in the performance of the trustee's fiduciary duties. Gross negligence should be defined as reckless indifference or deliberate disregard of the trustee's fiduciary duty.

A Chapter 11 trustee of a corporate debtor only should be subject to suit in the trustee's representative capacity and subject to suit in the trustee's personal capacity only to the extent that the trustee has violated the standard of care applicable to officers and directors of a corporation in the state in which the Chapter 11 case is pending.

Debtors in possession should remain subject to suit to the same extent as currently exists under state or federal law.

3.3.3 Qualification of Professionals under 11 U.S.C. § 1107(b)

Section 1107(b) should be amended to provide that a person should not be disqualified for employment under § 327 solely because such person holds an insubstantial unsecured claim against or equity interest in the debtor. Section 327 and § 101(14) should remain unchanged.
3.3.4 National Admission to Practice

Admission to practice in one bankruptcy court, usually by virtue of being admitted to practice in the relevant United States District Court, should entitle an attorney, on presentation of a certificate of admission and good standing in another district court, to appear in the other bankruptcy court without the need for any other admission procedure.

The Recommendation will not affect requirements (if any) to associate with local counsel. Similarly, the Recommendation will not change the requirements under state law governing the practice of law and the maintenance of an office for the practice of law. The Recommendation will only amend the local bankruptcy rule or practice requirements governing special admission of attorneys to the bankruptcy court who are otherwise not admitted to the bar of the district court in the district where the bankruptcy court is located to appear in a particular bankruptcy case.

3.3.5 Fee Examiners

The Bankruptcy Code should explicitly preclude the appointment of fee examiners as an improper delegation of the court's duty to review and award compensation under 11 U.S.C. § 330. The Recommendation does not affect the court's authority under 11 U.S.C. § 1104(c) to appoint an examiner to investigate and report on certain aspects of a Chapter 11 case, for example, a potential fraudulent transfer or a particularly complicated claims estimation.

3.3.6 Attorney Referral Services

11 U.S.C. § 504 should be amended to permit an attorney compensated out of a bankruptcy estate to remit a percentage of such compensation to a bona fide, nonprofit, public service referral program. Such attorney referral program must be operating in accordance with state laws and ethical rules and guidelines governing referrals. The Recommendation does not affect the requirement that all compensation arrangements be disclosed in the application for retention under Fed. R. Bankr. P. 2014 and in the application for compensation under Fed. R. Bankr. P. 2016(a).
Chapter 4: Data Compilation and Dissemination

4.1.1 Establish as policy that all data held by bankruptcy clerks in electronic form, to the extent it reflects only public records as defined in Bankruptcy Code § 107, should be released in electronic form to the public, on demand.

4.1.2 Establish and fund a pilot project to aggregate the data from sources, particularly bankruptcy clerks, and make that data available to the public in electronic form, on demand.

4.1.3 Secure limited-duration appointment of a coordinator, who, with the head of the AO's office and the head of EOUST, would be charged with the duty of:
   (1) Making recommendations to increase the accuracy of the debtor's petitions, schedules and statements.
   (2) Setting the data-collection goals.
   (3) Coordinating the bankruptcy data-collection efforts of the central reporting agencies.
   (4) Reporting on an annual basis to the Congress, the Chief Justice, and the President.

4.1.4 Establish a bankruptcy data system in which (1) a single set of data definitions and forms are used to collect data nationwide and (2) all data for any particular case are aggregated in the same electronic record.

4.1.5 Maximize the number of documents filed electronically and maximize open-to-the-public remote electronic access to all data for free, or at the lowest possible cost.

Chapter 4: Taxation and the Bankruptcy Code

4.2.1 Clarify provisions of the Bankruptcy Code on providing reasonable notice to governmental units.

4.2.2 Amend the Bankruptcy Code to prescribe that to the extent that a tax claim presently is entitled to interest, such interest shall accrue at a stated statutory rate.
4.2.3 The Commission should submit to the Advisory Committee on Bankruptcy Rules of the Judicial Conference ("Rules Committee") a recommendation that the Federal Rules of Bankruptcy Procedure require that notices demanding the benefits of rapid examination under 11 U.S.C. § 505(b) be sent to the office specifically designated by the applicable taxing authority for such purpose, in any reasonable manner prescribed by such taxing authority.

4.2.4 Conform §346 of the Bankruptcy Code to IRC 1398(d)(2) election; also conform local and state tax attributes that are transferred to the estate to those tax attributes that are transferred to the bankruptcy estate under IRC §1398.

4.2.5 Amend 11 U.S.C. §507(a)(8) and 523(a)(1) to provide for the tolling of relevant periods in the case of successive filings. Thus, in the event of successive bankruptcy filings, the time periods specified in §507(a)(8) shall be suspended during the period in which a governmental unit was prohibited from pursuing a claim by reason of the prior case.

4.2.6 Amend 11 U.S.C. §507(a)(8)(ii) to toll the 240-day assessment period for both pre- and post assessment offers in compromise.

4.2.7 Amend the Bankruptcy Code to require "small business debtors" to create and maintain separate bank accounts for trust fund taxes and nontax deductions from employee paychecks. Also, any proposal should provide for sanctions for failure to comply with this Bankruptcy Code requirement.

4.2.8 Amend 11 U.S.C. §1141(d)(3) to except from discharge taxes unpaid by businesses entities, which nonpayment arose from fraud.

4.2.9 Amend 11 U.S.C. §362(a)(8) to confine its application to proceedings before the Tax Court for tax periods ending on or prior to the filing of the petition in the bankruptcy case and to permit appeals from Tax Court decisions.

4.2.10 Application of the periodic payment provisions of §1129(a)(9)(C) to secured tax that would be entitled to priority absent their secured status.

4.2.11 Amend 11 U.S.C. §545(2) to overrule cases that have penalized the government due to certain benefits for purchasers provided for in the lien provisions of the Internal Revenue Code.
4.2.12 Amend 11 U.S.C. §503 and 28 U.S.C. §960 to eliminate the need for a governmental unit to make a “request” to the debtor to pay tax liabilities that are entitled to payment as administrative expenses.

4.2.13 Amend 11 U.S.C. §§502(a)(1) and 503(b)(1)(B) to provide that postpetition ad valorem real estate taxes should be characterized as an administrative expense whether secured or unsecured and such taxes should be payable as an ordinary course expense.

4.2.14 Amend the Bankruptcy Code to overrule Investors of The Triangle v. Carolina Triangle Ltd. Partnership (In re Carolina Triangle Ltd. Partnership), 166 B.R. 411 (9th Cir. B.A.P. 1994), and to ensure that postpetition ad valorem real-estate taxes are a reasonable and necessary cost of preservation of the estate.

4.2.15 Amend the Bankruptcy Code to establish that ad valorem taxes are incurred by the estate and, therefore, are entitled to administrative expense priority status.

4.2.16 & 4.2.17 Amend the Bankruptcy Code to conform the treatment of state and local tax claims to that treatment provided for federal tax claims by, among others, amending 11 U.S.C. § 346 to conform state and local tax attributes to the federal list in IRC § 1398.

4.2.18 Clarify IRC §1398 to provide that the bankruptcy estate’s income is subject to alternative minimum tax and capital gains tax treatment if otherwise applicable.

4.2.19 Amend the Bankruptcy Code to provide that the term “assessed or assessment” as used in 11 U.S.C. §§362(b)(9) and 507(a)(8) shall mean “that time at which a taxing authority may commence an action to collect the tax.”

4.2.20 Amend 11 U.S.C. §1125(b) to establish standards for tax disclosures in a Chapter 11 disclosure statement.

4.2.21 Clarify 11 U.S.C. §726(a)(1) to provide that a taxing authority must file a claim for a priority tax before the final order approving the trustee’s report is entered by the court.

4.2.22 Conformity of Chapter 13 plans with provisions of the Bankruptcy Code: Requirement to file returns.
Recommendations to Congress

4.2.23 Whether an income tax return prepared by the taxing authority should be considered a filed income tax return for purposes of the Bankruptcy Code.

4.2.24 Dismissal and injunction against filing subsequent case where court determines that a Chapter 13 debtor is abusing the bankruptcy process.

4.2.25 Create a method by which a trustee may obtain a safe harbor and certainty regarding the nature, amount, and consequences of debt discharged.

4.2.26 Amend IRC §1398(e)(3) to provide that a debtor should be treated as an employee of the bankruptcy estate as to payments by the estate of estate assets to the debtor for services performed.

4.2.27 & 4.2.28 Tax treatment of the sale by the estate of a debtor’s homestead: Availability of capital gain exclusion on sale of residence to the trustee of an individual debtor.

4.2.29 Whether changes are needed in IRC §§108 and 382 with respect to the issuance of stock for debt.

4.2.30 Whether IRC §1001 should be modified to provide for parallel tax treatment of recourse and nonrecourse debt.

4.2.31 Tax treatment of abandonment of property by an estate to the debtor.

4.2.32 Application of §505(b) discharge to estate as well as to the debtor, successor to the debtor, and trustee where taxing authority does not audit.

4.2.33 Bifurcation for claim filing purposes of a corporate tax year that straddles the petition date.

4.2.34 Requirement of periodic payment for deferred payments of tax under §1129(a)(9) and designation of interest rate used while making those deferred payments.

4.2.35 Authority of bankruptcy courts to grant declaratory judgments on prospective tax issues in Chapter 11 plans of reorganization.
4.2.36 Whether payment of prepetition nonpecuniary loss tax penalties in Chapter 11, 12, and 13 cases should be subordinated to payment of general unsecured claims.

4.2.37 Whether a substitute for return shall constitute a filed return for purposes of dischargeability issues.

Chapter 4: Chapter 9 - Municipal Bankruptcy Relief


The securities contract liquidation provisions in 11 U.S.C. §§ 555, 556, 559 & 560 should be applicable in Chapter 9 cases and should be added to the list contained in section 901(a).

4.3.2 Chapter 9 Petition as Order for Relief

Section 921(d) should be deleted. Section 921(c) authorizes the court to dismiss a Chapter 9 petition for (1) lack of good faith; or (2) failure to meet the requirements of title 11. Deletion of section 921(d) will eliminate the statutory conflict between section 301 providing that a voluntary petition constitutes an order for relief and section 921(d) authorizing the court to order relief only if the petition is not dismissed under section 921(c). Deletion of section 921(d) will also conform Chapter 9 to all other chapters of the Bankruptcy Code where a voluntary petition is the order for relief.

4.3.3 Eligibility of Municipalities to Serve on Creditors' Committees

11 U.S.C. § 101(41) should be amended to permit municipalities to serve on creditors' committees in Chapter 9 cases under the provisions of 11 U.S.C. § 1102.

4.3.4 Elimination of 11 U.S.C. § 921(b)

Section 921(b) should be deleted. Bankruptcy judges should be appointed to preside over Chapter 9 cases in the same manner as they are appointed to supervise all other cases under the Bankruptcy Code.
4.3.5 *Inclusion of “Employees” in 11 U.S.C. § 922(a)*

11 U.S.C. § 922(a)(1) should be amended to provide stay protection to nonresident “employees” of municipalities that have filed for Chapter 9 relief. Section 922(a)(1) should read:

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against an officer, employee, or inhabitant of the debtor that seeks to enforce a claim against the debtor[.]

4.3.6 *Treatment of Municipal Obligations in Chapter 9*

Chapter 9 should be amended to provide comparable protection to all types of tax-exempt obligations sold in the municipal marketplace. The Recommendation will not affect the right of a municipality to use special revenues for the provision of necessary municipal services.

Chapter 4: Chapter 12 - Bankruptcy Relief for Family Farmers

4.4.1 *Sunset Provision and Chapter 12 Eligibility*

The sunset provision should be eliminated. Chapter 12 should be made a permanent addition to the Bankruptcy Code. Section 101(18) should be amended to increase the aggregate debt limits to $2,500,000. The other eligibility requirements in section 101(18) should remain unchanged.

4.4.2 *Direct Payment Plans*

28 U.S.C. § 586(e) should be amended to clarify that the calculation of the standing trustee’s percentage fee should be based upon the aggregate of those payments “made under the plan” on account of claims impaired or modified by operation of bankruptcy law regardless of who makes the payment.
BANK SALES OF INSURANCE

POINTERS AND PRECAUTIONS

Julie Mix McPeak
Counsel, Kentucky Department of Insurance
Frankfort, Kentucky

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SECTION I
BANK SALES OF INSURANCE:
Pointers and Precautions

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SECTION I
Bank Sales of Insurance: Pointers and Precautions

I. Introduction

The sale of insurance by state and national banks has been a rapidly advancing area of the law since the United States Supreme Court decided the infamous case, *Barnett Bank of Marion County vs. Nelson*, 116 S.Ct. 1103 (1996). This outline addresses the implications of *Barnett Bank* on both the national marketplace and the regulatory environment in the Commonwealth of Kentucky. Additionally, this outline discusses the procedure for licensure to engage in the business of insurance in the Commonwealth, the standard of conduct for agencies and agents and the inherent problems with the conversion of insurance sales to the banking industry.

A. Kentucky’s role in the national marketplace

Kentucky is becoming nationally known for pioneering the issues inherent in the introduction of banks into the insurance marketplace. Commissioner George Nichols III is the Secretary/Treasurer of the National Association of Insurance Commissioners and chairs the NAIC’s Committee on Banking and Insurance. In that capacity, he has testified twice before the U.S. House of Representatives on Federal financial services modernization legislation.

Additionally, Kentucky was one of the first states in the nation to promulgate a regulation or codify a statute on banks’ sale of insurance and the Department of Insurance recently completed eight workshops throughout the state educating bankers on the insurance marketplace and procedures for licensure.

B. Issues for discussion

1. Pointers:

   a) Opportunities for your bank in pursuing an insurance program.
b) Details to consider in implementing an insurance program within your bank.

c) The procedure for becoming licensed to engage in the insurance marketplace in the Commonwealth.

2. Precautions:

a) Solicitation & referrals

b) Advertising

c) Consumer complaints

C. The role of the Kentucky Department of Insurance

1. The goal of the Department

The goal, mission and job description of individuals involved with the Insurance Department is clearly consumer protection. We recognize the need for competition in the insurance marketplace, as numerous participants in the industry benefit consumers in terms of rates, policy provisions, claim settlement and access to agents.

However, the Department also recognizes that subtle coercion may exist for the insurance consumer when banks make credit decisions and sell insurance to the same consumer. Therefore, our role requires a delicate balance in the marketplace, neither hostile to insurance companies nor lenient in consumer protection enforcement. In addition, as a Department, we must evolve to adapt to new licensees that may not enjoy insurance as their sole or main industry.

2. Scope of Regulatory Authority

a) Consumer Protection Regulation

The Department delineates its authority in three distinct areas: consumer protection regulation, solvency regulation and competitive market regulation. Consumer protection regulation is the most visible aspect of our authority and the most commonly distinguished. The Department safeguards consumers by enforcing statutes concerning unfair trade
practices, illegal or unfair sales of insurance, and insurance fraud. See KRS 304.12-010, et.seq.

b) Solvency Regulation

Solvency regulation is one of the most important duties of the Kentucky Department, and also one of the least known. The Commissioner enjoys examination authority over all companies licensed to conduct insurance business in the Commonwealth and performs on-site examinations at least every three years. KRS 304.2-210.

(1) Financial examinations

The examinations focus on the financial condition of the company, the company’s underwriting, and the maintenance of appropriate reserves to ensure the financial stability of the company and the company’s ability to pay its incurred claims. KRS 304.2-210. Further, the Commissioner may examine all insurance company affiliates, subsidiaries and holding companies in the corporate structure to determine whether the entities of common ownership are an unreasonable strain on the assets of the insurance company. KRS 304.2-220.

(2) Guaranty funds

In the case of an insurer insolvency, the Commissioner possesses the authority to invoke a guaranty fund to alleviate some of the losses incurred by insurance consumers. KRS 304.36-100. The funds are created by assessments to all companies in the same line of business as the insolvent insurer, subject to a maximum amount. KRS 304.36-080.

c) Competitive marketplace regulation

While the Commissioner enjoys the authority to approve policy forms and premium rates for insurance coverage in the Commonwealth, a competitive marketplace must be maintained. Therefore, the Department cannot unreasonably restrict the industry’s ability to determine coverage or rates, as consumer’s access to numerous companies and coverages is a basic tenet of consumer protection.
II. Background Information


This opinion affirms the ability of a national bank, located in a place of less than 5,000 population, to engage in insurance activities, as such activities are "incidental to banking" under Section 92 of the National Bank Act. In addition, no state law may "prevent or significantly interfere" with the national bank's exercise of such authority. See Appendix A.

B. The Office of the Comptroller of the Currency issues an Advisory Letter on Retail Sales of Nondeposit Investment Products

This letter is advisory only, and is not enforceable as a regulation. However, the Comptroller has recommended the Federal Financial Institutions Examination Council revise the Interagency Statement on Retail Sales of Nondeposit Investment Products as an interagency regulation and address areas of consumer protection and disclosures. See Appendix B.

C. The Kentucky Department of Financial Institutions issues Parity Letter 96-2

In order for state banks to apply for licensure to sell insurance, in parity with the national banks according to *Barnett Bank*, the Kentucky Department of Financial Institutions issued a Parity Letter for that purpose. Litigation ensued challenging the authority of the Department to issue a parity letter and the constitutionality of the parity statute.

D. The Kentucky Department of Insurance promulgates the administrative regulation on bank sales of insurance, 806 KAR 9:240

The Kentucky Bankers Association and the Independent Insurance Agents of Kentucky assisted the Department in promulgating a regulation on bank sales of insurance. See Appendix C.
E. Rhode Island’s banking and insurance statute is questioned by the OCC as violative of the Barnett Bank standard.

The Comptroller of the Currency requested comments from interested parties regarding whether the Rhode Island statute prohibits or significantly interferes with a national bank’s ability to engage in the business of insurance. Although the comment period has expired, the Comptroller has yet to issue an opinion on the matter.

F. The OCC authorizes Bank One to underwrite mortgage guaranty reinsurance.

Upon application of Bank One, the Comptroller approved the bank’s proposal to underwrite mortgage guaranty reinsurance through an operating subsidiary. The Comptroller opined that such activity was “incidental to banking” according to Section 92 of the National Bank Act. See Appendix D.

G. Federal legislation to revise the banking, insurance and securities industries passes the House Banking Committee.

H.R. 10 passed the U.S. House of Representatives Committee on Banking. This bill contains numerous provisions preempting states’ regulation of insurance, including redomestication, demutualization, licensing and financial oversight.

H. The OCC authorizes Zions First National Bank to underwrite municipal revenue bonds.

Upon Zions First’s application, the Comptroller approved the bank’s proposal to underwrite municipal revenue bonds through an operating subsidiary of the bank. The OCC concluded that underwriting and dealing in revenue bonds is part of the business of banking according to Section 20 of the Glass-Steagall Act. See Appendix E.
I. Differing Federal financial services modernization legislation passes the House Commerce Committee.

The Commerce Committee of the U.S. House of Representatives reported a committee substitute to H.R. 10, with the continued intention of revising the banking, securities and insurance industries. While many provisions were modified, significant preemption of state insurance regulation remained in the bill.

J. The Federal Reserve Board considers revisions to Regulation K.

The Federal Reserve Board solicited comments from interested parties on several revisions to its Regulation K, including an authorization to underwrite and reinsure life insurance and annuity products sold in the United States through an offshore affiliate. See Appendix F.

K. Kentucky’s banking and insurance statute is prefiling in the 1998 General Session.

House Bill 429 was a joint effort of the Kentucky Bankers Association, the Independent Insurance Agents of Kentucky and the Kentucky Department of Insurance. The majority of the administrative regulation was retained in the statute, with minor modifications. See Appendix G.

L. The industries create a compromise to Federal legislation

On March 12, 1998, a compromise bill was published by the U.S. House of Representatives. Several provisions were modified and a vote on the House floor is anticipated prior to the end of March, 1998. A summary of the insurance provisions may be found at Appendix H.

III. Pointers: Why should your bank pursue an insurance program?

Banks have enumerated several reasons for adding insurance to its traditional line of products and services:
A. Insurance is perceived as a valuable product that may be offered as a convenience to customers.

B. Banks have the ability to tailor lines of insurance to their customer base and line of business.

C. Banks perceive a significant capital inflow from insurance premium commissions.

D. Marketing of products may be enhanced as banks share customer databases with insurance agents and agency affiliates.

IV. Pointers: Issues to consider in developing an insurance program for your bank.

A. Corporate structure

Many possibilities abound when considering the structure for an insurance program within a bank. Many banks have chosen to license the bank itself as an insurance agency. Others have chosen to create a separate corporate entity as an affiliate or subsidiary of the bank to license as an insurance agency.

B. Agents

Several alternatives exist regarding the individuals to license as agents of the bank’s insurance products. These include:

1. A bank purchasing an existing agency.

2. A bank hiring licensed agents as employees.

3. A bank and an agent or agency forming a joint venture.
4. A bank licensing its own employees.

5. A bank, without independent licensure, creating an organized referral program with a licensed agency or agent.

**CAUTION** Any person or entity accepting commissions from the sale of insurance must be appropriately licensed. Please refer to KRS 304.9-421 and Bulletin 97-5 included in Appendix I.

V. **Pointers: Procedure for becoming licensed as an agent or agency in the Commonwealth**

A. To obtain an agent’s license

1. Attend 40 hours of approved classroom training.

2. Apply for licensure on the application form provided by the sponsoring company, with appropriate proof of financial responsibility (a surety bond, cash bond, or Errors and Omissions policy.) See Appendix J.

3. Pass the licensing examination administered by the Department.

4. Obtain 24 hours of continuing education each biennium to maintain the license.

B. Agency License

1. Contact an interested and licensed insurance company and agent.

2. Apply for licensure with the Kentucky Department of Insurance, including the following documentation:

   a) A completed application, acquired from the sponsoring company.
b) A copy of the bank’s Articles of Association, charter or other document illustrating the existence of a corporate entity, national bank or state bank.

c) A Resolution from the Board of Directors stating that only those persons duly licensed with the Department will be acting on behalf of the bank regarding insurance products. See Appendix K.

VI. Kentucky’s Banking and Insurance Statute

A. At the time of drafting, HB 429 is posted in the House of Representatives for Concurrence.

B. HB 429 and 806 KAR 9:240 are included for your reference at Appendices C & G.

C. HB 429 contains several important provisions, including:

1. KRS 387.030(4) is repealed and replaced with affirmative language authorizing banks to engage in the sale of insurance.

2. A new section of the Kentucky Insurance Code is created:

   a) Requiring all persons involved in the business of insurance to be licensed by the state.

   b) Prohibiting any violation of Federal anti-tying laws, and making any Federal violation a violation of state law.

   c) Prohibiting any delay in a banking transaction for the purpose of influencing a consumer’s selection or purchase of insurance.
d) Specifying the requirements for a paid referral program within the bank.

3. Disclosures:

806 KAR 9:240 and HB 429 require three disclosures to be propounded to any consumer purchasing insurance from a bank-affiliated agent. These include:

a) Notice must be given to the consumer that he or she has a free choice of insurance agent or company, to evidence compliance with KRS 304.12-150. This document must be executed prior to the sale of insurance.

b) Consumers must be given a notice and opportunity to authorize the disclosure of their consumer information to any person. A consumer’s refusal to execute this disclosure may not affect the purchase of insurance in any fashion.

c) Standard investment disclosures, similar to FDIC disclosures, must be executed by the consumer prior to the purchase of insurance. Similar disclosures are in use in almost every state.

According to HB 429, the Commissioner shall promulgate forms for the above disclosures by regulation. Sample forms drafted by the Department are included in Appendix L.

VII. Precautions: Solicitations and Referrals

A. Who is an agent?

Kentucky law is transaction-driven. Any person performing the duties normally conducted by an insurance agent should be licensed appropriately.
B. Agent activities include:

1. Solicitation
2. Advertising
3. Taking applications & premiums

C. Definitions:

1. Solicitation—To aid, assist, or facilitate the offering of insurance products.

2. Advertising—Descriptive literature and sales aids disseminated to the public.

3. Taking Applications—Completing or providing the following information:
   a) General application information,
   b) Underwriting information, specifically health questions,
   c) Discussing any coverages, including any requested,
   d) Providing premium quotes, and
   e) Witnessing signatures.

4. Handling Premiums—Handling premium funds is specifically an agent duty, even if merely administrative.
D. Administrative Staff

A very limited exception to the licensing statutes exists for administrative staff of licensed agents. However, the following requirements must be met:

1. Property and casualty lines of business only,
2. Direct supervision by an agent,
3. Individuals must be full-time clerical and administrative staff only,
4. Employees must be paid by salary only (no commissions), and
5. The taking of applications and premiums must be incidental to the employees normal duties.

E. Referral Fees

A significant revision in Department policy is contained in 806 KAR 9:240 and HB 429 regarding the ability of unlicensed individuals to receive a paid referral to a licensed agent. The following requirements must be satisfied to qualify for this limited exemption:

1. The referral fee is paid regardless of whether insurance is sold to the consumer referred,
2. The referral fee must be a fixed amount,
3. The referral fee must be paid by the financial institution, and
4. The referral fee program must be a part of a comprehensive referral program.
VIII. Precautions: Advertising

Advertising of bank-affiliated insurance products has been the source of several complaints to the Department of Insurance. A copy of the regulation concerning advertising of insurance products, 806 KAR 12:010, is included at Appendix M. The regulation specifically restricts the form and content of all advertisements of insurance products.

A. Frequently utilized banking and insurance advertisements:

1. Business displays
2. Direct mail advertising
3. Endorsements
4. Uncompensated referrals

B. Telemarketing

Another significant revision to Department policy concerns telemarketing. Recently, the Department has concluded that telemarketing is more similar to an advertisement than a personal solicitation. Accordingly, to qualify as a telemarketing promotion, rather than solicitation, the following requirements must be satisfied:

1. Telemarketers are supervised by licensed agents.
2. A script is required and must be followed by the telemarketers,
3. The promotion must comply with the advertising regulation, 806 KAR 12:010,
4. Any interested consumer is referred to a licensed agent, and
5. The licensed person must complete the application
IX. Precautions: Complaints

The Department of Insurance maintains legal and consumer protection divisions to respond to consumer complaints regarding the advertising and sale of insurance products, as well as settlement of insurance claims.

A. Written Complaints

The Department receives approximately 6,000 complaints annually. The Insurance Department is statutorily required to determine whether each written complaint is justified and is required to maintain all complaint records for 5 years. Additionally, the Department enjoys subpoena authority, the authority to grant limited immunity and prosecute for perjury. However, most complaints are resolved by Agreed Order.

B. Penalties and Restitution

1. Restitution is the primary goal of the Department. The Department prefers making the consumer whole when the complaint warrants the action.

2. The Department historically holds both the agent and insurance company responsible when the situation demands.

3. The Department may impose the following penalties:
   a) Cease and Desist orders,
   b) Probation,
   c) Suspension,
   d) Revocation of license, and/or
   e) Administrative fines of up to $10,000 per occurrence.
Barnett Bank v. Nelson

BARNETT BANK OF MARION COUNTY, N.A., Petitioner

v

BILL NELSON, Florida Insurance Commissioner, et al.

517 US -, 134 L Ed 2d 237, 116 S Ct —

[No. 94-1837]


Decision: Federal statute (12 USCS § 92) authorizing national banks to sell insurance in small towns held to (1) pre-empt Florida statute restricting bank insurance sales, and (2) specifically relate to business of insurance within meaning of McCarran-Ferguson Act.

SUMMARY

It is provided in 12 USCS § 92, which was enacted in 1916, that any national bank located and doing business in any place with a population of not more than 5,000 may act as the agent for any insurance company authorized by the state to sell insurance. Under § 2(b) of the McCarran-Ferguson Act (15 USCS § 1012(b)), which was enacted in 1945, an act of Congress may not be construed to invalidate, impair, or supersede any state law enacted for the purpose of regulating the business of insurance unless the congressional act "specifically relates to the business of insurance." In 1974, the state of Florida enacted a statute which prohibited the selling of most kinds of insurance in Florida by all banks except those which were located in a city having a population of less than 5,000 and which were not a subsidiary or an affiliate of a bank holding company. In 1993, an affiliated national bank which did business through a branch in a Florida town with a population of less than 5,000 bought a Florida-licensed insurance agency. On the day of the purchase, the bank filed an action in the United States District Court for the Middle District of Florida against the Florida insurance commissioner for permanent injunctive and declaratory relief, on the grounds that § 92 pre-empted the Florida statute. Four days later, the commissioner ordered the agency to stop selling the prohibited kinds of insurance. Thereafter, the bank moved in District Court for a preliminary injunction against the commissioner. The District Court, denying both preliminary and permanent relief, ruled that § 92 did not pre-empt the Florida statute, as (1) the Florida statute was a law enacted for the purpose of regulating the business of insurance within the meaning of § 2(b), and (2) § 92 did not fall within § 2(b)'s
anti-pre-emption rule because § 92 did not specifically relate to the business of insurance (859 F. Supp 835). On appeal, the United States Court of Appeals for the Eleventh Circuit affirmed for similar reasons (49 F 3d 631).

On certiorari, the United States Supreme Court reversed. In an opinion by Breyer, J., expressing the unanimous view of the court, it was held that § 92 pre-empted the Florida statute, because (1) under ordinary legal principles of federal pre-emption, the intent of § 92 was to grant limited authority to small town national banks to sell insurance regardless of whether a state granted its own state banks or national banks similar approval; and (2) § 92 specifically related to the business of insurance within the meaning of § 2(b).

HEADNOTES

Classified to United States Supreme Court Digest, Lawyers' Edition

Banks § 59; Commerce § 103(1) — national banks — selling of insurance — state law pre-emption — McCarran-Ferguson Act

1a-1d. 12 USCS § 92—which was enacted in 1916 and provides that, in addition to the powers vested by law in national banks, any such bank located and doing business in any place within a city having a population of not more than 5,000 may act as the agent for any insurance company authorized by the state to sell insurance, under such rules and regulations as the Comptroller of the Currency may prescribe—pre-empts a state statute that describes an affiliate of a bank holding company, because (1) under ordinary legal principles of federal pre-emption, the intent of § 92 is to grant authority to small town national banks to sell insurance regardless of whether a state grants its own state banks or national banks similar approval, in that (a) the language of § 92 suggests that § 92 grants national banks a broad permission to sell insurance which is not conditioned upon state permission, (b) there is a history in the United States Supreme Court of interpreting grants of both enumerated and incidental powers to national banks as grants of authority not normally limited by, but ordinarily pre-empting, contrary state law, (c) nothing in the background or history of § 92 significantly supports the argument that special circumstances surrounding the enactment of § 92 demonstrate Congress' intent to grant national banks only a limited permission to sell insurance subject to state approval, and (d) the Comptroller's subsequent interpretation of § 92 does not suggest that § 92 provides national banks with only a limited authority to sell insurance subject to similar state approval; and (2) § 92 “specifically relates to the business of insurance” within the meaning of § 2(b) of the McCarran-Ferguson Act (15 USCS § 1012(b))—which provides that an act of Congress may not be construed to invalidate, impair, or supersede any state law enacted for the purpose of regulating the business of insurance unless the congressional act specifically relates to the business of insurance—and thus § 2(b)’s special anti-pre-emption rule does not apply, in that (a) in ordinary English, § 92 “specifically” “relates” to the “business of insurance,” and in setting forth certain specific rules for banks, § 92 not only focuses directly upon industry-specific selling practices but also affects the relation of insured to insurer and the spreading of risk, and (b) a purpose of the McCarran-Ferguson Act (15 USCS §§ 1011-1015) as set forth in 15 USCS § 1011, namely that silence on the part of Congress shall not be construed to impose any barrier to the regulation or taxation of the business of insurance by the several states, indicates—as the circumstances surrounding enactment of the McCarran-Ferguson Act also suggest—that the McCarran-Ferguson Act seeks to protect state regulation primarily against inadvertent federal intrusion, such as by enactment of a federal statute that describes an affected activity in broad, general terms, of which the insurance business happens to comprise one part.

States, Territories, and Possessions § 22 — federal pre-emption — intent — tests

2. If Congress, in enacting a federal statute, intends to exercise its constitutionally delegated authority to set aside the laws of a state, then the Federal Constitution’s supremacy clause (Art VI, cl 2) requires courts to follow federal law, not state law; where explicit pre-emption language does not appear, or does not directly answer the question of whether the federal statute pre-empts state law, courts must consider whether the federal statute’s structure and purpose, or nonspecific statutory language, nonetheless reveal a clear but implicit pre-emptive intent—as, for example, where (1) a federal statute creates a scheme of federal regulation so pervasive as to make reasonable the inference that Congress left no room for the states to supplement it, (2) federal law is in irreconcilable conflict with state law, (3) compliance with both the federal statute and the state statute is a physical impossibility, or (4) the state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.

Banks § 59 — national banks — power of state

3. States have the power to regulate national banks where doing so does not prevent or significantly interfere with a national bank’s exercise of its powers.

Municipal Corporations § 34.5; Statutes § 178 — term “specifically relates” — ordinance

4. For purposes of construing the statutory term “specifically relates,” a statute may specifically relate to more than one thing; just as an ordinance forbidding dogs in city parks specifically relates to dogs and to city parks, so a statute purporting to authorize banks to sell insurance can specifically relate to banks and to insurance.

Commerce § 103(1) — McCarran-Ferguson Act — state law pre-emption

5. Neither the language nor the purpose of § 2(b) of the McCarran-Ferguson Act (15 USCS § 1012(b))—which provides that an act of Congress may not be construed to invalidate, impair, or supersede any state law enacted for the purpose of regulating the business of insurance unless the congressional act specifically relates to the business of insurance—requires that a federal statute relate predominantly to insurance in order to pre-empt state law.

Bankruptcy § 15; Commerce § 103(1) — McCarran-Ferguson Act — pre-emption of state law

6. The anti-pre-emption rule enunciated by § 2(b) of the McCarran-
Ferguson Act (15 USCS § 1012(b))—which provides that an act of Congress may not be construed to invalidate, impair, or supersede any state law enacted for the purpose of regulating the business of insurance unless the congressional act specifically relates to the business of insurance—applies where federal statutes with a potential pre-emptive effect upon state law, such as the bankruptcy statutes, (1) use general language that does not appear to specifically relate to insurance, and (2) conflict with state law that was enacted for the purpose of regulating the business of insurance.

RESEARCH REFERENCES
10 Am Jur 2d, Banks § 303; 43 Am Jur 2d, Insurance §§ 37, 38
12 USCS § 92; 15 USCS § 1012(b)
L Ed Digest, Banks § 59; Commerce § 103(I)
L Ed Index, Banks; McCarran-Ferguson Act
ALR Index, Banks and Banking; Insurance Agents and Brokers; McCarran-Ferguson Act; National Banks
Annotations:
Supreme Court's views as to validity, construction, and application of McCarran-Ferguson Act (15 USCS §§ 1011-1015), concerning regulation of business of insurance by state or federal law. 125 L Ed 2d 879.
Public regulation or control of insurance agents or brokers. 10 ALR2d 950.
Auto-Cite®: Cases and annotations referred to herein can be further researched through the Auto-Cite® computer-assisted research service. Use Auto-Cite to check citations for form, parallel references, prior and later history, and annotation references.

APPEARANCES OF COUNSEL ARGUING CASE
Nathan Lewin argued the cause for petitioner.
Richard P. Bress argued the cause for the United States, as amicus curiae, by special leave of court.
Daniel Y. Sumner argued the cause for state respondents.
Ann M. Kappler argued the cause for private respondents.

SYLLABUS BY REPORTER OF DECISIONS
A 1916 federal law (Federal Statute) permits national banks to sell insurance in small towns, but a Florida law (State Statute) prohibits such banks from selling most types of insurance. When petitioner Barnett Bank, a national bank doing business in a small Florida town, bought a state licensed insurance agency, respondent State Insurance Commissioner ordered the agency to stop selling the prohibited forms of insurance. In this action for declaratory and injunctive relief, the District Court held that the State Statute was not pre-empted, but only because of the McCarran-Ferguson Act's special insurance-related anti-pre-emption rule. That rule provides that a federal law will not pre-empt a state law enacted "for the purpose of regulating the business of insurance"—unless the federal statute "specifically relates to the business of insurance." 15 USC § 1012(b) (emphasis added). The Court of Appeals affirmed.

Held: The Federal Statute pre-empts the State Statute.
(a) Under ordinary pre-emption principles, the State Statute would be pre-empted, for it is clear that Congress, in enacting the Federal Statute, intended to exercise its constitutionally delegated authority to override contrary state law. The Federal and State Statutes are in "irreconcilable conflict," Rice v Norman Williams Co., 458 US 654, 659, 73 L Ed 2d 1045, 109 S Ct 399, unless, as the State contends, Congress intended to limit federal permission to sell insurance to those circumstances permitted by state law. However, by providing, without relevant qualification, that national banks "may . . . act as the agent" for insurance sales, 12 USC § 92 (12 USCS § 92), the Federal Statute's language suggests a broad, not a limited, permission. That this limitation is granted in "addition to the powers now vested . . . in national [banks]," ibid. (emphasis added), is also significant. Legislative grants of both enumerated and incidental "powers" to national banks historically have been interpreted as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law. See, e.g., First Nat. Bank of San Jose v California, 262 US 366, 368-369, 67 L Ed 1030, 43 S Ct 602. Where, as here, Congress has not expressly granted a power of national origin, § 1012(b) grants of power upon a grant of state permission, this Court has ordinarily found that no such condition applies. See Franklin Nat. Bank v New York, 347 US 373, 38 L Ed 767, 74 S Ct 550.
The State's argument that special circumstances surrounding the Federal Statute's enactment demonstrate Congress' intent to grant only a limited permission is unpersuasive.
(b) The McCarran-Ferguson Act's anti-pre-emption rule does not govern this case, because the Federal Statute "specifically relates to the business of insurance." This conclusion rests upon the Act's language and purposes, taken together. The word "relates" is highly general; and in ordinary English, the Federal Statute—which focuses directly upon industry-specific selling practices and affects the relation of insured to insurer and the spreading of risk—"specifically relates to the insurance business. The Act's mutually reinforcing purposes—that state regulation and taxation of the insurance business is in the public interest, and that Congress' "silence . . . shall not be construed to impose any barrier to [such] regulation or taxation," 15 USC § 1011 (15 USCS § 1011) (emphasis added)—also support this view. This phrase, especially the word "silence," indicates that the Act seeks to protect state regulation primarily against inadvertent federal intrusion, not to insulate state insurance regulation from the reach of all federal law. The circumstances surrounding the Act's enactment also suggest that the Act was passed to ensure that generally phrased con-
gressional statutes, which do not mention insurance, are not applied
to the issuance of insurance policies,
thereby interfering with state regula-
tion in unanticipated ways. The par-
ties' remaining arguments to the con-
trary are unconvincing.
43 F. 3d 631, reversed.
Breyer, J., delivered the opinion
for a unanimous Court.

OPINION OF THE COURT

Justice Breyer delivered the opin-
ion of the Court.

[1a] The question in this case is
whether a federal statute that per-
mits national banks to sell insurance
in small towns pre-empts a state sta-
tute that forbids them to do so. To
answer this question, we must con-
sider both ordinary pre-emption prin-
ciples, and also a special federal anti-
pre-emption rule, which provides that
a federal statute will not pre-
empt a state statute enacted "for the
purpose of regulating the business of
insurance"—unless the federal statu-
to "specifically relates to the busi-
ness of insurance." McCarran-
Ferguson Act, 15 USC § 1012(b) [15
USCS § 1012(b)] (emphasis added).
We decide that the McCarran-
Ferguson Act's special anti-pre-
emption rule does not govern this
case, because the federal statute in
question "specifically relates to the
business of insurance." We conclude
that, under ordinary pre-emption prin-
ciples, the federal statute pre-
empts the state statute, thereby pro-
hibiting application of the state statu-
te to prevent a national bank from
selling insurance in a small town.

In 1916 Congress enacted a federal
statute that says that certain na-
tional banks "may" sell insurance
in small towns. It provides in relevant
part:

"In addition to the powers now
vested by law in national [banks]
organized under the laws of the
United States any such [bank] lo-
cated and doing business in any
place [with a population] . . . [of
not more than] five thousand . . .
may, under such rules and regula-
tions as may be prescribed by the
Comptroller of the Currency, act
as the agent for any one life, or
other insurance company autho-
rized by the authorities of the State
... to do business [there]. . . by
soliciting and selling insurance
Provided, however, That no such
bank shall . . . guarantee the payment of any claim . . . and
further, that the bank shall not guarantee the truth of any
statement made by an assured
[when applying] for insur-
ance." Act of Sept. 7, 1916 (Federal
Statute), 39 Stat. 753, 12 USC § 92
[12 USCS § 92] (emphases changed).

In 1974 Florida enacted a statute
that prohibits certain banks from
selling most kinds of insurance. It
says:

"No [Florida licensed] insurance
agent . . . who is associated with,
. . . owned or controlled by . . . a
financial institution shall engage in
insurance agency activities . . . ." Fla.
The term "financial institution"
includes

"any bank . . . [except for a] bank
which is a subsidiary of an affili-
ate of a bank holding company or
is located in a city having a popula-

Thus, the State Statute says, in es-
sence, that banks cannot sell insur-
ance in Florida—except that an
unaffiliated small town bank (i.e., a
bank that is not affiliated with a
bank holding company) may sell in-
surance in a small town. ibid.

In October 1993 petitioner Barnett
Bank, an "affiliated" national bank
which does business through a
branch in a small Florida town,
bought a Florida licensed insurance
agency. The Florida State Insurance
Commissioner, pointing to the State
Statute, (and noting that the unaffili-
ated small town bank exception did
not apply), ordered Barnett's insur-
ance agency to stop selling the pro-
hibited forms of insurance. Barnett,
claiming that the Federal Statute
pre-empted the State Statute, then
filed this action for declaratory and
injunctive relief in federal court.

The District Court held that the
Federal Statute did not pre-empt the
State Statute, but only because of
the special insurance-related federal
anti-pre-emption rule. The
McCarran-Ferguson Act, which cre-
ates that rule, says:

"No act of Congress shall be con-
strued to invalidate, impair, or
supercede any law enacted by any
State for the purpose of regulating
the business of insurance, or which
imposes a fee or tax upon such
business, unless such Act specifi-
cally relates to the business of in-
surance . . . ." McCarran-
Ferguson Act (or Act), § 2(b), 59
Stat. 34, 15 USC § 1012(b) [15 USCS
§ 1012(b)].

The District Court decided both (1)
that the Federal Statute did not fall
within the McCarran-Ferguson Act's
exception because it did not "specifi-
cally relate[ ] to the business of insur-
ance"; and (2) that the State Statute
was a "law enacted . . . for the pur-
pose of regulating the business of
insurance." Barnett Bank v. Gallagher,
939 F. Supp. 835, 840-841, 843 (MD Fl.
1993) (internal quotation marks omit-
ted). Consequently, the McCarran-
Ferguson Act, in the District Court's
view, instructs courts not to "con-
strue[ ]" the Federal Statute "to in-
vaidate" the State Statute. 15 USC
§ 1012(b) [15 USCS § 1012(b)]. The
Eleventh Circuit Court of Appeals,
for similar reasons, agreed that the
Federal Statute did not pre-empt the
State Statute. Barnett Bank v. Gal-

We granted certiorari due to uncer-
tainty among lower courts about the
pre-emptive effect of this Federal
Statute. See Overseas National Bank
of New Orleans v. Stephens, 44 F. 3d
388 (CA6 1994) (pre-emption of Kentucky statute that prevents national banks from
selling insurance in small towns);
First Advantage Ins., Inc. v. Green,
654 So. 2d 562 (La. Ct. App.), rev-
den., 654 So. 2d 331 (1995) (no pre-
emption). We now reverse the Ele-
venth Circuit.

II

[2] We shall put the McCarran-
Ferguson Act's special anti-pre-
emption rule to the side for the mo-
ment, and begin by asking whether,
in the absence of that rule, we should
construe the Federal Statute to pre-
empt the State Statute. This question
is basically one of congressional in-
tent. Did Congress, in enacting the
Federal Statute, intend to exercise
its constitutionally delegated author-
ity to set aside the laws of a State? If

Sometimes courts, when facing the pre-emption question, find language in the federal statute that reveals an explicit congressional intent to pre-empt state law. E.g., Jones v Rath Packing Co., 430 US 519, 525, 530-531, 51 L Ed 2d 604, 97 S Ct 1305 (1977). More often, explicit pre-emption language does not appear, or does not directly answer the question. In that event, courts must consider whether the federal statute's "structure and purpose," or nonspecific statutory language, nonetheless reveal a clear, but implicit, pre-emptive intent. Id., at 525, 51 L Ed 2d 604, 97 S Ct 1305; Fidelity Fed. Sav. & Loan Assn. v De la Cuesta, 458 US 141, 152-153, 73 L Ed 2d 664, 102 S Ct 3014 (1982). A federal statute, for example, may create a scheme of federal regulation "so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it." Rice v Santa Fe Elevator Corp., 311 US 219, 220, 51 L Ed 1447, 67 S Ct 1146 (1947). Alternatively, federal law may be in "irreconcilable conflict" with state law. Rice v Norman Williams Co., 458 US 654, 659, 73 L Ed 2d 1042, 102 S Ct 3294 (1982). Compliance with both statutes, for example, may be a "physical impossibility," Florida Lime & Avocado Growers, Inc. v Paul, 373 US 132, 142-143, 10 L Ed 2d 248, 83 S Ct 1210 (1963); or, the state law may "stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." Hines v De Forest, 291 US 52, 67, 85 L Ed 581, 61 S Ct 399 (1941). In this case we must ask whether or not the Federal and State Statutes are in "irreconcilable conflict." The two statutes do not impose directly conflicting duties on national banks—as they would, for example, if the federal law said, "you must sell insurance," while the state law said, "you may not." Nonetheless, the Federal Statute authorizes national banks to engage in activities that the State Statute expressly forbids. Thus, the State's prohibition of those activities would seem to "stand as an obstacle to the accomplishment" of one of the Federal Statute's purposes—unless, of course, that federal purpose is to grant the bank only a very limited permission, that is, permission to sell insurance to the extent that state law also grants permission to do so.

That is what the State of Florida and its supporting amici argue. They say that the Federal Statute grants national banks a permission that is limited to circumstances where state law is not to the contrary. In their view, the Federal Statute removes only federal legal obstacles, not state legal obstacles, to the sale of insurance by national banks. But we do not find this, or the State's related, ordinary pre-emption arguments convincing.

[1b] For one thing, the Federal Statute's language suggests a broad, not a limited, permission. That language says, without relevant qualification, that national banks "may ... act as the agent" for insurance sales. 12 USC § 92 (12 USCS § 92). It specifically refers to "rules and regulations" that will govern such sales, while citing as their source not state law, but the federal Comptroller of the Currency. Ibid. It also specifically refers to state regulation, while limiting that reference to licensing—not of banks or insurance agents, but of the insurance companies whose policies the bank, as insurance agent, will sell. Ibid.

For another thing, the Federal Statute says that its grant of authority to sell insurance is an "addition to the powers now vested by law in national [banks]." Ibid. (emphasis added). In using the word "powers," the statute chooses a legal concept that, in the context of national bank legislation, has a history. That history is one of interpreting grants of both enumerated and incidental "powers" to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law. See, e.g., First Nat. Bank of San Jose v California, 262 US 366, 368-369, 67 L Ed 1030, 43 S Ct 602 (1923) (national banks' "power" to receive deposits pre-empts contrary state escrow law); Easton v Iowa, 188 US 220, 229-230, 47 L Ed 452, 23 S Ct 288 (1903) (national banking system normally "independent, so far as powers conferred are concerned, of state legislation"); cf. Waite v Dowsley, 94 US 527, 533, 24 L Ed 181 (1877) ("Where there exists a concurrent right of legislation in the States and in Congress, and the latter has exercised its power, there remains in the States no authority to legislate on the same matter").

Thus, this Court, in a case quite similar to this one, held that a federal statute permitting, but not requiring, national banks to receive savings deposits, pre-empts a state statute prohibiting certain state and national banks from using the word "savings" in their advertising. Franklin Nat. Bank v New York, 347 US 373, 375-379, 98 L Ed 767, 74 S Ct 550 (1954) (Federal Reserve Act provision that national banks "may continue . . . to receive . . . savings deposits" read as "declaratory of the right of a national bank to enter into or remain in that type of business"). See also De la Cuesta, supra, at 154-159, 73 L Ed 2d 664, 102 S Ct 3014 (1982) (federal regulation permitting, but not requiring, national banks to include in mortgage contracts a debt accelerating "due on sale" clause, pre-empts a state law forbidding the use of such a clause); cf. Lawrence County v Lead-Deadwood School Dist. No. 40-1, 469 US 256, 83 L Ed 2d 635, 105 S Ct 695 (1985) (federal statute providing that local government units "may" expend federal funds for any governmental purpose pre-empts state law restricting their expenditure).

[3] In defining the pre-emptive scope of statutes and regulations granting a power to national banks, these cases take the view that normally Congress want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted. To say this is not to deprive States of the power to regulate national banks, where (unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers. See, e.g., Anderson Nat. Bank v Luckett, 321 US 233, 247-252, 88 L Ed 692, 64 S Ct 599, 151 ALR 824 (1944) (state statute administering abandoned deposit accounts did not "unlawfully[ly] encroach[ on] the rights and privileges of national banks"); McClellan v Chipman, 164 US 347, 358, 41 L Ed 461, 17 S Ct 85 (1896) (application to national banks of state statute forbidding certain real estate transfers by insolvent transferees would not "destroy" or harm Congress' intent; hence, the National Bank v Commonwealth, 9 Wall 353, 362, 19 L Ed 701 (1870) (national banks subject to state law
that does not "interfere with, or impair [national banks'] efficiency in performing the functions by which they are designed to serve [the Federal Government]."

Nor do these cases control the interpretation of federal banking statutes that accompany a grant of an explicit power with an explicit statement that the exercise of that power is subject to state law. See, e.g., 12 USC § 36c(1) (McFadden Act) (authorizing national banks to operate branches, but only where state law authorizes state banks to do so); § 92a(a) (Comptroller of Currency may grant fiduciary powers "by special permit to national banks applying therefor, when not in contravention of State or local law"). Not surprisingly, this Court has interpreted those explicit provisions to mean what they say. See, e.g., First Nat. Bank in Plant City v. Dickinson, 396 US 122, 131, 24 L Ed 2d 312, 90 S Ct 337 (1969) (under McFadden Act, state branching restrictions apply to national banks); First Nat. Bank of Logan v. Walker Bank & Trust Co., 385 US 252, 260-261, 17 L Ed 2d 343, 87 S Ct 492 (1966) (same); see also Van Allen v. Assessors, 3 Wall 573, 586, 18 L Ed 229 (1866) (enforcing 1864 amendments to National Bank Act expressly authorizing state taxation of national bank shares).

But, as we pointed out, supra, at 439, under the McFadden Act, congress has not expressly conditioned the grant of "power" upon a grant of state permission, the Court has ordinarily found that no such condition applies. In Franklin Nat. Bank, the Court made this point explicit. It held that Congress did not intend to subject national banks' power to local restrictions, because the federal power-granting statute there in question contained "no indication that Congress [so] intended . . . as it has done by express language in several other instances." 347 US, at 378, and n. 7, 78 L Ed 767, 74 S Ct 550 (emphasis added) (collecting examples).

[160] The Federal Statute before us, as in Franklin Nat. Bank, explicitly grants a national bank an authorization, permission, or power. And, as in Franklin Nat. Bank, it contains no "indication" that Congress intended to subject that power to local restriction. Thus, the Court's discussion in Franklin Nat. Bank, the holding of that case, and the other precedent we have cited above, strongly argue for a similar interpretation here—a broad interpretation of the word "may" that does not condition federal permission upon that of the State.

Finally, Florida and its supporters challenge this interpretation by arguing that special circumstances surrounding the enactment of the Federal Statute nonetheless demonstrate Congress' intent to grant only a limited permission (subject to State approval). They point to a letter to Congress written by the Comptroller of the Currency in 1916. The Comptroller attached a draft of what became the Federal Statute, and the letter explains to Congress why the Comptroller wants Congress to enact his proposal. The letter says that, since 1900, many small town national banks had failed; that some States had authorized small town state banks to sell insurance; that providing small town national banks with authority to sell insurance would help them financially; and that doing so would also improve their competitive position vis-a-vis state banks. The relevant language in the letter (somewhat abridged) reads as follows:

"[Since 1900, of 3,084 small national banks, 438 have either failed or gone into liquidation. . . . [There are many banks located in [small towns]. . . . where the small deposits which the banks receive may make it somewhat difficult [to earn] . . . a satisfactory return . . . ."

"For some time I have been giving careful consideration to the question as to how the powers of these small national banks might be enlarged so as to provide them with additional sources of revenue and place them in a position where they could better compete with local State banks and trust companies which are sometimes authorized under the law to do a class of business not strictly that of commercial banking . . . ."

"[The federal banking laws, while granting national banks certain "incidental powers," do not give them] either expressly or by necessary implication the power to act as agents for insurance companies. . . ."

"My investigations lead me respectfully to recommend to Congress an amendment to the national-bank act by which national banks located in [small towns] . . . may be permitted to act as agents for insurance companies . . . ."

It seems desirable from the standpoint of public policy and banking efficiency that this authority should be limited to banks in small communities. This additional income will strengthen them and increase their ability to make a fair return . . . ."

BARNETT BANK v NELSON
(1966) 134 L Ed 2d 237

"I think it would be unwise and therefore undesirable to confer this privilege generally upon banks in large cities where the legitimate business of banking affords ample scope for the energies of trained and expert bankers . . . ."

"I inclose . . . a draft . . . designed to empower national banks located in [small towns] . . . under such regulations and restrictions as may from time to time be approved and promulgated by the Comptroller of the Currency, to act as agents for the placing of insurance policies . . . ." 53 Cong. Rec. 11001 (1916) (Letter from Comptroller Williams to the Chairman of the Senate Bank and Currency Committee).

Assuming for argument's sake that this letter is relevant, and in response to the arguments of Florida and its supporters, we point out that the letter does not significantly advance their cause. As we pointed out, the letter mentions that enacting the powers of small national banks will help them "better compete with local State banks," it primarily focuses upon small town national banks' need for added revenue—an objective met by a broad insurance-selling authority that is not limited by state law. The letter refers to limitations that federal regulation might impose, but it says nothing about limitations imposed by state regulation or state law. The letter makes clear that authority to sell insurance in small towns is an added "incidental power" of a national bank—a term that, in light of this Court's then-existing cases, suggested freedom from conflicting state regulation. See Easton, 188 US, at 229-230, 47 L Ed 452, 23 S Ct 288; First Nat. Bank, 262 US, at 368-369, 67 L Ed 1030, 43 S Ct 692.
The letter sets forth as potential objections to the proposal, (or to its extension to larger national banks), concerns about distracting banking management or inhibiting the development of banking expertise—not concerns related to state regulatory control.

We have found nothing elsewhere in the Federal Statute's background or history that significantly supports the State's arguments. And as far as we are aware, the Comptroller's subsequent interpretation of the Federal Statute does not suggest that the statute provides only a limited authority subject to similar state approval. Cf. 12 CFR § 7.7100 (1995); OCC Interpretive Letter No. 366, CCH Fed. Banking L. Rep. ¶ 85,536, p. 77,833 (1986).

In light of these considerations, we conclude that the Federal Statute means to grant small town national banks, and other similar banks, whether or not a State grants its own state banks or national banks similar approval. Were we to apply ordinary legal principles of pre-emption, the federal law would pre-empt that of the State.

III

[14d] We now must decide whether ordinary legal principles of pre-emption, or the special McCarran-Ferguson Act anti-pre-emption rule, governs this case. The lower courts held that the McCarran-Ferguson Act's special anti-pre-emption rule applies, and instructs courts not to "construe" the Federal Statute to "invalidate, impair, or supersede" that of the State. 15 USC § 1012(b) [15 USCS § 1012(b)]. By its terms, however, the Act does not apply when the conflicting federal statute "specifically relates to the business of insurance." Ibid. (emphasis added).

In our view, the Federal Statute in this case "specifically relates to the business of insurance"—therefore the McCarran-Ferguson Act's special anti-pre-emption rule does not apply.

Our conclusion rests upon the McCarran-Ferguson Act's language and purpose, taken together. Consider the Act's specific words "finance, banking, and insurance" that refer to the "business of insurance." In ordinary English, a statute that says that banks may act, as insurance agents, and that the Comptroller of the Currency may regulate their insurance-related activities, "relates" to the insurance business. The word "relates" is highly general, and this Court has interpreted it broadly in other pre-emption contexts. See, e.g., Pilot Life Ins. Co. v Dedeaux, 481 US 41, 47, 95 L Ed 2d 39, 107 S Ct 1549 (1987) (words "relate to" have "broad common-sense meaning, such that a statute ... relates to a ... plan ... if it has a connection with or reference to such a plan") (quoting Metropolitan Life Ins. Co. v Massachusetts, 471 US 724, 739, 85 L Ed 2d 728, 105 S Ct 2380 (1985), and Shaw v Delta Air Lines Inc., 463 US 85, 97, 77 L Ed 2d 490, 103 S Ct 2890 (1983)); Morales v Trans World Airlines Inc., 504 US 374, 383-384, 119 L Ed 2d 157, 112 S Ct 2031 (1992) (interpreting similarly the words "relating to" in the Airline Deregulation Act).

More importantly, in ordinary English, this statute "specifically" relates to the insurance business. "Specifically" can mean "explicitly, particularly, or [at] definitely." Black's Law Dictionary 1398 (6th ed. 1990), thereby contrasting a specific reference with an implicit reference made by more general language to a broader topic. The general words "business activity," for example, will sometimes include, and thereby implicitly refer, to insurance; the particular words "finance, banking, and insurance" make that reference explicitly and specifically.

Finally, using ordinary English, one would say that this statute specifically relates to the "business of insurance." The statute explicitly grants non-life insurance permission to "act as the agent for any fire, life, or other insurance company," to "solicit[] and sell[] insurance," to "collect[] premiums," and to "receive for services so rendered ... fees or commissions," subject to Comptroller regulation. 12 USC § 92 [12 USCS § 92]. It also sets forth certain specific rules prohibiting banks from guaranteeing the "payment of any premium on insurance policies issued through its agency ... ." and the "truth of any statement made by an assured in filling its application for insurance," Ibid. The statute thereby not only fosters good practice in the industry-specific selling practices, but also affects the relation of insured to insurer and the spreading of risk—matters that this Court, in other contexts, has placed at the core of the McCarran-Ferguson Act's concern. See, e.g., Pilot Life Ins. Co. v Dedeaux, 481 US 41, 47, 95 L Ed 2d 39, 107 S Ct 1549 (1987); Delta Air Lines Inc., 463 US 85, 97, 77 L Ed 2d 490, 103 S Ct 2890 (1983); Morales v Trans World Airlines Inc., 504 US 374, 383-384, 119 L Ed 2d 157, 112 S Ct 2031 (1992) (interpreting similarly the words "relating to" in the Airline Deregulation Act).

Consider, too, the McCarran-Ferguson Act's basic purposes. The Act sets forth two mutually reinforcing purposes in its first section, namely that "continued regulation and taxation by the several States of the business of insurance is in the public interest," and that "silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States." 15 USC § 1011 [15 USCS § 1011] (emphasis added). The latter phrase, particularly the word "silence," indicates that the Act does not seek to insulate state insurance regulation from the reach of all federal law. Rather, it seeks to protect state regulation primarily against inadvertent federal intrusion—say, through enactment of a federal statute that describes an affected activity in broad, general terms, of which the insurance business happens to comprise one part.

The circumstances surrounding enactment of the McCarran-Ferguson Act suggest the same. Just prior to the law's enactment, this Court, in United States v South-Eastern Underwriters Assn., 322 US 533, 88 L Ed 1440, 64 S Ct 1162 (1944), held that a federal antitrust law, the Sherman Act, applied to the business of insurance. The Sherman Act's high generality, and the language said nothing specifically about insurance. See 15 USC § 1 [15 USCS § 1] (forbidding every "contract, combination . . . or conspiracy, in restraint of trade or commerce among the several States"). The Sherman Act applied only to activities in or affecting interstate commerce. Hopkins v United States, 171 US 578, 586, 43 L Ed 290, 19 S Ct 198 (1898).

Many lawyers and insurance professionals had previously thought, (relying, in part, on this Court's opinion in Paul v Virginia, 8 Wall 168, 185, 19 L Ed 357 (1869), and others), that the issuance of an insurance policy was not a "transaction of commerce," and therefore fell outside the Sherman Act's scope. South-Eastern Underwriters told those professionals that they were wrong about interstate commerce, and that the Sher-
man Act did apply. And South-Eastern Underwriters' principle meant, consequently, that other generally phrased congressional statutes might also apply to the issuance of insurance policies, thereby interfering with state regulation of insurance in similarly unanticipated ways.

In reaction to South-Eastern Underwriters, Congress "moved quickly," enacting McCarran-Ferguson "to restore the supremacy of the States in the realm of insurance regulation." Fabe, supra, at 500, 124 L Ed 2d 449, 113 S Ct 2202. But the circumstances we have just described mean that "restoration" of "supremacy" basically required setting aside the unanticipated effects of South-Eastern Underwriters, and cautiously avoiding similar unanticipated interference with state regulation in the future. It did not require avoiding federal pre-emption by future federal statutes that indicate, through their "specific relation" to insurance, that Congress had focused upon the insurance industry, and therefore, in all likelihood, consciously intended to exert upon the insurance industry whatever pre-emptive force accompanied its law. See also, e.g., insofar as relevant, 91 Cong. Rec. 483 (1945) (statement of Sen. O'Mahoney, floor manager of the Act, that the Act was intended to be "a sort of catch-all provision to take into consideration all other acts of Congress which might affect the insurance industry, but of which we did not have knowledge at the time"); ibid. (similar statement of Sen. Ferguson). The language of the Federal Statute before us is not general. It refers specifically to insurance. Its state regulatory implications are not surprising, nor do we believe them inadvertent. See Part II, supra. Consequently, considerations of purpose, as well as of language, indicate that the Federal Statute falls within the scope of the McCarran-Ferguson's "specifically relates" exception to its anti-pre-emption rule. Cf. John Hancock Mut. Life Ins. Co v Harris Trust & Sav. Bank, 510 US — , 126 L Ed 2d 524, 114 S Ct 517 (1993) (adopting the United States' view that language in the Employee Retirement Income Security Act of 1974 defining a "guaranteed benefit policy" as a certain kind of "insurance" policy, "obviously and specifically relates to the business of insurance") (internal quotation marks omitted).

(4, 5) We shall mention briefly why we are not convinced by several of the parties' remaining arguments. Florida says that the Federal Statute "specifically relates" to banking, not to insurance. But, a statute may specifically relate to one thing. Just as an ordinance forbidding dogs in city parks specifically relates to dogs and to parks, so a statute permitting banks to sell insurance can specifically relate to banks and to insurance. Neither the McCarran-Ferguson Act's language, nor its purpose, requires the Federal Statute to relate predominantly to insurance. To the contrary, specific detailed references to the insurance industry in proposed legislation normally will achieve the McCarran-Ferguson Act's objectives, for they will call the proposed legislation to the attention of interested parties, and thereby normally guarantee, should the proposal become law, that Congress will have focused upon its insurance-related effects.

(6) An amicus argues that our interpretation would give the Act "little meaning," because "whenever a state statute 'regulates' the business of insurance, any conflicting federal statute necessarily will 'specifically relate' to the insurance business." Brief for American Council of Life Insurance as Amicus Curiae 4. We disagree. Many federal statutes with potentially pre-emptive effect, such as the bankruptcy statutes, use general language that does not appear to "specifically relate" to insurance; and where those statutes conflict with state law that was enacted "for the purpose of regulating the business of insurance," the McCarran-Ferguson Act's anti-pre-emption rule will apply. See generally Fabe, 508 US, at 501, 124 L Ed 2d 449, 113 S Ct 2202 (noting the parties' agreement that federal bankruptcy priority rules, although conflicting with state law, do not "specifically relate" to the business of insurance.)

The lower courts argued that the Federal Statute's 1916 date of enactment was significant, because Congress would have then believed that state insurance regulation was beyond its "Commerce Clause" power to affect. The lower courts apparently thought that Congress therefore could not have intended the Federal Statute to pre-empt contrary state law. The short answer to this claim is that there is no reason to think that Congress believed state insurance regulation beyond its constitutional powers to affect—insofar as Congress exercised those powers to create, to empower, or to regulate, national banks. See McCulloch v Maryland, 4 Wheat 316, 4 L Ed 579 (1819); Farmers' and Mechanics' Nat. Bank v Deering, 91 US 29, 33, 23 L Ed 196 (1875); see also, e.g., Easton v Iowa, 188 US, at 298, 47 L Ed 452, 22 S Ct 288. We have explained, see Part II, supra, why we conclude that Congress indeed did intend the Federal Statute to pre-empt conflicting state law.

Finally, Florida points to language in Fabe, which states that the McCarran-Ferguson Act "imposes what is, in effect, a clear-statement rule" that forbids pre-emption "unless a federal statute specifically requires otherwise." 508 US, at 507, 124 L Ed 2d 449, 113 S Ct 2202. Florida believes that this statement in Fabe means that the Federal Statute would have to use the words "state law is pre-empted," or the like, in order to fall within the McCarran-Ferguson Act exception. We do not believe, however, that Fabe imposes any such requirement. Rather, the quoted language in Fabe was a general description of the Act's effect. It simply pointed to the existence of the clause at issue here—the exception for federal statutes that "specifically relate[ ] to the business of insurance." But it did not purport authoritatively to interpret the "specifically relates" clause. That matter was not at issue in Fabe. We therefore believe that Fabe does not require us to reach a different result here.

For these reasons, the judgment of the Court of Appeals is reversed. It is so ordered.
NR 98-12
January 30, 1998

WASHINGTON, DC -- Comptroller of the Currency Eugene A. Ludwig asked bank, thrift and credit union regulators January 26 to consider whether the interagency guidelines on nondeposit investment products should be converted into regulations.

Mr. Ludwig also asked the four agencies to consider whether insurance sales activities by banks should be brought within uniform interagency standards.

Mr. Ludwig said in his letter that it is an appropriate time to consider a regulation because the agencies now have several years of experience in working with the guidelines. The interagency guidelines, which were adopted on February 15, 1994, set out standards for banks that sell investment products, including disclosures that such products are not insured by the FDIC or guaranteed by the bank.

The letter went to the members of the Federal Financial Institutions Examinations Council, an umbrella organization whose members include the OCC, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration. Mr. Ludwig currently chairs the FFIEC.

A copy of the Comptroller's letter is attached.

The OCC charters, regulates and supervises approximately 2,600 national banks and 66 federal branches and agencies of foreign banks in the U.S., accounting for more than 56 percent of the nation's banking assets. Its mission is to ensure a safe, sound and competitive national banking system that supports the citizens, communities and economy of the United States.
January 26, 1998

The Honorable Susan M. Phillips  
Vice Chair  
Board of Governors of the Federal Reserve System  
20th and C Streets, N.W.  
Washington, D.C. 20551

The Honorable Andrew C. Hove  
Acting Chairman  
Federal Deposit Insurance Corporation  
550 17th Street, N.W.  
Washington, D.C. 20429

The Honorable Ellen S. Seidman  
Director  
Office of Thrift Supervision  
1700 G Street, N.W.  
Washington, D.C. 20552

The Honorable Norman E. D'Amours  
Chairman  
National Credit Union Administration  
1775 Duke Street  
Alexandria, Virginia 22314

Dear FFIEC Members:

I am writing to recommend that the FFIEC consider initiating an interagency effort to reevaluate the Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994) ("Interagency Statement"). Our review of this area may be appropriate at this time based on our several years of experience with the Interagency Statement, and in light of the recently adopted rule of the National Association of Securities Dealers ("NASD") which specifies requirements applicable to broker-dealers operating on the premises of financial institutions (NASD Notice to Members 97-89, December 1997) ("NASD Rule").

At the time we adopted the Interagency Statement, retail sales of nondeposit investment products through financial institutions was a relatively new activity that merited the flexibility afforded by the Interagency Statement as the activity evolved. Now that the agencies have had more experience supervising these activities, and the NASD has included provisions from the Interagency Statement in its Rule, it may be timely for us to consider whether parts of the Interagency Statement should be modified or adopted as a uniform interagency regulation.

I also want to raise another related issue with you. As you know, financial institutions are becoming increasingly involved with selling insurance products. This expanding activity raises a variety of regulatory issues, including some of the same types of disclosure and customer protection issues that are addressed by the Interagency Statement. Our review of this area could reasonably include consideration of whether insurance sales activities by financial institutions should be brought within our uniform interagency standards.

In considering these issues, we need to be mindful of the wide variety of financial institutions involved in providing these investment and insurance products. We also need to ensure that effective disclosures are provided to financial institutions' customers, particularly regarding the lack of federal deposit insurance coverage. Our concern with promoting the best interests of financial institutions' customers in connection with these activities must be reflected in any new initiatives.

Our agencies have coordinated effectively in establishing standards for sales of nondeposit investment products through financial institutions. I look forward to our continued cooperation on these important issues and welcome your views on this proposed FFIEC initiative.

Sincerely,

Eugene A. Ludwig  
Comptroller of the Currency
Advisory Letter 96-8 - Guidance to national banks on insurance and annuity sales activities

October 8, 1996

TO: Chief Executive Officers of all National Banks, Department and Division Heads, and all Examining Personnel

PURPOSE

This advisory provides guidance to national banks on various issues raised by insurance and annuities sales. Each bank's management should address these issues in a manner appropriate to the nature and extent of insurance and annuity sales activities conducted by its organization.

DISCUSSION

A. Introduction

The ability of national banks to sell diverse and complementary financial products and services, including insurance products and annuities, helps bank customers to meet specific financial objectives, benefits consumers by promoting competition, and can make insurance products and annuities available to customers that are underserved or unserved by other distribution systems. The Supreme Court's March 1996 decision in *Barnett Bank of Marion County N.A. v. Nelson, Florida Insurance Commissioner* ("Barnett") provided important clarification of the authority of national banks to sell insurance. The Court's 1995 decision in *NationsBank v. Variable Annuity Life Insurance Co.* also upheld the broad authority of national banks to engage in the "business of banking" and sustained the OCC's determination that the power to sell annuities is part of that authority. Thus, insurance and annuity sales have been, and promise to continue to be, an important line of business for national banks.

Adequate consumer protections, qualified employees, and appropriate sales practices are key to responsible insurance and annuity sales activities -- by any type of seller. The OCC is committed to ensuring that national banks' insurance and annuity sales activities meet high standards.

The following sections of this advisory (1) review the federal statutory anti-tying rules applicable to banks; (2) discuss how state laws apply to national banks; (3) highlight issues raised by insurance and annuities sales that national banks should evaluate and address when they structure their sales programs and oversee their sales activities; and (4) summarize the OCC's basic approach to oversight of national banks' sales of insurance and annuities.<1>

B. Federal Prohibitions on Tying

Tying the availability of credit from the bank to the purchase of insurance or annuities offered by the bank or a bank affiliate is illegal. Under 12 U.S.C. 1972, a bank is prohibited (subject to certain exceptions) <2> from requiring a customer to obtain credit, property, or services as a prerequisite to obtaining other credit, property, or services. This standard applies whether the customer is retail or
in institutional, or the transaction is on bank premises or off. The OCC has extended these protections to cover national bank operating subsidiaries.

The OCC remains committed to enforcing 12 U.S.C. 1972 and expects national banks to have adequate policies and procedures in place to prevent violations. OCC Bulletin 95-20 describes measures that help to ensure compliance with the tying prohibitions. The measures include:

- Monitoring to eliminate impermissible coercion when offering customers multiple products or services.
- Training bank employees about the tying prohibitions, including providing examples of prohibited practices and sensitizing employees to the concerns raised by tying.
- Involving management in reviewing training, audit, and compliance programs, and updating any policies and procedures to reflect changes in products, services, or applicable law.
- Reviewing customer files to determine whether any extension of credit is conditioned impermissibly on obtaining an insurance product or annuity from the bank or its affiliates.
- Monitoring incentives, such as commissions and fee splitting arrangements, that may encourage tying.
- Responding to any customer allegations of prohibited tying arrangements.

The tying prohibitions do not prevent bank sales personnel from informing a customer that insurance is required in order to obtain a loan or that loan approval is contingent on the customer obtaining acceptable insurance. In such circumstances, sales personnel may indicate that insurance is available from the bank and may provide instructions on how the customer can obtain additional information.

However, the bank should take steps necessary to make clear to the customer that the bank’s decisions with respect to a loan application are independent of the customer’s decision where to obtain insurance. For example, in the situation described above, when a customer is first informed that insurance is available from the bank, the customer also should be clearly and unambiguously informed that he or she need not purchase insurance from the bank, its subsidiary, an affiliate, or any particular unaffiliated third party, that insurance is available through brokers or agents other than the bank, and that the customer’s choice of insurance provider will not affect the bank’s credit decision or credit terms in any way. These disclosures are particularly important in situations where it is not feasible to have different bank employees involved in the loan and the insurance transactions. See also "Sales of Insurance in Connection with Extending a Loan."

The same concerns are equally pertinent and potentially more acute, if a type of insurance that is unrelated to or not required in connection with a pending loan application is offered to a loan applicant as part of the loan application process. In that situation, banks should use heightened care to dispel any impression that the unrelated products are being mentioned because of a potential connection to the bank’s credit decision, and should ensure that, if such offers are permitted, they are adequately monitored by the bank’s compliance systems.

C. Applicability of State Laws

The application of state laws to national banks' insurance and annuity sales can present complex
issues. In general, however, the OCC anticipates that a state law that applies generally to regulate insurance agents and agencies will apply to national banks provided the law does not effectively prevent national banks from conducting activities authorized under federal law, and provided that, if the law interferes with those authorized activities, the interference is insignificant. When state laws result in special burdens on the ability of national banks to exercise the powers granted to them under federal law, however, the possibility of federal preemption of state law arises.

For example, the Supreme Court's decision in *Barnett* clarified that traditional judicial standards of federal preemption should govern whether 12 U.S.C. 92, which authorizes national banks to sell insurance in an agency capacity, preempts state laws (or rules) that interfere with a bank's exercise of that authority. In *Barnett*, the Supreme Court first noted that courts have historically interpreted "grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law." But, the Court then noted, this does not "deprive States of the power to regulate national banks, where . . . doing so does not prevent or significantly interfere with the national bank's exercise of its powers." Thus, if a state law only interferes with a national bank's exercise of its powers in an insignificant way, the state law would not be preempted and would be applicable.

In practice, these principles should mean that most state laws that apply generally to regulate insurance agents and agencies and that do not discriminate against or have a disparate impact on banks would not be preempted because, ordinarily, they would not prevent national banks from exercising their federally authorized powers and the extent to which they might actually interfere with or impair the ability of a national bank to exercise those powers would be insignificant. If a state law prevented or impaired significantly the ability of national banks to exercise their powers, however, that state law would not be applicable because it would be preempted under the standards set by the Supreme Court.

Thus, for example, and provided a particular law is not preempted, the types of state laws applicable to national banks would include non-discriminatory requirements such as:

- Licensing requirements establishing character, experience, and educational qualifications for individuals selling insurance as agent;
- Testing and continuing education requirements, and requirements for license renewals, for individuals selling insurance as agent;
- Licensing requirements pertaining to different types of insurance that apply to individuals selling particular types of insurance in an agency capacity; and
- Market conduct and unfair trade practices standards prohibiting insurance agents from making unfair and deceptive statements; falsifying financial statements; engaging in defamation, boycott, coercion and intimidation; unfairly discriminating; improperly rebating; coercing customers; improperly disclosing confidential information; and engaging in unfair claims settlement practices.

When state laws are not preempted, the OCC recognizes the role and ability of state insurance regulators to administer and oversee compliance with those laws.

**D. Management Oversight**
Bank management is responsible for ensuring that a bank's insurance and annuity sales are conducted in a safe and sound manner and in accordance with applicable law. Sound management practices include active oversight by senior management, competent personnel, and internal controls that effectively identify, monitor, and control significant aspects of the seller's insurance and annuity sales operations. These principles apply not just to banks, but to all sellers of insurance and annuities.

The practices and policies each bank applies will depend on the activities it undertakes and the manner in which it offers products. For example, although certain issues arise in all circumstances, the complexity of the products offered and the volume of insurance and annuities sales may require some banks to establish more elaborate internal controls or management processes than banks with relatively simple insurance and annuities sales activities. A bank's approach should be tailored to its goals and resources and should be well understood by bank personnel engaged in insurance and annuity sales. Banks also are encouraged to seek advice from professionals with expertise in the insurance and annuities field who can provide guidance with respect to legal, regulatory, and business considerations presented by the bank's insurance and annuities sales activities.

The following sections describe issues that may arise when sales and recommendations for insurance products and annuities are made by a national bank and its employees, as well as by employees of any third party (a national bank subsidiary or affiliate, or an unrelated third party), when the third party sells from bank premises. If these issues arise from a national bank's insurance and annuities sales program, bank management should address them in a manner appropriate and effective for the particular bank. Considerations that apply to both insurance and annuity sales are set forth first, then issues distinct to sales of insurance and annuities, respectively.

**General Considerations**

1. **Evaluation and Selection of Products**

The success of a sales program and the satisfaction of the bank's customers are directly related to the quality and nature of the insurance products and annuities sold by the bank. Bank customers benefit from bank sales of insurance and annuities when the bank offers products responsive to the diverse needs of its customers and those products perform as customers expect. The safety, soundness, and claims paying ability of the companies that originate the insurance and annuity products sold by a bank are considerations for bank customers and may also present risks for the reputation of the bank's other products and services, as well as the potential for future claims against the bank. The company originating the products sold by the bank should be in good standing and maintain the necessary licenses required to operate its insurance business. A bank's selection of the products it offers should be founded on the quality and customer benefits of the products available from those companies, not on a company's commission structure. In addition, a bank should help to ensure the quality of the insurance products and annuities that it sells, and protect itself from future complaints, by evaluating at the outset and periodically thereafter:

- The company's rating by a nationally recognized rating service and other readily available information on the historical performance of the company (or companies), as well as its current financial and managerial strength.

- When available, the number and substance of material complaints filed against the company, and the existence of any criminal judgments against the company or its senior management.
• The extent to which particular products are available from various companies.

• The pricing of the insurance products or annuities, including the premium rates, compared with that of similar products offering the same benefits or coverage (if such similar products are available).

• The sales support provided by the company, including the marketing and sales strategy for the products it provides.

• Readily available information concerning the first hand experience of other financial institutions with products of the company.

2. Qualifications and Training

Knowledgeable, experienced, and qualified personnel help to ensure that the bank’s sales program is carried out in a manner that provides customers with competitive products, sound advice, and accurate information. Familiarity with the bank’s policies and procedures also ensures better compliance with the bank’s internal guidelines and facilitates management oversight. Timely and regularly scheduled training can keep personnel aware of the latest innovations in financial products, changes in bank policies, and developments in applicable laws or regulations. Measures the bank should use to achieve these goals include:

• Clearly defining the responsibilities of personnel authorized to sell insurance products or annuities and the scope of the activities of any third party involved in the sales program.

• Verifying that sales personnel are licensed and in good standing under applicable state and, if appropriate, federal law, and, where feasible, ascertaining whether individuals have been the subject of disciplinary action.

• Limiting the involvement of tellers and individuals not qualified to sell insurance or annuities to directing customers to qualified personnel who can provide authoritative information.

3. Inappropriate Recommendations or Sales

Customers interested in purchasing insurance products or annuities may have particular needs based on their financial status, current insurance coverage, or other circumstances. Customers inexperienced in dealing with financial products, particularly those involving an investment risk component, may also require more detailed information about the products offered. Bank management should evaluate, for the types of insurance and annuity products it offers, the extent to which it is necessary to inquire into the appropriateness of the product for a particular customer in order to assist the customer in making informed product selections, and the nature of the inquiry that is desirable (or that may be required by other regulatory requirements). In addition, regardless of the product involved, management should clearly communicate to its sales personnel that it is unacceptable to recommend and sell new or replacement insurance or annuity policies to customers on the basis of commissions to the seller rather than the benefits of the policy.<10> Such "churning" may also violate applicable state laws.
4. Employee Compensation

Commission-based compensation is a common method of selling insurance and annuities and may help to increase customer awareness of the availability of the insurance products and annuities offered by a bank. However, whenever an employee is compensated for a sale or referral, management needs to be sensitive to the concern that the employee might be motivated by the prospect of financial reward for the sale or referral rather than the best interests of the customer. As noted above, sales should not be driven by commissions and management should clearly communicate to its sales personnel that it is unacceptable to engage in high pressure sales tactics, sell duplicative or unnecessary insurance, or recommend and sell new or replacement insurance policies to customers on the basis of commissions to the seller rather than the benefits of the policy.

5. Complaints and Compliance

Even the most well-managed insurance and annuity sales program can be subject to some customer complaints. Both customers and the bank will benefit if the bank has an orderly process for assessing and addressing customer complaints and resolving compliance issues. A process that keeps track of customer complaints also helps the bank to identify and monitor any systemic problems in its sales program that could harm its franchise. This process might include maintaining records concerning the number, nature, and disposition of customer complaints received by a bank, subsidiary, or affiliated or unaffiliated third party. For non-complex banks, the process could take the form of a complete and orderly "complaint" file. Management should also ensure that there is an effective process through which management receives information about complaints or other concerns in connection with a bank's insurance and annuity sales so that management may implement corrective measures. The bank's systems must be sufficient to monitor compliance with the bank's own policies, applicable federal and state laws, and OCC guidance.

National banks also should comply with state laws that require copies of any customer complaints to be forwarded to the appropriate state insurance regulatory authority, or that require that when an insurance sale is consummated, the customer be advised that he or she may forward any complaints to that state insurance authority.

6. Advertising

Advertising is a fundamental marketing tool, and banks often disseminate information, written or otherwise, including by telephone or other electronic means, to bank customers and the general public describing insurance products or annuities that are available from the bank, its subsidiaries or affiliates, or unaffiliated third parties. Banks also communicate with their customers on how to obtain more information about insurance products or annuities. These communications must not suggest or convey any inaccurate information, and should be designed with care to avoid misunderstanding, confusion, or misrepresentation to the bank's customers. Accordingly, bank management should ensure that:

- To the extent disclosed, the nature, terms, or conditions of any insurance product or annuity, and the financial condition of any person, entity, or legal reserve system in any way related to an insurance product or annuity, are not misrepresented.

- Disclosures regarding particular products identify clearly the company that is underwriting the insurance or annuity product and that the company is not the bank.
• Steps are taken through other disclosures, including prominent and distinct signage, separate business cards, and distinctive promotional material, to minimize customer confusion about the nature of the product and to clarify that the product is not guaranteed by the bank and is not insured by the FDIC.

• Terminology customarily associated with insured bank products that obscures the nature of a payment or policy is avoided, e.g., use of the word "deposit" to describe a premium payment, or referring to an insurance policy or annuity as an "account."

7. Customer Privacy

In the course of providing banking and other services, banks will acquire various types of financial and personal information about their customers. Bank management should be sensitive to privacy expectations of the bank's customers regarding this information. Management should take appropriate internal measures to safeguard the security of customer information as well as developing internal policies on the use of customer information. These considerations apply generally to all aspects of a bank's operations. Insurance and annuity sales activities are but one context in which questions regarding the use and sharing of customer information arise. Nor are banks unique in facing issues relating to customer privacy.

Banks' policies on use of customer information should also recognize that different types of information can present different degrees of sensitivity from a customer perspective. Information of an especially personal nature, such as information regarding the health or physical well-being of a customer, may be viewed as particularly sensitive and thus warrant safeguards or restrictions under the bank's policies.

Use of certain customer information in connection with the sale of insurance products, such as that bearing on a customer's credit standing, as well as disclosure of this information to third parties, including bank affiliates, can present various legal issues and may be restricted by law. Banks should consider especially whether any provisions of the Fair Credit Reporting Act are applicable before using or disclosing customer information.<11> That Act allows banks to share with third parties information about their transactions with a customer. Recent amendments to that Act also allow parties related by common ownership or affiliated by corporate control to share other information that is not a consumer report provided the customer in question is given an opportunity to object.<12> In addition, among other things, the Act permits banks and affiliates to obtain limited information from a consumer report for use in connection with firm offers to provide consumer related insurance products to potential customers.

8. Third-Party Arrangements

If a national bank, directly or indirectly, including through a subsidiary, sells insurance products or annuities through a third party, the performance and reputation of the third party reflect on the bank and might even give rise to liabilities that the bank must bear. Developing knowledge and understanding about the third party's qualifications and operations can assist the bank in avoiding problems and uncertainties. Particularly when a bank is using an unrelated third party to sell insurance and annuities on bank premises, it is important for the agreement with the third party to:
• Describe the duties and responsibilities of each party, including the permissible activities by the third party on the national bank's premises; the terms governing the use of the national bank's space, personnel, and equipment; and the compensation arrangements for personnel of the national bank and the third party. Where a bank and a third-party subsidiary, affiliate, or unrelated entity utilize joint employees, the duties, responsibilities, and job responsibilities should be clearly articulated in the agreement with the third party, as well as communicated to these employees.

• Authorize the national bank to monitor the third party as appropriate to the volume and complexity of the products offered, in order to effectively review and verify that the third party and its sales representatives are complying with the agreement.

• Require the third party to indemnify the national bank for potential liability resulting from actions of the third party with respect to the insurance product or annuity sales program.

• Require the third party to forward any customer complaints to appropriate state insurance authorities and to the bank.

Insurance Sales

The following issues are applicable to situations in which the Interagency Statement on Retail Sales of Nondeposit Investment Products does not apply. (See "Annuities and Investment Product Sales," below, for a summary of the Interagency Statement.)

1. Sales of Insurance in Connection with Extending a Loan

When a bank requires a customer to obtain insurance in connection with a loan and the insurance is available through the bank, under some circumstances, a customer may believe either that the insurance must be purchased from the bank or that a purchase from the bank will improve the customer's chances of a favorable credit decision.<13> As discussed in section B., above, sales personnel may inform customers that insurance is required in order to obtain a loan or that loan approval is contingent on the customer obtaining acceptable insurance. Sales personnel may inform customers that insurance is available from the bank, its subsidiary, an affiliate, or particular unaffiliated third parties, and indicate how to obtain additional information.

However, the bank should take steps necessary to make clear to its customer that the bank's decisions with respect to the loan application are independent of the customer's decision of where to obtain insurance. For example, to avoid the impression that a linkage exists between the bank's credit decision and the customer's choice of insurance seller, the customer should also be clearly and unambiguously informed that he or she need not purchase insurance from the bank, its subsidiary, an affiliate, or any particular unaffiliated third party, that the insurance is available through brokers or agents other than the bank, and that the customer's choice of insurance provider will not affect the bank's credit decision or credit terms in any way. These disclosures should be provided when the bank first informs a customer that insurance required in connection with a loan is available from the bank, a subsidiary, affiliate, or unaffiliated third party selling insurance on bank premises. Banks should also consider:
• Providing the disclosures described above in writing, and obtaining a signed statement from the customer, at or prior to closing the insurance sale, acknowledging that the customer has received, has read, and understands the disclosures.

• Whether any customer confusion arises because the bank uses combined documentation for related credit and insurance transactions and whether separate and independent documents would effectively reduce this confusion.

As also discussed in section B., if a type of insurance that is unrelated to, or not required in connection with, a loan is offered to a loan applicant as part of the loan application process, banks should use heightened care to dispel any impression that the unrelated product is being mentioned because of a potential connection to the bank's credit decision, and to monitor this aspect of its insurance and annuity sales activities.

2. Setting and Circumstances of Insurance Sales Activities and Specific Disclosures

The way in which insurance products are sold within a bank can help customers distinguish between deposits that are insured or are obligations of the bank and uninsured products offered by the bank or another entity. A bank's objective should be to avoid misunderstanding, confusion or misrepresentation to its customers. Although the particular measures that are most effective to accomplish this may vary on a case-by-case basis, several steps are most important.

Banks should define clearly and limit the roles of bank employees when they operate in a traditional physical setting, generally a "teller window," that is closely associated with and predominantly services insured deposit account transactions. To the extent practicable, a bank's sales of insurance should take place in a location that is distinct from such a traditional teller window setting. The involvement of tellers and individuals not qualified to sell insurance products also should be limited to directing customers to qualified personnel who can provide information. When physical considerations, such as the size or design of a particular bank facility, prevent sales from being conducted in a location distinct from the common teller area, the bank should make every effort to minimize customer confusion.

In addition, during any customer contact, including communication by telephone or other electronic means, banks should disclose to customers that an insurance product is not FDIC insured, is not a deposit or obligation of the bank, is not guaranteed by the bank, and (if applicable) is subject to investment risk, including possible loss of principal, unless the bank affirmatively determines, for specific products, that customers would not reasonably benefit from, or might in fact be confused by, these disclosures. Management should address the manner in which the disclosures are provided to a proposed insured, and the point or points during the solicitation or sales transaction at which written or oral disclosures should be furnished to customers. Other aids to customers distinguishing between products include:

• Specifying how individuals selling or recommending insurance products identify themselves and their sales role.

• Conspicuous signage in the areas where insurance is sold that clarifies that the insurance sold by or through the bank is not a deposit or obligation of the bank, is not guaranteed by the bank, and is not insured by the FDIC.
Annuities and Investment Product Sales

The Interagency Statement on Retail Sales of Nondeposit Investment Products contains standards for sales and recommendations of nondeposit "investment products," which include fixed and variable annuities. Under the Interagency Statement, when a bank recommends or sells to retail customers nondeposit "investment products," the bank should, among other things and at a minimum, inform the customer that the nondeposit investment products are (a) not insured by the FDIC; (b) not a deposit or other obligation of, or guaranteed by, the depository institution; and (c) subject to investment risks, including possible loss of the principal amount invested. The Interagency Statement calls for these disclosures to be provided (a) orally during any sales presentation; (b) orally when investment advice concerning the nondeposit investment products is provided; (c) orally and in writing prior to or at the time an investment account is opened to purchase these products; and (d) in advertisement and other promotional materials, as specified in the Interagency Statement. In addition, a bank should obtain a signed statement from the customer at the time an account is opened, acknowledging that the customer has received and understands these disclosures. Any written disclosures should be conspicuous and presented in a clear and concise manner.

The Interagency Statement provides that confirmations and account statements for nondeposit investment products should contain the minimum disclosures if they contain the name or logo of the bank or an affiliate, in addition to any other required disclosures. If a customer's periodic deposit account statement includes account information concerning the customer's nondeposit investment products, the information concerning these products should be clearly separate from the information concerning the deposit account and should be introduced with the minimum disclosures and the identity of the entity conducting the nondeposit transaction. In addition, where applicable, the bank should disclose the existence of any advisory or material relationship between the bank or an affiliate of the bank and an investment company whose shares are sold by the bank and any material relationship between the bank and an affiliate involved in providing nondeposit investment products.

The foregoing is only a summary of provisions of the Interagency Statement. Bank management should be familiar with the standards contained in the Statement if the bank sells annuities or other investment products covered by the Statement and managers should address those standards in the bank's sales practices.

E. OCC Supervision

The OCC's evaluation of a bank's insurance and annuity sales activities will be guided by the OCC's supervision-by-risk approach, which focuses on identifying problems, or potential problems, in individual banks or the banking system, and ensuring that problems are appropriately corrected. The OCC applies this philosophy in all supervisory activities it conducts, including safety and soundness, compliance, and fiduciary.

The types of risk most likely to arise in connection with insurance and annuity sales include reputation risk, compliance risk, transaction risk, and strategic risk. In general, experience has demonstrated that national banks conduct their insurance and annuity sales activities in a safe and sound manner and that their activities have been responsive to the interests of their customers. Thus, insurance and annuity sales should be a relatively low risk activity.

The OCC believes that it can identify and focus on key indicators of potential problems with a bank's sales of insurance and annuities as part of the examination process, and will be developing additional
instructions to guide its examiners in this area. (The considerations specified in this advisory, therefore, are not intended for use as an examination checklist by OCC examiners, but are designed to help national banks identify and manage relevant risk areas for each institution.) For example, customer complaints can be valuable signals of problems in each of the risk areas mentioned above. Thus, the OCC anticipates that as part of national banks' regularly scheduled examinations for compliance with applicable federal requirements, including compliance with anti-tying standards, OCC examiners will review the level and nature of customer complaints concerning the bank's insurance and annuity sales activities.

The OCC also expects to work cooperatively with state insurance regulators and recognizes their role and their ability to administer and oversee compliance with the types of state laws, discussed in section B., that are applicable to national banks.

FURTHER INFORMATION

For further information or questions relating to this advisory, please contact the Legislative and Regulatory Activities Division, (202) 874-5090.

/s/
Julie L. Williams
Chief Counsel

Endnotes:

1. National banks also are reminded that the Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994) contains guidelines for the sale of nondeposit investment products, which include annuities. The provisions of 12 C.F.R. Part 2 also apply to sales of credit life insurance, which is defined as "credit life, health, and accident insurance, sometimes referred to as credit life and disability insurance, and mortgage life and disability insurance." In addition, 12 C.F.R. 7.3001 applies when banks share space and employees with other businesses. Products that are securities under the federal securities laws also are subject to additional requirements and standards under rules of the Securities and Exchange Commission and the National Association of Securities Dealers.

2. In addition to statutorily enumerated exceptions, the statute authorizes the Federal Reserve Board to permit, by order or regulation, additional exceptions to the tying prohibitions. National banks can avail themselves of the Federal Reserve Board's exceptions to the extent they are applicable. Banks should also note that the Federal Reserve Board has recently proposed changes to its tying regulations. See 61 Fed. Reg. 47242 (Sept. 6, 1996).

3. This advisory is designed to complement, not to displace, state laws that may apply to national banks' sales of insurance and annuity products. It is intended to highlight for national banks particular issues and aspects of insurance and annuity sales activities that the OCC believes should be areas of attention for bank management. In addition, the advisory addresses certain issues not covered by some state laws, such as particular disclosure requirements that are intended to differentiate insurance products or annuities from insured deposits. Banks should also note that, for purposes of state law, many states regulate annuities as insurance products.

4. Section 92 provides that national banks "located and doing business in any place the population of which does not exceed 5,000 inhabitants, as shown by the last preceding decennial census,
may, under such rules and regulations as may be prescribed by the [OCC], act as the agent for any fire, life or other insurance company authorized by the authorities of the State in which said bank is located to do business in said State...."


6. Id., at 1109.

7. This threshold reflects the Barnett decision's discussion of federal preemption and the cases cited by the Supreme Court in its description of the federal preemption test. These cases use terms such as "interfere with, or impair" (First National Bank v. Commonwealth of Kentucky, 76 U.S. (9 Wall.) 353, 362 (1870)); "incapacitates" (Id.); "hinders" (Id., at 363); "infringe" (Anderson National Bank v. Luckett, 321 U.S. 233, 248 (1944)); "infringe or interfere" (Id., at 249); "encroachment" (Id., at 249); "frustrate the purpose" (McClellan v. Chipman, 164 U.S. 347, 357 (1896)); "hampered" (Id., at 358); and "impairs the efficiency" (Davis v. Elmira Savings Bank, 161 U.S. 275, 283 (1895)) to reflect that a relatively small level of impact on the authority of national banks is sufficient to result in federal preemption of the state law at issue.

8. Because of the variety of state laws that could raise this concern, the OCC would need to do a factual analysis of the impact of each particular law on the operations of national banks, as well as a complete legal analysis, both of which are beyond the scope of this advisory, in order to reach conclusions about preemption. If asked by national banks or state insurance regulatory authorities, the OCC expects that it would opine on state law preemption questions on a case by case basis. Various preemption issues also may be subject to a public notice and comment process pursuant to section 114 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. 103-328 (12 U.S.C. 43). In any case, the OCC will apprise the relevant state insurance regulator and will consult with that regulator, when such a question is posed.


10. The OCC has recently revised Part 2 of its regulations, which governs aspects of national bank sales of credit life, health and accident insurance, to state specifically that recommendations to customers to buy insurance should be based on the benefits of the policy, not the commissions received from the sale. See 12 C.F.R. 2.3(b); 61 Fed. Reg. 51777 (October 4, 1996).

11. Additional requirements and standards may also impact the extent to which the bank can share information with third parties. For example, if the third party is a securities broker-dealer, special rules may apply to it, as well. See, e.g., National Association of Securities Dealers, Inc. Conduct Rules, National Association of Securities Dealers, Inc. Manuel (CCH), page 4101 et. seq.; see also Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Regulating the Conduct of Broker/Dealers Operating on the Premises of a Financial Institution, 61 Fed. Reg. 11913 (Mar. 22, 1996).
as amended by section 2402(e) of the Economic Growth and Regulatory Paperwork Reduction

13. This situation does not include when the bank places insurance on real or personal property
because a customer has failed to provide reasonable evidence of required insurance in
accordance with the terms of a loan or extension of credit.
Kentucky Department of Insurance
Administrative Regulation On Bank Sales of Insurance

806 KAR 9:240. Financial institutions licensed as noncredit-related insurance agents.

RELATES TO: KRS 304.9-080, 304.9-130, 304.12-140, 304.12-150, 304.12-160, 304.12-170
STATUTORY AUTHORITY: KRS 304.2-110
NECESSITY, FUNCTION, AND CONFORMITY: KRS 304.2-110 provides that the Commissioner of Insurance may make reasonable rules and administrative regulations necessary for or as an aid to the effectuation of any provision of the Kentucky Insurance Code. This administrative regulation confirms the applicability of licensure statutes and insurance consumer protections to financial institutions exercising their authority to sell insurance under the U.S. Supreme Court decision in Barnett Bank of Marion County, N.A v. Nelson, 116 S.Ct. 1103 (1996), and the Department of Financial Institutions Parity Letter 96-2.

Section 1. Definitions. (1) "Financial institution" means a bank or bank holding company, as defined in the Bank Holding Company Act of 1956, as amended, 12 USC sec. 1841, a savings bank, savings and loan association, trust company, or any depository institution as defined by the Federal Deposit Insurance Act, in 12 USC sec. 1813(c)(1), or any affiliate or subsidiary of any of the above, and any other individual, corporation, partnership, or association authorized to take deposits and make loans in the Commonwealth, including state banks exercising their authority under the Department of Financial Institutions Parity Letter 96-2; and

(2) “Insurance agency activities” means any activity relating to insurance other than credit life insurance, credit health insurance, force-placed or voluntary credit property, credit involuntary unemployment insurance, or insurance of the interest of a real property mortgagee in mortgaged property, other than title insurance, for which a license as agent, solicitor, broker, or consultant is required pursuant to KRS Chapter 304; and

(3) “Insurance information” means any information provided by a consumer in order to obtain insurance.

Section 2. All financial institutions located and doing business in a place the population of which does not exceed 5,000 inhabitants, as shown by the last preceding decennial census, its subsidiaries, or any officer, agent, representative, or employee thereof, may exercise its authority under 12 USC sec. 92 and be licensed to act as agent for any fire, life or other insurance company authorized pursuant to this chapter to engage in the business of insurance in the Commonwealth if:

(1) The financial institution or officer, agent, representative or employee thereof otherwise qualifies for licensure under all applicable provisions of KRS Chapter 304; and

(2) The licensee abides by all applicable provisions of KRS Chapter 304 and applicable administrative regulations; and

(3) Any financial institution licensed as an insurance agency must be a "bona fide" insurance agency and must be located in a place of less than 5,000 inhabitants where the financial institution is located or has a branch and will:

(a) List the place of less than 5,000 inhabitants as the agency's business location; and

(b) The financial institution insurance agents will be managed through the agency; and

(c) The licensed agency will be responsible for processing and delivering insurance policies and collecting premiums; and

(d) The insurance agency business records will be available at the place of less than 5,000 location.

Section 3. Notice of Free Choice of Agent or Insurer. A financial institution shall provide a written statement, signed or initialed by the consumer, to evidence compliance with KRS 304.12-150.

Section 4. Insurance Information. If the consumer voluntarily discloses or authorizes in a written statement, signed or initialed by the consumer, the disclosure of insurance information about the consumer to any person, the statement shall be an acknowledgment that the disclosure is not to the detriment of the consumer.

Section 5. Tying Arrangements Prohibited. (1) A financial institution licensed by the Department of Insurance to engage in insurance agency activities shall:

(a) Not violate the antitying provisions of the Federal Bank Holding Company Act, 12 USC §1971, et seq.; and

(b) Notify the department in writing within ten (10) days of any final judgment or any final administrative action by a federal agency authorized to enforce the antitying provisions which finds that the financial institution or any of its employees committed any such violation.

(2) Any final and unappealable judgment or final and unappealable administrative action shall be deemed a violation of the Kentucky Insurance Code.

Section 6. Written Disclosures. Prior to the sale of any policy of insurance to a consumer, a financial institution shall provide the consumer a written statement, signed or initialed by the consumer, that:

(1) The insurance offered by the financial institution is not a deposit;

(2) The insurance offered by the financial institution is not insured by the Federal Deposit Insurance Corporation or other government agency which insures deposits;

(3) The insurance offered by the financial institution is not guaranteed by the financial institution;

(4) The insurance is optional or, if required, that the insurance may be purchased from any insurance agent or insurer selected by the consumer which provides the same or equivalent coverage; and

(5) That not purchasing the insurance if it is optional, or that purchasing the insurance from another insurance agent or insurer if the insurance is required, will not in any way affect current or future credit decisions.

Section 7. Transaction Delay. An officer or employee of a financial institution shall not directly or indirectly delay or impede the completion of a loan transaction or any other transaction with a financial institution for the purpose of influencing a consumer's selection or purchase of any insurance.

Section 8. Referral Fees. An employee of a financial institution may receive compensation for the referral of a consumer who seeks information about or to purchase any insurance product to a licensed person for the provision of the telephone number of a licensed person who sells or provides information on the product only if:

(1) The employee receives the referral fee regardless of whether insurance coverage is sold;

(2) The referral compensation is a fixed amount;

(3) The referral compensation is a portion of the financial institution's program offering referral fees for other noninsurance products or services marketed by the financial institution; and

(4) The referral compensation is paid by the financial institution.

Section 9. All financial institutions whose authorization to engage in the sale of general lines insurance is not based on 12 USC §92, the Barnett Bank decision or the Department of Financial Institution's Parity Letter 96-2 are only governed by the provisions of Sections 3, 4, 5, 7, and 8 of this administrative regulation. (23 Ky.R. 2906; eff. 3-12-97.)
Comptroller of the Currency  
Administrator of National Banks  

Washington, DC  20219  

Corporate Decision #97-27  
May 1997  

May 2, 1997  

Steven Alan Bennett, Esquire  
Senior Vice President  
and General Counsel  
Banc One Corporation  
100 East Broad Street  
Columbus, Ohio  43271-0158  

Re: Notification by Bank One, Columbus, N.A., Columbus, Ohio, of its intent to establish an operating subsidiary to reinsure mortgage insurance  
Application Control Number: 97-ML-08-008  

Dear Mr. Bennett:  

This responds to the notification filed by Bank One, Columbus, N.A., Columbus, Ohio (the “Bank”), of the Bank’s intent to establish an operating subsidiary (the “Subsidiary”) to reinsure a portion of the mortgage insurance on loans originated or purchased by the Bank or the Bank’s lending affiliates. Based upon the representations made by the Bank in writing and in subsequent telephone discussions, we have no objection to the Bank’s plan to establish the Subsidiary to engage in the proposed activity.  

1 As discussed in the “Analysis” section of this letter, the OCC concluded in Corporate Decisions No. 97-15 (March 17, 1997) (the “PNC Letter”) and No. 97-06 (January 22, 1997) (the “Chase Letter”), and in Interpretive Letter 743 (October 17, 1996) (“IL 743”), that reinsuring a portion of the mortgage insurance on loans originated or purchased by the parent bank of an operating subsidiary, or by affiliates of that bank, is generally permissible under the National Bank Act as part of, or incidental to, the business of banking.
BACKGROUND

A. Mortgage Insurance Generally

Mortgage insurance protects an investor holding a mortgage loan against default by the mortgagor. Banks and mortgage lenders generally require that borrowers obtain mortgage insurance from third-party mortgage insurers on low down payment loans.  

Mortgage insurance has played a vital role in helping low and moderate-income families become homeowners by allowing families to buy homes with less cash. Mortgage insurance also has expanded the secondary market for low down payment mortgages and the funding available for these loans. Government sponsored enterprises such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, and most other purchasers in the secondary market, typically will not consider purchasing low down payment conventional loans unless the loans have mortgage insurance. Secondary market purchases of low down payment loans with mortgage insurance helped fuel the expansion in home construction and sales during the 1970s and 1980s, aiding many first-time and other home buyers. See Mortgage Insurance Companies of America 1995-1996 Fact Book.

B. The Proposed Reinsurance Activities

1. The Reinsurance Relationship Generally

Under the Bank’s proposal, the Subsidiary will enter into reinsurance agreements with a number of unaffiliated insurance carriers that issue mortgage insurance on mortgage loans originated or purchased by the Bank or its affiliates. Under the Bank’s proposal, therefore, the Subsidiary is agreeing to accept from a mortgage insurer a portion of the risk of default associated with certain mortgage loans made or purchased by the Bank or the Bank’s affiliates. In return for accepting risk of default, the Subsidiary will receive a share of

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2For purposes of this letter, “low down payment loans” are those loans with down payments of less than 20 percent of the property’s value, or loans with loan-to-value ratios in excess of 80 percent.

3Reinsurance is a process whereby an original insurer reduces its underwriting risk by passing all or part of this risk on to another insurance company. The first underwriter may retain only a portion of the risk and reinsure the balance with a second company that then owns the cash flow and assumes that portion of the risk. See 13A John Alan Appleman & Jean Appleman, Insurance Law and Practice § 7681 (1976).

4The Bank, either directly, or through its affiliates, will originate or purchase all the residential mortgage loans covered by mortgage insurance that the Subsidiary will reinsurance.
premiums paid under reinsurance agreements between the Subsidiary and one or more primary mortgage insurers (each an "Insurer").

2. Terms of the Reinsurance Agreements

Under the reinsurance agreements, the Subsidiary will become liable to the extent provided in the reinsurance agreement to the Insurer when a loan insured by an Insurer goes into default (i.e., the borrower does not make a scheduled payment of principal and/or interest by the stated due date or within the stated grace period). The Bank represents that under the terms of the reinsurance agreements between the Subsidiary and the Insurers, the Subsidiary's maximum contractual exposure will be limited to an exact percentage of the mortgage insurance risk on each loan or on a pool of loans. Additionally, the Bank represents that its potential liability for the Subsidiary's reinsurance obligation will not exceed the Bank's investment in the Subsidiary.

The Subsidiary will not reinsure insurance on mortgage loans that have not been originated or purchased by the Bank or its affiliates, and will not underwrite such insurance as a primary insurer.

3. Capitalization and Reserve Requirements

The capitalization of the Subsidiary will be subject to both initial and ongoing requirements, which may vary depending on its size and expected book of business, and other factors. The Subsidiary will maintain a statutory contingency reserve as required by state insurance authorities. This reserve is essentially a "reservation of capital" that restricts dividend payments. The Bank represents that in most states, the contingency reserve is accumulated by retaining 50 percent of earned premiums each year. In most states, the Subsidiary may make withdrawals from the contingency reserves to the extent that losses exceed 35 percent of earned premiums in any year.

Also, the OCC requires that national banks hold capital commensurate with the level and nature of all the risks of their business, including the operation of operating subsidiaries. If the OCC determines that the Bank's capital levels do not adequately protect the Bank from any risks of the reinsurance business of its Subsidiary, the OCC may use its authority under 12 C.F.R. Part 3 to require the Bank to maintain additional capital. The Bank has made a

5All investments made by the Subsidiary will be limited to those investments which are permissible for national banks.

6Section 3.10 specifically authorizes the OCC to require higher capital ratios for an individual bank in view of its circumstances. For example, higher capital ratios may be required for "a bank with significant exposure due to the risks from concentrations of credit, certain risks arising from nontraditional activities, or management's overall inability to
commitment to evaluate the risks presented by the Subsidiary’s reinsurance activities and to maintain appropriate levels of capital for the Bank and the Subsidiary. The Bank represents that it will have in place management information systems that will enable the Bank, and the OCC as part of its supervision of the Bank, to monitor, on a quarterly basis, the amount of the Bank’s risk based capital and the amount of reinsurance risk in force at the Subsidiary to verify that the level of Bank capital is sufficient to support the risk. Moreover, the Bank represents that the Subsidiary has made a commitment to establish and maintain adequate contingency and specific case basis reserves as required under the reinsurance agreements with the account balance supported by an analysis of the appropriate factors.

The Bank represents that under standard insurance accounting practices and the applicable reinsurance agreements, the reinsurer or the primary insurer is required to establish the following types of reserves for reinsurance risks: an unearned premium ("UEP") reserve, a loss reserve, and an incurred but not reported ("IBNR") loss reserve. The UEP reserve represents the unearned portion of premiums assumed. The loss reserve represents estimated future loss payments for loans that are delinquent but for which an insurance claim has not yet been perfected and paid. The IBNR loss reserve is a liability for future estimated losses and loss adjustment expenses for loans which are delinquent, but not yet reported as such to the primary mortgage insurer.


The Bank has relationships with various mortgage insurance companies and purchases mortgage insurance directly from an insurer. The borrower is charged for the cost of such insurance. Charges for mortgage insurance are included in the monthly payments and annual percentage rates disclosed by banks to customers who are shopping for a low down payment mortgage. Mortgage insurance fees thus are a component of the costs customers consider when comparing competitive loan products. The Bank has represented that, in the highly competitive market for residential mortgage loans, the Bank and its affiliates have an overriding incentive to arrange for reasonably priced mortgage insurance fees in order to offer

monitor and control financial and operating risks presented by concentrations of credit and nontraditional activities.” 12 C.F.R. 3.10(d).

7The OCC will treat the Subsidiary’s reinsurance obligation as recourse with respect to loans that the Bank originates or acquires, and subsequently sells, and will apply a capital requirement for the obligation equivalent to the Bank’s maximum contractual obligation, which, in this case will be limited to its investment in the Subsidiary. To the extent that the Bank believes and can demonstrate to the satisfaction of the OCC that its actual risk is less than this amount, the OCC will consider whether a different approach to determining the Bank’s capital requirement would be more appropriate.
competitively priced loans. The Bank has also represented that mortgage insurers are regulated under state laws that include requirements for rate filings and approval.

The Bank also represents that the Bank and its affiliates will disclose to borrowers prior to loan closing that the Subsidiary will reinsure a portion of the mortgage insurance issued in connection with the loan and, in return for assuming such risk, the Subsidiary will receive a portion of the insurance premium. These disclosures will assure borrowers that the reinsurance arrangement does not affect the costs of such insurance to the borrower. The Bank further represents that it will allow its borrowers the option to exclude their mortgage insurance from the reinsurance arrangement with the Subsidiary.

5. Safety and Soundness Considerations

The Bank’s proposal includes safeguards to limit its mortgage reinsurance risk. The Subsidiary will be a state-chartered monoline company (that is, its business will be restricted to the reinsurance of mortgage insurance) and will reinsure mortgage insurance only on loans originated or purchased by the Bank or one of its affiliates. The Subsidiary will not reinsure other mortgage loans, and it will not underwrite mortgage insurance as a primary insurer.

The Bank’s own credit standards and credit underwriting experience will provide valuable tools to manage risk since the Subsidiary will only accept home mortgage loan credit risks consistent with the Bank’s underwriting standards. At present, the Bank and its mortgage lending affiliates purchase mortgage insurance from several different underwriters.

The Subsidiary will also be subject to regulation and oversight by regulatory authorities. As a state-chartered reinsurer, the Subsidiary will be subject to regulation by the state insurance authorities and state law requirements including licensing, capital, and reserve requirements. The Bank has represented that its current intention is for the Subsidiary to be chartered in Vermont. The Bank also represents that under the reinsurance agreements between the Subsidiary and the mortgage insurers, the Subsidiary will comply with the reinsurance regulatory requirements of the mortgage insurer’s state of domicile.

In return for accepting the limited credit risk associated with the proposed reinsurance arrangement, the Subsidiary will receive insurance premiums, as well as investment income from its cash flow, providing a potentially important source of revenue for the Bank and the Subsidiary.

ANALYSIS

A. Business of Banking Analysis

8 The Bank has represented that its affiliates use underwriting standards comparable to the Bank’s for their mortgage loans.
The OCC previously has determined that reinsuring a portion of the mortgage insurance on loans originated or purchased by the parent bank of an operating subsidiary, or by the parent bank’s lending affiliates, is generally permissible under the National Bank Act because this activity is part of, or incidental to, the business of banking. See PNC Letter; Chase Letter; and IL 743. In the PNC Letter, the Chase Letter, and IL 743, the OCC concluded that, in general, this kind of reinsurance activity is part of the business of banking because the activity (1) is functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) responds to customer needs or otherwise benefits the bank or its customers; and (3) involves risks similar in nature to those already assumed by banks. The OCC also concluded in the PNC Letter, the Chase Letter, and IL 743 that, even if the activity were not part of the business of banking, it would be permissible as an activity incidental to banking, particularly to a national bank’s express power to make loans, because it optimized the use of the bank’s credit underwriting capacities.

In determining whether this activity is permissible in the Bank’s particular case, we will discuss each of the “business of banking” factors analyzed in the PNC Letter, the Chase Letter, and IL 743, and apply them to the specific facts of the Bank’s proposal.

1. Functionally Equivalent to or a Logical Outgrowth of Recognized Banking Functions

The Bank’s reinsurance, through its Subsidiary, of mortgage loans made or purchased by the Bank or its affiliates, is functionally equivalent to, or a logical outgrowth of, the Bank’s business of underwriting mortgage loans. National banks are expressly authorized to make loans under 12 U.S.C. § 24(Seventh) and to underwrite mortgages under 12 U.S.C. § 371. The proposed reinsurance arrangements are comparable to the extension of low down payment mortgage loans without mortgage insurance, but with higher interest rates to cover the risk of nonpayment. Through the reinsurance vehicle, the Bank is engaged in credit judgments and assumes credit risks comparable to those involved in making these mortgage loans without mortgage insurance. With both arrangements, the Bank’s decision to accept those credit risks are determined by the Bank’s underwriting standards, which are derived from the Bank’s lending experience and expertise. Moreover, the risks assumed by the Bank are credit risks rather than actuarial risks. Unlike many traditional forms of insurance, which relate to casualties, death, disability, etc., the Subsidiary’s reinsurance would relate to the

As discussed previously, the Subsidiary will only reinsure loans that meet the Bank’s credit standards. The approval of mortgage loans by the Bank and the Bank’s mortgage lending affiliates therefore will, in effect, be the basis upon which to engage in the reinsurance activity. Accordingly, the Subsidiary will be relying on the same credit analysis and underwriting standards used by the Bank or the Bank’s mortgage lending affiliates in determining whether to approve a mortgage loan in the first instance. Thus, the proposed reinsurance activity is functionally comparable to a lender’s role, based on the same credit analysis and standards used by the lender.
ability of the mortgage borrower to pay the underlying mortgage obligation. Thus, when reinsuring a mortgage insurance risk, the Subsidiary essentially assumes credit rather than actuarial risk.

The Subsidiary’s proposed reinsurance activities also are functionally equivalent to a partial repurchase of a national bank’s own loans, a traditional banking activity. It is well established that banks may originate, purchase and sell mortgage and other loans. See 12 U.S.C. § 371(a); OCC Letter No. 418, reprinted in Fed. Banking L. Rep. (CCH) [1988-89 Transfer Binder] ¶ 85,642, at 78,011 (Feb. 17, 1988) (referring to origination, making, purchase and sale of real estate loans as “centrally traditional banking activities”); OCC, Mortgage Banking: Comptroller’s Handbook 1-3, 9-10 (March 1996). Under the proposed reinsurance arrangements, the Subsidiary will accept from a primary mortgage insurer part of the credit risk from loans originated or purchased by the Bank or its affiliates. Both the proposed mortgage reinsurance and the repurchase of participations in the Bank’s loans thus would involve credit decisions based on the same underwriting criteria and comparable credit risks. Both involve the receipt of income for assuming those credit risks and the assumption of losses when the borrower defaults for any reason. The proposed reinsurance activities thus are functionally equivalent to established bank lending activities.

The process of reinsuring mortgage insurance in the manner proposed by the Bank is “functionally interchangeable” with the process of lending and is essentially a new way of conducting an aspect of the very old business of banking. See M&M Leasing Corp. v. Seattle First National Bank, 563 F.2d 1377, 1382 - 1383 (9th Cir. 1977). In the M&M Leasing Corp. decision, the court affirmed the opinion of the Comptroller, holding that personal property leasing was a permissible activity for national banks. The court concluded that leasing, when the transaction constitutes a loan secured by leased property, is essentially the lending of money on personal security, an express power under the National Bank Act. Id. at 1382. In its analysis, the court discussed how financial leasing is similar to lending on personal security, serves the same purpose as lending, and is “functionally interchangeable” with lending. The court stressed that this “functional interchangeability” was the touchstone of its decision. Id. at 1383. Similarly, in American Insurance Association v. Clarke, 865 F.2d 278 (D.C. Cir. 1988), the court also considered whether a new activity was “functionally equivalent” to a recognized banking power. There, the court affirmed the Comptroller’s opinion that the use of standby credits to insure municipal bonds was functionally equivalent to the issuance of a standby letter of credit, a device long recognized as within the business of banking. The Bank’s proposal to reinsure loans through its Subsidiary is clearly consistent with this line of analysis and represents an alternative way for the Bank to extend mortgage loans.

The Bank’s proposal is also consistent with other bank activities related to banks’ lending powers. Under 12 C.F.R. § 7.1013 a national bank may offer debt cancellation contracts for
the death or disability of a borrower. 10 The Bank’s credit position, as reinsurer of mortgage loans through its Subsidiary, would resemble the position assumed by lenders in issuing debt cancellation contracts. In both of these activities, the initial credit decision also provides the basis for assuming the additional role involving the loan. Moreover, in both cases the risk assumed is closely related to the risk of default that is inherent in banks’ lending functions. The fact that the Subsidiary’s reinsurance activities will include reinsuring mortgage insurance on certain mortgage loans that are not originated or purchased by the Bank, i.e., mortgage loans that are originated or purchased by the Bank’s mortgage lending affiliates, does not affect the permissibility of the Bank’s proposal. Under the Bank’s proposed reinsurance arrangement, a portion of the risk of default associated with a loan held by a mortgage lending affiliate would simply be transferred to the Subsidiary. According to the Bank, the Subsidiary will only reinsure those loans that meet the Bank’s credit standards. In any case, the Bank has represented that its affiliates use comparable underwriting standards for their mortgage loans. 12 As a result, the Bank will be reinsuring essentially homogenous mortgage loans originated under the oversight and subject to the credit guidelines of the same overall banking company. The fact that the banking company may choose for business reasons to originate some portion of these mortgage loans from the Bank’s affiliates, or to purchase some portion of these mortgage loans, does not in this instance limit the Bank’s authority to engage in the proposed reinsurance activity. 13


11 Debt cancellation contracts provide for the cancellation of specified loan amounts upon the occurrence of a specific event (e.g., the borrower’s death), whereas private mortgage insurance covers mortgage loan defaults for any reason where there is insufficient mortgage loan collateral. Thus, the risks assumed when a bank reinsures mortgage loans is more analogous to a bank’s lending than the risks assumed when a bank issues debt cancellation contracts.

12 See footnote 8, supra.

13 In many respects, the Subsidiary’s reinsurance on a portion of the Bank’s affiliates’ mortgage loans is equivalent to purchasing participations in those mortgage loans, an express power. In general, a mortgage insurance reinsurer relies on the same credit standards as a bank would in determining whether to purchase a loan participation. A mortgage insurance reinsurer and the purchaser of a loan participation also receive income for assuming credit risks and incur loss when the borrower defaults for any reason.
2. Respond to Customer Needs or Otherwise Benefit the Bank or Bank Customers

The Bank's proposal potentially benefits the Bank and its customers. The Bank and its mortgage lending affiliates usually require a down payment of at least 20 percent of the appraised value of a home. However, the Bank and its mortgage lending affiliates will accept smaller down payments if repayment of a mortgage is backed by mortgage insurance. Thus, customers benefit from mortgage insurance because it enables them to make small down payments on the purchases of their homes. They have the option of paying the higher monthly costs associated with low down payments, or paying a larger down payment. The Bank's involvement in mortgage reinsurance should not diminish customers' ability to obtain optional mortgage insurance, and may even increase competition and promote the availability of mortgage insurance at competitive rates.

The Bank's proposal also benefits the Bank because it provides the Bank flexibility in structuring its activities to obtain new sources of credit-related income. Mortgage insurers assume some of the credit risks on the Bank's low down payment loans that would otherwise be borne by the Bank. Through the proposed reinsurance activities, the Bank may acquire additional mortgage credit business that can be managed as part of the Bank's overall mortgage credit risk management program. This additional business provides the Bank an alternative vehicle for achieving risk objectives. One alternative approach by which the Bank could expand its mortgage credit-related business would be to buy interests in loans originated by unrelated lenders. However, this approach has the drawback that the initial underwriting of the mortgage-related risk would not have been done by the Bank's own (or an affiliate's) personnel, using the Bank's underwriting standards. Thus, the Bank would need to review the underwriting standards and credit information for the loans, or obtain appropriate credit enhancements and guarantees, since it would not have the same familiarity with the borrowers as with its own (or its affiliate's) loans. Mortgage reinsurance thus may provide the Bank a means to manage its mortgage-related risk exposure that could be preferable due to cost or safety and soundness considerations.

3. Risks Similar in Nature to Those Already Assumed by National Banks

As discussed, the risks a national bank confronts in reinsuring mortgage insurance in the manner proposed by the Bank are essentially the same type as the risks associated with the permissible activities of underwriting mortgage loans. Through the proposed reinsurance activities, the Subsidiary will assume additional risks transferred by the Bank to a mortgage insurer. However, these Subsidiary risks are similar to risks that would be incurred by the Bank or its mortgage lending affiliates on a loan with a high loan-to-value ratio not covered by mortgage insurance or through purchases of participations in the Bank’s loans. Under the reinsurance agreement, this credit-like risk is simply transferred from the Bank or its
mortgage lending affiliates to the primary mortgage insurer, and then to the Subsidiary. The Subsidiary receives compensation for the risk of default through its share of premiums paid under the reinsurance contract. Because the Subsidiary will only reinsure loans that meet the Bank's credit standards, the Subsidiary's likelihood of liability on a claim is no different than that of the Bank (or the Bank's mortgage lending affiliate) upon default if the loan were not covered by mortgage insurance.

B. Incidental To the Business of Banking Analysis

The OCC also determined in the PNC Letter, the Chase Letter, and IL 743 that even if the Bank's proposal were not viewed as part of the business of banking, reinsuring a portion of the mortgage insurance on loans originated or purchased by the parent bank of an operating subsidiary, or originated or purchased by the parent bank's lending affiliates, is generally permissible because this activity is incidental to the business of banking. The OCC concluded in the PNC Letter, the Chase Letter, and IL 743 that this reinsurance activity is incidental to a national bank's express power to make loans.

Based on the particular facts of the Bank's case, the Bank's proposal clearly is incidental to the business of banking. In VALIC, the Supreme Court expressly held that the "business of banking" is not limited to the enumerated powers in 12 U.S.C. § 24(Seventh), but encompasses more broadly activities that are part of the business of banking. The OCC concluded in the PNC Letter, the Chase Letter, and IL 743 that this reinsurance activity is incidental to a national bank's express power to make loans.

Prior to VALIC, the standard that was often considered in determining whether an activity was incidental to banking was the one advanced by the First Circuit Court of Appeals in Arnold Tours, Inc. v. Camp, 472 F.2d 427 (1st Cir. 1972) ("Arnold Tours"). The Arnold Tours standard defined an incidental power as one that is "convenient or useful in connection

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14 The credit-like risk transferred to the Subsidiary is also similar to the risk assumed by a bank in repurchasing an interest in a loan that the bank has previously sold, or in retaining an interest in a pool of loans that the bank has securitized.

15 We note that as a result of the Subsidiary reinsuring mortgage insurance on the loans of the Bank and its affiliates, the Subsidiary would have the added advantage of commencing the activity with a clear understanding of the mortgage insurance reinsurance operation, the geographic distribution of the mortgage loan portfolio, and historic default rate experience. The Bank and its mortgage lending affiliates maintain risk management procedures designed to control geographic distribution of the mortgage loan portfolio and other concentration risks. The Bank represents that these risk management procedures enable the Bank and its mortgage lending affiliates to avoid undue concentrations in their loan portfolios. The Bank represents that these same risk management procedures will also enable the Bank to avoid undue concentrations in connection with the Subsidiary's mortgage reinsurance operations.
with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act." Arnold Tours, at 432 (emphasis added). Even prior to VALIC, the Arnold Tours formula represented the narrow interpretation of the "incidental powers" provision of the National Bank Act. Interpretive Letter 494 (December 20, 1989). The VALIC decision, however, has established that the Arnold Tours formula provides that an incidental power includes one that is convenient and useful to the "business of banking," as well as a power incidental to the express powers specifically enumerated in 12 U.S.C. § 24(Seventh).

The activity the Bank proposes is incidental to the business of banking under the Arnold Tours standard. Reinsuring mortgage insurance in the manner proposed by the Bank is incidental to its express power to make loans. The proposed activity is "convenient" and "useful" to the Bank's power to make loans because it will enable the Bank to structure mortgage loans in a more flexible way. Arnold Tours. Specifically, the proposed activity will provide the Bank an alternative structure for making loans that could otherwise be made with a higher rate of interest to cover the increased risk of nonpayment associated with a low down payment. The proposed activities also provide the Bank an alternative to participating in loans to expand its credit activities. This flexibility is convenient and useful to the Bank in determining how to structure its mortgage lending activities in the most efficient and profitable manner and in offering a competitive array of mortgage lending products to its customers. The proposed activities also are incidental to lending activities because they enable the Bank to optimize the use of its existing credit staff and credit expertise to generate additional revenues through activities that support and enhance the Bank's lending business. The activities also enable the Bank to better manage its credit portfolio.

CONCLUSION

Based upon the foregoing facts and analysis, and the commitments made by the Bank in connection with the Bank's request, the Subsidiary may reinsure mortgage insurance for loans made or purchased by the Bank or the Bank's mortgage lending affiliates, in the manner described in this letter.

Sincerely,

/s/

Julie L. Williams
Chief Counsel

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16See also, Franklin National Bank of Franklin Square v. New York, 347 U.S. 373 (1954) (power to advertise bank services); and Auten v. United States Nat'l Bank, 174 U.S. 125 (1899) (power to borrow money). In these cases the courts' holdings relied on whether the activity was "useful".
Office of the Comptroller of the Currency
Decision On Zions First National Bank’s
Application To Underwrite Municipal Revenue Bonds

Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

DECISION OF THE COMPTROLLER OF THE CURRENCY ON THE APPLICATION BY ZIONS FIRST NATIONAL BANK, SALT LAKE CITY, UTAH TO COMMENCE NEW ACTIVITIES IN AN OPERATING SUBSIDIARY

December 11, 1997

I. INTRODUCTION

On April 8, 1997, Zions First National Bank (“Bank”), Salt Lake City, Utah applied to the Office of the Comptroller of the Currency (“OCC”) pursuant to 12 C.F.R. § 5.34(f) for its operating subsidiary, Zions Investment Securities, Inc. (“Subsidiary”), to commence new activities. The Subsidiary proposes to engage in underwriting, dealing in and investing in securities of states and their political subdivisions. The securities would include: (i) obligations of states and political subdivisions (“general obligation securities”) and (ii) other obligations of states and political subdivisions that do not qualify under the OCC’s current definitions as general obligation securities (hereafter “revenue bonds”).¹ The Subsidiary currently engages in providing brokerage and investment advisory services with respect to corporate equity securities, U.S. government securities, annuities and other securities and investment products. Although the Bank itself is experienced in underwriting and dealing in various government-issued securities, the Subsidiary does not currently underwrite or deal in any securities.

The OCC published notice and request for public comment concerning the Application in the Federal Register on April 18, 1997. The OCC received thirteen comments on the Application. The comment letters received by the OCC included three from national banks, three from trade associations (including bank and securities trade associations), one from a consumer advocacy group, four from communities in Utah, one from a federal bank regulatory agency, and one from a federal securities regulatory agency. The majority of comments recommended approval of the Application, noting the benefits, including the lower cost of financing, that local

¹ Section 16 of the Banking Act of 1933 (the “Glass-Steagall Act”), 12 U.S.C. § 24(Seventh), authorizes national banks to underwrite, deal and invest in general obligations and housing, university and dormitory bonds and hold municipal revenue bonds for investment purposes, but that section does not authorize national banks to underwrite or deal in municipal revenue bonds.
governments and taxpayers would enjoy from the increased competition in municipal financing. Most commenters also agreed that the proposed activity is legally permissible for an operating subsidiary of a national bank because it is part of or incidental to the business of banking and is allowable under the Glass-Steagall Act.

The OCC also received four comments in opposition to approval of the Application from the Securities Industry Association (SIA), a securities firm trade association, the Securities and Exchange Commission (SEC), the Board of Governors of the Federal Reserve System (Federal Reserve), and Consumers Union, a consumer advocacy group (collectively “the protestants”). Several of the protestants contend that an operating subsidiary of a national bank should not be permitted to engage in any activity that is not permissible for a national bank. They claim that permitting operating subsidiaries to engage in the proposed securities underwriting and dealing would vitiate the central purpose of the Glass-Steagall Act by allowing national banks to establish subsidiaries to underwrite and deal in securities prohibited for banks. In addition, the SIA objected to the Application on the grounds that the OCC does not have authority under the Bank Holding Company Act to permit an operating subsidiary of a national bank to underwrite and deal in bank-ineligible securities. The SEC expressed concerns regarding its ability to regulate and oversee the Subsidiary’s activities and how the Subsidiary would satisfy certain broker-dealer requirements. The SIA also requested a hearing on the Application prior to a decision by the OCC. This request has been separately addressed by the OCC.²

In addition, as part of its evaluation of the Bank’s Application, OCC staff has conferred with supervisory staff of the National Association of Securities Dealers, Regulation, Inc. (NASDR), the Securities and Exchange Commission (SEC), the Federal Reserve, and the Federal Reserve Bank of New York regarding their supervision of nonbank subsidiaries of bank holding companies (section 20 subsidiaries) engaged in securities underwriting and dealing. None of the agencies noted unique compliance or supervisory problems relating to underwriting and dealing in revenue bonds through section 20 subsidiaries.³ This also is consistent with the Federal Deposit Insurance Corporation’s (FDIC) general experience with the activities of bona fide securities subsidiaries of insured nonmember banks.⁴

² The OCC believes that the record on the Application is more than sufficient to permit it to make a fully informed determination on the Application. Accordingly, the OCC decided not to grant the SIA’s request for a hearing. See Letter to Marc E. Lackritz, President, Securities Industry Association from Troy Dixon, Director, Corporate Activity, OCC (November 14, 1997).

³ The Federal Reserve, in fact, recently noted that “the risks of securities underwriting and dealing have in the Board’s experience proven to be manageable in a bank holding company framework, and bank holding companies and banks have successfully undertaken and managed activities posing similar risks for which no firewalls were erected.” See 62 FEDERAL REGISTER 2622, 2623 (January 17, 1997).

Under 12 C.F.R. § 5.34(d), the OCC may permit a national bank to conduct an activity through its operating subsidiary that is different from those permissible for the parent national bank, subject to the additional requirements specified in 12 C.F.R. § 5.34(f), provided that the OCC concludes that the activity is part of or incidental to the business of banking or is permitted under other statutory authority. In considering the proposed activity, the OCC considers the particular activity at issue and must weigh: 1) the form and specificity of the restriction applicable to the parent bank; 2) why the restriction applies to the parent bank; and 3) whether it would frustrate the purpose underlying the restriction on the parent bank to permit a subsidiary of the bank to engage in the particular activity. The OCC’s evaluation of these factors will also take into account safety and soundness implications of the activity, the regulatory safeguards that apply to the operating subsidiary and to the activity itself, any conditions that may be imposed in conjunction with an application approval, and any additional undertakings by the bank or the operating subsidiary that address the foregoing factors.

The OCC has carefully considered all of the information available to it, including the information and representations provided by the Applicant, and the comments from the public for and against the proposal. Based upon this review and for the reasons discussed below, the OCC has concluded that the proposed expansion of activities in the Subsidiary is legally authorized under the above standards and consistent with safe and sound banking practices. Accordingly, for the reasons discussed below, and subject to the conditions specified herein, the Bank’s Application is approved.

II. THE BANK’S PROPOSAL

Under the proposal, the Subsidiary will engage in underwriting, dealing in and investing in revenue and general obligation bonds. The Subsidiary also will continue to provide brokerage

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6 See Id.

7 The Subsidiary has proposed to underwrite and deal in revenue bonds that either are rated investment grade or, if not rated, are of sufficiently high credit quality as to warrant, in the judgment of the Subsidiary, an investment grade rating. In determining whether to underwrite and deal in unrated bonds, the Subsidiary will consult with employees of the Bank who are experienced in assessing the credit quality of issuers of non-rated bonds and who are not involved in the underwriting.

8 The Subsidiary has committed that the revenues derived from underwriting and dealing in revenue bonds will not exceed 25% of its total revenues. The OCC notes that the Federal Reserve has previously determined that an affiliate of a member bank earning 25% or less of its revenue from underwriting and dealing in securities impermissible for a member bank to underwrite and deal in directly is not "principally engaged" in that activity for purposes of section 20 of the Glass-Steagall Act (12 U.S.C. § 377). See Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 FEDERAL REGISTER 68750 (December 30, 1996) ("Revenue Test Notice").
and investment advisory services with respect to corporate equity securities, U.S. government securities, annuities, and other securities, and investment products to its retail customers. In addition, the Subsidiary has proposed to provide brokerage and investment advisory services with respect to revenue bonds it underwrites and deals in. In advising customers with respect to investment in revenue bonds, the Subsidiary has committed that it will inform its customers that it is an underwriter or dealer in such securities. The Subsidiary is registered as a broker-dealer with the SEC and is a member of the NASD.

The Subsidiary does not currently underwrite or deal in any securities. The Bank has significant experience in substantially similar activities, however, and will continue to conduct various securities activities directly. Specifically, for the past 21 years, the Bank has engaged in underwriting and dealing in general obligation bonds and in revenue bonds that are bank eligible (i.e., bonds for housing, university or dormitory purposes) (collectively, "bank-eligible bonds"). In addition, the Bank underwrites and deals in U.S. government and agency securities including U.S. Treasuries, and obligations issued by the Federal Home Loan Banks, Federal National Mortgage Association, Federal Home Loan Mortgage Association, the Small Business Administration and Student Loan Marketing Association. The Bank also is an experienced primary dealer in government securities and a member of the Government Agency Selling Group. It is the only primary dealer located between Chicago and California.

In addition to its underwriting activities, the Bank provides brokerage and advisory services to its institutional clients, including states and municipalities concerning the issuance of both general obligation and revenue bonds. If the Application is approved, the Bank expects to offer to its institutional customers, solely as agent, the revenue bonds underwritten by the Subsidiary. The Bank has committed that it will fully disclose that it acts solely as agent for its customers and that the Subsidiary is the underwriter or dealer of the securities.

III. LEGAL ANALYSIS

Introduction and Summary Conclusion

The Supreme Court has long-stated that the starting point for any statutory analysis is the language of the statute itself. Accordingly, that is where we begin. Since the enactment of the National Bank Act in 1864, section 24(Seventh) has expressly authorized national banks to carry

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9 The Bank has underwritten significant volumes of bank-eligible bonds over the last few years. For example, during 1996 the Bank co-managed the underwriting of over $330 million aggregate principal amount of "bank-eligible" revenue bonds and managed, co-managed, or participated in the underwriting of over $5.4 billion aggregate principal amount of general obligation bonds. See Responses of Zions First National Bank in Connection with Application for Approval (August 13, 1997).

on "the business of banking," including "discounting and negotiating promissory notes" and "other evidences of debt," and to "exercise powers that are incidental thereto." 12 U.S.C. § 24(Seventh). During the latter part of the nineteenth century, and into the twentieth century, national banks relied on this statutory authority to underwrite and deal in both debt and equity securities. Indeed, underwriting and dealing was part of the business of many banks.

In 1927, the McFadden Act limited one aspect of these investment banking activities. The specific language of that Act regulated the extent to which an "association," namely, a national bank, could underwrite and deal in debt securities of any single issuer. The McFadden Act did not change the nature or components of the business of banking, however, nor did it attempt to regulate activities of entities that were related to a national bank. Rather, that Act regulated how a national bank itself could conduct one recognized aspect of the business of banking.

The Glass-Steagall Act in 1933 further regulated the extent to which national banks could engage in investment banking activities and also, for the first time, regulated the investment banking activities allowed for entities that were related to a national bank. Section 16 of the Glass-Steagall Act, while recognizing a national bank's ability to engage in investment banking activities, provided that investment banking functions with respect to certain types of securities could not be undertaken by the "association" -- the national bank itself. But, section 20 of the Act expressly preserved the authority of an "affiliate" of a national bank to conduct investment banking activities involving securities of all types, including bank-ineligible securities, provided the affiliate was not "engaged principally" in underwriting and dealing in bank-ineligible securities. The term "affiliate" was very precisely defined by Congress in the statute and specifically included companies owned or controlled by national banks, i.e., bank subsidiaries.

Thus, although Congress chose to restrict the types of securities in which a national bank could directly underwrite and deal, it specifically allowed underwriting and dealing free from those restrictions in bank affiliates, including subsidiaries, as long as the affiliate is not engaged principally in underwriting or dealing in the type of securities not permitted for the bank itself. This different treatment afforded banks and their affiliates in the Glass-Steagall Act is explicit and unambiguous in the language of the statute itself, and demonstrates that Congress distinguished among the potential risks involved in underwriting and dealing in different types of securities and chose to allow bank "affiliates" to continue to engage in investment banking activities, albeit to a limited extent, with respect to a wider range of securities than permitted for the bank itself.

Accordingly, for the reasons discussed in detail below, the OCC finds that the activities proposed to be conducted by the Subsidiary may be permitted for a subsidiary of a national bank. The activities are authorized by section 24(Seventh) of the National Bank Act and, as proposed, are allowed under section 20 of the Glass-Steagall Act.
A. Underwriting and Dealing in Revenue Bonds is Part of the Business of Banking

The authority to underwrite and deal in revenue bonds is derived from section 24(Seventh) of the National Bank Act. That section provides that national banks shall have the power:

[to exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing and circulating notes . . . .]


National banks relied on this authority to engage in a wide range of investment banking activities, including underwriting and dealing, in the latter part of the nineteenth century and early part of the twentieth century. The specific legal basis for underwriting and dealing in debt securities was the authority to “discount and negotiate evidences of debt.” Investment banking involving both debt and equity securities was also authorized as part of the business of banking generally.

The Glass-Steagall Act did not redefine the business of banking to exclude investment banking. If anything, the Act recognized that investment banking was an authorized banking function, but then provided that investment banking activities with respect to certain types of securities could not be undertaken directly by the bank, but could be conducted -- subject to certain size restrictions -- by a bank “affiliate.”

1. Historical Recognition that Underwriting and Dealing is Part of the Business of Banking

Underwriting and dealing was already considered a customary part of the business of banking by the time the National Banking System was created by President Abraham Lincoln. Indeed, commercial and investment banking have been closely connected from the time banks first appeared in the United States. Commercial banks, from the earliest period, had been major providers of long-term credit to governments, investing their capital in government securities, selling securities and providing long-term loans. Indeed, most of the institutions in the early investment banking business were commercial banks. By the 1830s, a number of leading commercial banks, such as the Bank of the United States of Pennsylvania, the Morris Canal and Banking Company, the Phoenix Bank, and the Bank of the Manhattan Company, developed

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investment banking as a line of their regular business. Commercial bank involvement in investment banking continued to grow as a result of the immense financing needs of the Civil War and the railroads.

With the enactment of the National Currency Act in 1863, national banks entered the investment banking business. The First National Bank of New York, for example, sold war bonds during the war, and continued to engage in the buying and selling of government securities after 1865. By 1900 it "was one of the half dozen leading investment banking institutions in the country" and national banks were providing customers with all the services provided by private investment banking houses. That national banks were engaged in investment banking under the authority to conduct the business of banking was widely recognized and acknowledged at the time.

For example, in 1927 the McFadden Act placed quantitative limits on the extent to which national banks could undertake investment banking activities with respect to debt securities of any single issuer. And in 1933, the Glass-Steagall Act replaced those limits with the now familiar limits on investment banking activities involving a wider range of securities. Throughout congressional deliberations on these proposals it was repeatedly recognized and stated that national banks were already engaged in these activities under their existing bank powers. As the House Report relating to the bill that became the McFadden Act noted:

It is a matter of common knowledge that national banks have been engaged in the investment securities business . . . for a number of years. In this they have proceeded under their incidental corporate powers to conduct the banking business. Section 2(b) recognizes this situation but declares a public policy with reference thereto and thereby regulates these activities.


12 See Redlich, Vol. I. supra at 50.
13 The National Currency Act was renamed the National Bank Act in 1864.
15 The House Report went on to note that while the bill regulated the ability of national banks to invest in securities, it also "recognizes the right of national banks to continue to engage in the business of buying and selling investment securities." Id. at 3-4. See also 1924 Annual Report of the Comptroller of the Currency at 12 (suggesting legislation which was a forerunner of the McFadden Act's investment securities provision and stating the "provision would make very little change in existing practice, since a great number of national banks now buy and sell investment securities, and the office of the comptroller has raised no objection because this has become a recognized service which a bank must render").
The Supreme Court has also recognized that national banks had the authority to underwrite and deal in securities prior to the Glass-Steagall Act. For example, in *NationsBank v. Variable Annuity Life Insurance Company*, 513 U.S. 251, 258, 115 S.Ct. 810, 814 (1995) ("VALIC"), the Court noted that in "limiting" a national bank's authority to buy and sell securities in the McFadden Act, Congress also reaffirmed that the activity was authorized as part of the business of banking. The addition of this limitation on purchasing and selling securities "makes sense only if banks already had authority to deal in securities, authority presumably encompassed within the 'business of banking' language which dates from 1863." Id. Similarly, in *Securities Industry Association v. Comptroller of the Currency*, 479 U.S. 388, 407-408 (1987), the Court noted that "in passing the McFadden Act, Congress recognized and for the first time specifically authorized the practice of national banks' engaging in the buying and selling of investment securities. Prior to 1927, banks had conducted such securities transactions on a widespread . . . basis."

Thus, prior to the enactment of the Glass-Steagall Act in 1933, the authority of national banks to engage in investment banking activities had developed and become established as part of their banking powers. The Glass-Steagall Act did not redefine the business of banking to exclude investment banking functions. Indeed, both the McFadden Act and the Glass-Steagall Act recognized and sought to regulate investment banking functions conducted as part of the business of banking. The Glass-Steagall Act further distinguished the potential risks involved in underwriting and dealing in different types of securities and specifically allowed bank "affiliates" to continue to engage in investment banking activities to a limited extent, with respect to a wider range of securities than permitted for the bank itself.

2. Underwriting and Dealing in Revenue Bonds is Part of the Business of Banking Under Section 24(Seventh)'s Enumerated Power to Discount and Negotiate Promissory Notes and other Evidences of Debt.

Section 24(Seventh) of the National Bank Act expressly authorizes national banks to conduct the business of banking, including "by discounting and negotiating promissory notes, drafts, bills of exchange and other evidences of debt." 12 U.S.C. § 24(Seventh). This authority to discount and negotiate evidences of debt clearly encompasses the power to underwrite and deal in debt securities, such as revenue bonds. First, the term "evidences of debt" includes a debt security such as a revenue bond. A revenue bond reflects the debt obligation of a state or its political subdivision to be repaid from the revenues generated by the project that the bond finances. Thus, a revenue bond represents evidence of debt on the part of the issuer.

Second, the phrase "to discount and negotiate" includes the power to buy and sell as principal. The courts have long held that the term "discount" includes purchases of notes and
other evidences of debt.\textsuperscript{16} And negotiation is a form of transfer, disposition or sale.\textsuperscript{17} Moreover, the authority to discount and negotiate is not subject to limitation. Thus, all types of buying and selling are authorized, including the authority to buy and sell as principal. Underwriting and dealing are, in their most basic forms, buying and selling as principal.

Prior to enactment of the McFadden Act and the Glass-Steagall Act, this power served as the legal basis for many of the investment banking activities of national banks.\textsuperscript{18} Thus, although the McFadden Act and the Glass-Steagall Act later provided that national banks could not conduct investment banking activities with respect to certain types of securities, the Acts did not alter the basic concept of the business of banking or the fact that one specifically identified component of that business was the ability to discount and negotiate promissory notes and other evidences of debt. The Glass-Steagall Act, in fact, specifically preserved, to a limited extent, the ability of a bank-related entity, such as a subsidiary, to engage in this activity with respect to a broader range of debt instruments than allowed for the bank itself.

3. Underwriting and Dealing in Revenue Bonds is also Part of the General Business of Banking.

Underwriting and dealing in revenue bonds is not only authorized by an enumerated power but also can be viewed as part of the general business of banking because of the financial nature of the activity and the relationship of the activity to other traditional banking functions. As noted above, national and state banks have a long tradition of underwriting and dealing in many types of government securities.\textsuperscript{19} In addition, national banks have substantial experience and expertise in investing in and analyzing revenue bonds and similar debt instruments for their own accounts. Thus, underwriting and dealing in revenue bonds is the functional equivalent of, or logical,
incremental extension of activities currently conducted by banks, potentially yielding significant public benefits in the form of increased competition, convenience, and lower cost of financing, and benefiting banks by providing additional sources of revenue. It also involves risks similar in nature to those already assumed by banks. 20

a. **Underwriting and dealing in revenue bonds is a functional equivalent or a logical outgrowth of activities currently conducted by national banks.**

Underwriting and dealing in revenue bonds is the functional equivalent or a logical extension of the underwriting and dealing activity currently being conducted safely and soundly by national banks. Underwriting involves the bank in its primary function as a financial intermediary, a “dealer” in capital, facilitating the flow of money and credit among different parts of the economy. 21 The role of a bank as underwriter of revenue bonds is to channel funds of investors to municipalities in need of capital. In that respect, it is similar to the role of banks in lending funds of its depositors to businesses to finance their capital needs.

The proposed underwriting and dealing in municipal revenue bonds also is the functional equivalent or logical outgrowth of a national bank’s authority in Section 16 of the Glass-Steagall Act to underwrite and deal in various types of revenue bonds, including those issued for housing, university or dormitory purposes, as well as municipal general obligation bonds (GOs). 12 U.S.C. § 24(Seventh). 22 Functionally, there is no significant difference between underwriting the proposed revenue bonds and the types of revenue bonds enumerated in section 16, and little difference between underwriting the municipal revenue bonds and underwriting general obligation bonds. 23

20 The Supreme Court has held that Section 24(Seventh) is a broad grant of power to engage in the business of banking, including but not limited to the five specifically recited powers and the business of banking as a whole. See VAlLIC, supra. Many activities that are not included in the enumerated powers are also part of the business of banking. Judicial cases reflect three general principles used to determine whether an activity is within the scope of the “business of banking”: (1) is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) would the activity respond to customer needs or otherwise benefit the bank or its customers; and (3) does the activity involve risks similar in nature to those already assumed by banks? See, e.g., Merchants’ Bank v. State Bank, 77 U.S. 604 (1871); M&M Leasing Corp. v. Seattle First National Bank, 563 F.2d 1377, 1382 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978); American Insurance Association v. Clarke, 865 F.2d 278, 282 (2d Cir. 1988).


22 Section 16 also authorizes national banks to underwrite and deal in U.S. government and agency securities. 12 U.S.C. § 24(Seventh).

23 The Federal Reserve has previously determined that underwriting and dealing in municipal revenue bonds is a “natural extension of activities currently conducted by bank, involving little additional risk . . . and potentially yielding significant public benefits in the form of increased competition and convenience and lower cost.” Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation, 73 FEDERAL RESERVE BULLETIN
Municipal revenue bonds, like housing, university, dormitory bonds, and GOs, are debt obligations of a state or political subdivision, such as a county, city, town, village or municipal authority, issued for public purposes. In addition, the interest from the bonds, in most cases, is exempt from federal and state income taxation, and all of these types of bonds are subject to some credit, interest rate, and liquidity risk.\footnote{24}

The only significant difference between these bonds is the source of repayment from the issuer. Both municipal revenue bonds and housing, university and dormitory bonds are repaid from the revenues of the facility or project financed by the bonds.\footnote{25} In contrast, GOs are backed by an issuer’s general taxing powers and its full faith and credit. The presence of full faith and credit in a GO is reflected in the pricing of the bond and does not materially alter the nature of the activities involved in underwriting the bonds.

Indeed, underwriting and dealing in the proposed revenue bonds involves the same basic functions as underwriting and dealing in bank-eligible securities.\footnote{26} For both bank-eligible securities and revenue bonds, the underwriter sets a price at which it believes the securities can be sold to investors at a profit. This requires an analysis of the creditworthiness of the issuer\footnote{27} and an assessment of price volatility. Because of their traditional lending activities, banks and their subsidiaries are clearly qualified to perform the credit analysis required in both bank-eligible and the proposed underwritings. The underwriter also is responsible for distributing the securities to investors and generally deals in the issuer’s securities by purchasing and selling them for the

\footnote{24} The credit risk from the proposed revenue bonds is no different from other types of revenue bonds, such as housing and university bonds. Moreover, although general obligation bonds are often viewed from an investor’s perspective as safer than revenue bonds, both GOs and revenue bonds, unlike U.S. government securities, expose the investor to credit risk. The perceived safety of a GO is premised on the fact that it is backed by the taxing authority and full faith and credit of the issuer. Theoretically, this power is unlimited. However, political considerations can and do limit the ability of issuers to use this power.

\footnote{25} For example, the revenues securing college and university revenue bonds usually include dormitory room rental fees, tuition payments, and sometimes the general assets of the college or university. See Frank J. Fabozzi, ed., \textit{The Handbook of Fixed Income Securities}, 5th ed. (Chicago: Irving Professional Publishing, 1997) at 436 and 437.

\footnote{26} The Federal Reserve has previously determined that “the techniques involved in underwriting bank-eligible securities are the same, or substantially the same, as those that would be involved in conducting [municipal revenue bond] underwriting . . . .” \textit{Citicorp/J.P. Morgan & Co. Incorporated/Bankers Trust New York Corporation, 73 FEDERAL RESERVE BULLETIN} 473, 488 (1987).

\footnote{27} Because revenue bonds, unlike GOs, are not supported by the taxing authority of the State or municipality, the Subsidiary may be required to conduct a more extensive credit analysis and evaluation of the issuer than is required for general obligation bonds. The analysis required is essentially the same, however, as that required for other types of bank-eligible revenue bonds, such as housing-related bonds. Moreover, it is closely analogous to the credit analysis banks perform in their traditional lending activities.
underwriter's own account. Banks perform similar functions when they underwrite eligible securities. Thus, the activities involved in underwriting and dealing in revenue bonds are the functional equivalent or a logical extension of underwriting and dealing in bank-eligible securities.\textsuperscript{28}

b. Underwriting and dealing in revenue bonds potentially benefits local governments and taxpayers and increases bank revenues.

The Bank's proposal to underwrite and deal in revenue bonds through its operating subsidiary would also produce substantial benefits for local governments and taxpayers by providing communities with greater access to the municipal bond market and increasing competition in municipal bond underwriting. As the Bank notes, the number of firms involved in municipal financing has sharply declined over the last decade, decreasing the competition for revenue bond underwritings.

Since 1995, four major securities firms have eliminated their municipal financing businesses.\textsuperscript{29} Three other major firms had previously left the business or substantially reduced their operations.\textsuperscript{30} As several communities commenting on the Application noted, this reduction in competition has led to higher financing costs for many public issuers, particularly smaller communities. Indeed, several commenters noted that many communities, particularly smaller communities, no longer have access to the municipal bond market to finance small issuances. The increased competition from having additional participants in municipal bond underwriting should serve to reduce interest rates and underwriting costs for local governments. In addition, taxpayers would benefit from the lower taxes and improved services that lower financing costs and increased access to public financing should yield. Approval of the proposal should also result in greater convenience for municipal customers desiring this form of financing.

In addition, approval of the proposed activity would enable national banks to diversify their activities through operating subsidiaries and generate new sources of revenue. This activities diversification can have important benefits. Fees and other income from the subsidiaries may

\textsuperscript{28} The proposed underwriting activity also involves functions that are a logical outgrowth of other traditional banking activities. For example, the credit analysis required involves the same kind of assessment as is required when the bank purchases revenue bonds for its own account. In addition, the distribution function is similar to the activity banks perform when they arrange loan syndications.

\textsuperscript{29} The firms include CS First Boston, Donaldson, Lufkin & Jenrette, Lazard Freres, and Chemical Securities. See "Memorandum in Support of the Application of Zions First National Bank to Commence New Activities Through an Operating Subsidiary," at 19 ("Zions Memorandum").

\textsuperscript{30} Other major firms have either left the business (Salomon), been largely liquidated (Kidder Peabody) or substantially reduced their operations (Dean Witter). See Zions Memorandum, \textit{supra}, at 19.
enable banks to offset the effects of cyclical downturns in other sectors of the economy. Hence, bank earnings would be less volatile, reducing risks to the banking system as a whole. As former FDIC Chairman Helfer stated recently, allowing a bank to conduct new activities in a bank subsidiary "lowers the probability of bank failure and provides greater protection for the insurance fund" (than if the activities were conducted by holding company subsidiaries).

Stronger institutions with increased profits and asset growth will be better positioned to meet the credit needs in their communities and support the economy as a whole. The proposed activities can provide an income stream to support the Bank's Community Reinvestment Act (CRA) efforts, thereby increasing the potential pool of resources available to support disadvantaged communities.

c. The risks associated with underwriting and dealing in revenue bonds are the same risks already assumed by the bank in underwriting, dealing in bank-eligible securities and investing in revenue bonds.

The risks an operating subsidiary assumes in underwriting and dealing in revenue bonds are essentially the same risks as those associated with the permissible activity of underwriting and dealing in bank-eligible securities and investing in revenue bonds. The primary risks of

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32 Testimony of Ricki Helfer, supra, at 23.

33 The OCC considers the assets of a bank operating subsidiary when evaluating the capacity of the bank to serve its community. See OCC Bulletin 97-26, Performance Context (July 3, 1997).

34 In order to limit the risks of underwriting and dealing, national banks are subject to a 10% capital limitation per issuer for certain bank-eligible securities, such as housing or dormitory bonds.

35 National banks actively engage in holding and trading revenue bonds for their own account. This activity poses a risk of loss comparable to holding such securities as principal in an underwriting or dealing capacity. See 12 C.F.R. Part 1. In order to limit the risks of underwriting and dealing, national banks are subject to a 10% capital limitation per issuer for certain bank-eligible securities, such as housing or dormitory bonds.

36 Other risks associated with underwriting and dealing in revenue bonds include credit risk, transaction risk, compliance risk, and strategic risk. See Comptroller's Handbook, Large Bank Supervision, Supervision by Risk at 18-21. These same risks are associated with underwriting and dealing in bank-eligible securities. For example, both general obligation underwriting and revenue bond underwriting are subject to the rules of the Municipal Securities Rulemaking Board (MSRB), and the underwriter of both types of bonds is subject to oversight by the National Association of Securities Dealers, Regulation, Inc. (NASDR). Accordingly, the compliance risk associated with revenue bond underwriting is the same as that associated with underwriting general obligations. Similarly, because there are no substantial differences between the bank-eligible underwriting the Bank currently conducts and the proposed underwriting activities, there is no significant new strategic risk associated with the proposed "new line of business."
underwriting, dealing and investing in both bank-eligible and bank-ineligible securities are reputation risk\textsuperscript{37} and price risk\textsuperscript{38} National banks, and this Bank in particular, are very experienced in managing these types of risks as a result of their permissible underwriting and dealing activities, their permissible investment activities, and their traditional lending functions.\textsuperscript{39} Moreover, national banks have extensive expertise in evaluating the risk characteristics of revenue bonds as a result of their direct ability to invest in revenue bonds and similar securities for their own account.

**B. National Banks are Authorized to Own Operating Subsidiaries as an Incident to the Business of Banking**

It is well-settled that national banks may own operating subsidiaries as an incident to being in business.\textsuperscript{40} The OCC, the courts, and Congress have consistently recognized that national banks can own subsidiaries to conduct the business of banking.

The OCC has long recognized the authority of national banks to own subsidiaries. In the 1960s, the OCC first approved the establishment of operating subsidiaries through a series of rulings and regulations governing bank ownership of operating subsidiaries. In 1965, for example, Comptroller of the Currency Saxon permitted a national bank to acquire all of the outstanding stock of a trust company after concluding that 12 U.S.C. § 24(Seventh) allows national banks to “own corporate stock, or interests therein, when such ownership is a proper

\textsuperscript{37} Reputation risk is the risk to earnings or capital arising from negative public opinion. This affects the institution’s ability to establish new relationships or services or continue servicing existing relationships. This risk can expose the institution to litigation, financial loss, or damage to its reputation. See Comptroller’s Handbook, Large Bank Supervision, Supervision by Risk at 21.

\textsuperscript{38} Price risk is the risk to earnings or capital arising from changes in the value of portfolios of financial instruments. This risk arises from market-making, dealing, and position-taking activities in interest rate, foreign exchange, equity, and commodities markets. See Comptroller’s Handbook, Large Bank Supervision, Supervision by Risk at 19.

\textsuperscript{39} As the Federal Reserve noted, in approving this same activity for commonly controlled sister companies of banks in 1987:

The risks associated with underwriting and dealing in any revenue bond, whether eligible or not, are generally a function of the price volatility of the security, as well as the cash flow and viability of the project being financed. These risks are not, in the Board’s view, significantly greater for ineligible revenue bonds than for eligible bonds, given the very close functional similarity between the two kinds of obligations.


\textsuperscript{40} National banks are authorized to engage in activities that are incidental to enumerated powers or the business of banking under section 24(Seventh). See VALIC, supra, 513 U.S. at 258, n.2. This authority includes incidental activities necessary to conduct a business so that a bank may engage in activities that are convenient and useful to the conduct of its business, including ownership of operating subsidiaries. See Op Sub Legal Opinion at 2-18.
incident to banking.” 41 In 1966, the OCC adopted a regulation, 12 C.F.R. § 7.10 confirming that national banks could own subsidiaries. 42 The OCC approved 296 applications to establish or perform new activities in operating subsidiaries in 1996. These subsidiaries are engaged in a wide range of banking related activities.

In upholding the authority to own subsidiaries, the OCC has consistently interpreted the limitation on stock purchases added by section 16 of the Glass-Steagall Act in section 24(Seventh) as preventing national banks from undertaking investment banking activities with respect to shares of stock, i.e., engaging in the types of speculative stock purchases that were the object of the Act, not as a bar to the ability of national banks to have subsidiaries or to own stock, where such ownership is “otherwise permitted by law.” 43 One such “law” is the powers clause of 12 U.S.C. § 24(Seventh), which was unaffected by the section 16 changes. That clause, as explained above, states that a national bank is expressly authorized to carry on the business of banking and may exercise “all such incidental powers as shall be necessary” to carry on that business. Pursuant to that authority, banks may establish operating subsidiaries to conduct the business of banking.

The courts have consistently upheld the OCC’s position that national banks can own and operate subsidiaries. See, e.g., VALIC, supra (a national bank and its operating subsidiary had asked the permission of the OCC to sell annuities, and the Supreme Court held this would be lawful); Clarke v. Securities Industry Association, 479 U.S. 388 (1989) (operating subsidiaries of national banks can engage in the securities brokerage business at various nonbank locations); American Insurance Association v. Clarke, 865 F.2d 278 (D.C. Cir. 1987) (a national bank’s operating subsidiary can be a municipal bond insurance company).

Congress also has repeatedly recognized the authority of national banks to own subsidiaries through numerous legislative enactments. For example, the changes made to 12 U.S.C. § 24(Seventh) by the McFadden Act in 1927 and the Banking Act of 1933, including the Glass-Steagall Act, confirm that Congress also believed that national banks had the authority to own subsidiaries pursuant to their incidental powers. In each instance, the statute placed limitations on bank subsidiary activities, presupposing the ability of national banks to own and operate subsidiaries, even though such ownership is not expressly identified in the statute.

41 OCC Letter from Comptroller Saxon (unpublished) (July 30, 1965) (emphasis added); See also 12 C.F.R. § 7.10 (39 Fed. Reg. 11459 (August 31, 1966)) (explaining the authority of national banks to own subsidiaries); Op Sub Legal Opinion at 15-17.


43 That section provides: “Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase [by the bank] of any shares of stock of any corporation.” 12 U.S.C. § 24(Seventh).
The McFadden Act limited the amount a national bank could invest in a corporation that conducted the 'safe deposit business. The limitation on investment in corporations involved in the safe deposit business makes sense only if banks already had authority to own this type of corporation under 12 U.S.C. § 24(Seventh)." Similarly, in one of many examples from the 1933 Act supporting this proposition, that Act limited the amount a national bank could invest in a bank premises subsidiary corporation, thereby acknowledging the continued lawfulness of the activity. Indeed, the scope of these provisions would make no sense unless Congress believed that national banks had the authority in the first place to control a company as a subsidiary.

Accordingly, there can be no question that national banks may conduct the business of banking through operating subsidiaries.

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44 See Op Sub Legal Opinion at 5-6.

45 Indeed, the 1933 Act amounted to a comprehensive scheme of recognition and regulation of the ownership by national banks (and state member banks) of subsidiaries and other types of affiliates. Section 5 gave state member banks the same power, but no more, to own corporate stock as was possessed by national banks under the authority of 12 U.S.C. § 24(Seventh). Section 2(b) defined a member bank's affiliate to include a company owned by the bank as a subsidiary. Section 13 imposed capital-based limitations on the amount of stock a member bank could own in affiliates. It also added a new section 23A to the Federal Reserve Act (12 U.S.C. § 371c). The new section imposed qualitative standards and collateral limits on transactions between member banks and their affiliates. Section 14 required a national bank to obtain the OCC's permission in order to invest more than 100% of its capital funds in the stock of a bank premises corporation. Section 20 allowed a member bank to own the stock of a securities affiliate so long as the company was not engaged principally in the issue, underwriting or distribution of securities. And section 28(a) added a new provision to 12 U.S.C. § 481, authorizing the OCC to examine all of the affiliates of national banks. Together, these provisions clearly presuppose that national banks had the authority to own subsidiaries. See also Op Sub Legal Opinion at 11-14.

46 Congress has continued to acknowledge the authority of national banks to own subsidiaries in recent years. For example, the Banking Affiliates Act of 1982, Pub. L. No. 97-320, 96 Stat. 1515-1520, comprehensively revised section 23A of the Federal Reserve Act. In several provisions, the legislation gave subsidiaries of member banks special attention. As now amended, section 23A(a) assumes the authority of national banks and state member banks to own subsidiaries and, in contrast to section 20 of the Glass-Steagall Act, provides that the bank and its subsidiaries will be regulated in the same way, as a unit. Thus, under section 23A, transactions between a bank's subsidiaries and the other affiliates of the bank were made subject to the same controls that apply to direct dealings between the bank itself and those same affiliates. Similarly, in 1987, Congress added a new section 23B to the Federal Reserve Act, placing further restrictions on transactions of member banks and their subsidiaries with their affiliates, Pub. L. No. 100-86, sec. 102(a), 101 Stat. 564-567. The member bank "and its subsidiaries," by virtue of section 23B(a), could henceforth engage in transactions with affiliates only on terms and conditions that were at least as favorable to such bank or its subsidiary as those prevailing for comparable transactions in the marketplace or that would be offered to unaffiliated companies. None of these provisions would make any sense unless Congress understood that national banks and state member banks had authority to own subsidiaries. Moreover, these provisions demonstrate that when Congress intended bank subsidiaries to be subject to the same standard that applied to their parent bank, Congress knew how to say so.
C. Section 20 of the Glass-Steagall Act Permits Underwriting and Dealing by a Subsidiary of a National Bank

The Glass-Steagall Act, it is often said, was designed to effect a separation between commercial and investment banking. But as the Second Circuit has noted, "Senator Glass' aspiration to divorce completely commercial banks from their securities affiliates was never attained." 47 This is most clearly demonstrated by the different treatment Congress afforded national banks and their affiliates under the Glass-Steagall Act. 48

Under section 16 of the Act, "the association," namely the national bank, is precluded from engaging in investment banking functions with respect to various (but not all) types of securities. 49 "Affiliates" of national banks, on the other hand, are given a different statutory treatment under section 20 of the Act. That section provides that:

no member bank shall be affiliation in any manner ... with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. 50

12 U.S.C. § 377. Thus, unlike national banks, their "affiliates" are allowed to engage in investment banking activities with respect to all types of securities, provided the affiliate is not "engaged principally" in investment banking activities with respect to the types of securities in

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48 Indeed, Congress displayed this same precision in the different treatments it applied to other related entities of national banks. For example, holding company affiliates were subject to the same substantive test as other national bank "affiliates," but via a different implementing mechanism. Section 19(e) of the Glass-Steagall Act prevented a company that controlled a national or member bank from voting the stock it owned unless it obtained a voting permit. In order to get a voting permit, the holding company affiliate had to:

(1) show that it does not own, control, or have any interest in, and is not participating in the management or direction of, any corporation, business trust, association, or other similar organization formed for the purpose of, or engaged principally in, the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail or through syndicate participation, of stocks, bonds, debentures, notes, or other securities of any sort (hereafter referred to as 'securities company'); . . .


49 Section 5 of the Act applied these restrictions to state-chartered member banks. 12 U.S.C. § 335.

50 The term "dealing" is not included in the language of section 20. The Federal Reserve has interpreted the term "public sale" in section 20 to encompass dealing, however. See 73 FED. RES. BULL. 473, 481, 506-07 (1987).
which the bank may not directly underwrite or deal.51 The term "affiliate" is defined for this purpose to include:

any corporation, business trust, association, or other similar organization--

(1) Of which a member bank directly or indirectly owns or controls either a majority of the voting shares or more than 50 per centum of the number of shares voted for the election of its directors, trustees, or other persons, exercising similar functions at the preceding election, or controls in any manner the election of a majority of its directors, trustees, or other persons exercising similar functions.


An operating subsidiary is a company that is more than 50% owned or controlled by a national bank.52 Thus, by applying the literal language of the statute, an operating subsidiary is an "affiliate" for purposes of section 20 of the Glass-Steagall Act. As an "affiliate" of a national bank, an operating subsidiary therefore is able to underwrite and deal in securities of the type not permitted for its parent, provided that the subsidiary is not "engaged principally" in underwriting or dealing functions with respect to those bank-ineligible securities.

The Subsidiary’s proposed activities are permissible under this standard. The Federal Reserve has previously determined that an affiliate of a member bank earning 25% or less of its revenue from underwriting and dealing in securities impermissible for a member bank to underwrite and deal in directly, is not “principally engaged” in that activity for purposes of section

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52 Under 12 C.F.R. § 5.34, operating subsidiaries are defined to include entities in which the parent bank "owns more than 50% of the voting (or similar type of controlling) interest of the subsidiary: or the parent bank otherwise controls the subsidiary and no other party controls more than 50% of the voting (or similar type of controlling) interest of the subsidiary . . . ." 12 C.F.R. § 5.34(d)(2).
20 of the Glass-Steagall Act (12 U.S.C. § 377). The Subsidiary, in this case, has committed that the revenues derived from its proposed revenue bond underwriting and dealing activities will not exceed 25% of its total revenues. Accordingly, the Subsidiary will not be “engaged principally” in underwriting or dealing in bank-ineligible securities for purposes of section 20 of the Glass-Steagall Act.

In sum, the plain language of the Glass-Steagall Act distinguishes the potential investment banking risks presented by different types of securities and allows subsidiaries of national banks to engage in investment banking functions with respect to types of securities not permitted for the national bank itself. While section 16 prohibits “the association” from underwriting and dealing in certain types of securities, section 20 expressly allows “affiliates” of a bank, including its subsidiaries, to underwrite and deal in a broader range of securities—to a limited extent. Thus, it would not frustrate the purposes of the Glass-Steagall Act to permit revenue bond underwriting and dealing in a subsidiary of a national bank.

D. National Banks Are Authorized to Own Operating Subsidiaries Engaged in Activities Not Permissible for the Bank

As section 20 of the Glass-Steagall Act makes clear, subsidiaries of national banks may legally engage in activities not permitted for the bank itself. The OCC and the courts also have recognized, in various contexts, that limitations that apply to the bank itself do not necessarily apply to its affiliates or subsidiaries.

Most recently, the OCC revised its regulation on operating subsidiaries to permit an operating subsidiary to engage in activities not permitted for its parent bank as long as the OCC determines that the activities are part of or incidental to the business of banking or otherwise

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53 See Revenue Test Notice, supra.

54 In defining the term “affiliate” to include companies owned or controlled by member banks, Congress was well aware that national banks organized and controlled companies engaged in underwriting and dealing. For example, in 1932, while Congress was considering legislation to strengthen the banking system and to deal with banks’ involvement in the securities markets, Federal Reserve Board Chairman Eugene Meyer, testifying on companies owned or affiliated with national banks, submitted a chart listing 770 companies that were affiliates of national banks. Of those directly owned by national banks, four were identified as “securities companies”. See Hearings on S.4115 Before the Senate Committee on Banking and Commerce, 72d Cong., 1st Sess. (1932) at 391-392. See also Hearings on S. Res. 71 Before a Subcommittee of the Senate Committee on Banking and Currency, 71st Cong., 3d Sess. (1931); Hearings on S.Res. 18 Before the Senate Committee on Finance, 72d Cong., 1st Sess. (1932); Hearings on S.Res. 84 and S.Res. 239 Before a Subcommittee of the Senate Committee on Banking and Commerce, 72d Cong., 2d Sess.(1933); Hearings on S.Res. 84 and S.Res. 56 Before the Senate Committee on Banking and Currency, 73rd Cong., 1st Sess.(1933); Hearings on S.Res. 84 and S.Res. 97, Senate Committee on Banking and Currency, 73rd, Cong., 2d Sess (1934). See Hearings on S. 4115, supra, at 391-392. A 1930 bill, introduced by Senator Carter Glass, also defined “affiliate” to include securities companies owned or controlled by national banks. See S. 4723, 71st Cong., 2d Sess. (emphasis added). See also Op Sub Legal Opinion, supra, at 8, 11-12.
authorized by law and that the limitation applicable to the bank does not apply to the subsidiary. The new regulation is intended to clarify the OCC's position regarding whether the operating subsidiaries are subject to the same federal laws as apply to national banks. In the past, the OCC had generally taken a position that operating subsidiaries were subject to the same laws as national banks. Nevertheless, over the years, the OCC has made numerous exceptions to this policy when deemed appropriate in the circumstances, and has allowed subsidiaries to engage in banking and incidental-to-banking activities even though their parent bank could not engage in those activities directly.

For example, a letter from Deputy Comptroller DeShazo, dated October 25, 1967, permitted a Pennsylvania national bank to acquire up to 100% of the common stock of a commercial finance company headquartered in New York City where it conducted the bulk of its business. The approval was codified in Paragraph 7376 of the Comptroller's rulings (the operating subsidiary ruling). Nothing was said about any geographical problem or branching issue under 12 U.S.C. § 36, even though the bank could not be located in New York. The statement was made that "the operations of the finance company will in general be subject to the same laws and regulations as it is now after acquisition by the bank." (Emphasis added).

In addition, a January 1968 letter signed by Deputy Comptroller Watson held a mortgage company subsidiary's borrowing would be treated as being independent from the parent national bank's borrowings. This avoided a problem under the then-applicable capital limitations imposed on national bank borrowings by 12 U.S.C. § 82. The mortgage company also was allowed to buy real estate for its own future development purposes, and to make loans to finance a development tract on terms that would be impossible for the parent national bank under 12 U.S.C. §§ 84 and 371. The Watson letter explained why in this concluding statement:

a [controlled subsidiary corporation of a national bank] is a separate, legal entity, apart from its parent corporation, operating under its own charter and articles of incorporation with corporate power and authority to own property and to carry on its business. Accordingly, the Commerce Mortgage Company may pursue such activities which are consistent with its doing business as a mortgage servicing corporation.

More recently, operating subsidiaries have been permitted to act as a general partner in various types of business enterprises, despite the Supreme Court's holding in Merchants National Bank v. Wehrmann, 202 U.S. 295 (1906), that it is ultra vires for a national bank to take on the unlimited liability of a general partner in a partnership. The OCC reasoned in these cases that an

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55 Three commenters objected to the application on the grounds that national bank subsidiaries should not be permitted to engage in any activity prohibited for the bank itself.

operating subsidiary could lawfully be a general partner because the unlimited partner liability would be cut off at the level of the subsidiary and not flow through to the parent bank, thereby addressing the issue that concerned the Court in the Wehrmann case.

The courts also have recognized that limitations that apply to a bank do not always apply to its affiliates or subsidiaries. In Board of Governors, FRS v. Investment Company Inst., 450 U.S. 46 (1981), the Supreme Court upheld the Federal Reserve's determination that a nonbank subsidiary of a bank holding company could sponsor, organize, control, and act as investment advisor to a closed-end investment company. The Court examined the language, structure, and legislative history of the Glass-Steagall Act and concluded that the activities were permissible for affiliates of banks. In upholding the permissibility of the activities, the Court made the key determination that activities of bank affiliates are governed by section 20 of the Glass-Steagall Act, not sections 16 or 21. Section 20, the Court noted, "does not prohibit bank affiliation with a securities firm unless that firm is 'engaged principally' in activities such as underwriting." As a result, the court noted that "bank affiliates may be authorized to engage in certain activities that are prohibited to banks themselves."

In Investment Company Institute v. Federal Deposit Insurance Corp., 606 F. Supp. 683 (D.D.C. 1985) the district court upheld a regulation issued by the FDIC to "govern the manner in which nonmember state banks can arrange to own subsidiaries . . . engaged in aspects of the securities business, particularly underwriting various types of securities," The court held that a state nonmember bank could own a securities firm subsidiary even though the bank could not itself engage in the activities of the subsidiary. The case hinged on the scope of section 21 of the Glass-Steagall Act, which prohibits insured non-member state banks from engaging directly in a full-scale securities business. The plaintiffs argued that the restrictions of section 21 also

57 The Court also pointed out that the bank itself could engage in the activity. See Id. at 62.

58 Id. at 64.

59 Id. at 60. See also SIA v. Board of Governors, Federal Reserve System, 839 F.2d 47 (2d Cir. 1988), cert. denied, 486 U.S. 1059, 108 S. Ct. 2830; SIA v. Board of Governors, Federal Reserve System, 847 F. 2d 890 (D.C. Cir. 1988) (both holding that a member bank's affiliate may engage in some securities activities that would be prohibited to the member bank itself).

60 Id. at 684.

included subsidiaries of a bank and that subsidiaries should be treated as "alter egos" of their parent bank. The court rejected the effort to include the subsidiary within the limitations applicable to its parent under section 21, finding no Congressional intent to apply that section to an entity separate from a bank, even one that the bank controlled.

In Securities Industry Association v. Federal Home Loan Bank Board, 588 F. Supp. 749 (D.D.C. 1984) (SIA v. Bank Board), the Federal Home Loan Bank Board ("Bank Board") had permitted several federal savings and loan associations to own service corporations which, in turn, owned out-of-state subsidiaries engaged in securities brokerage and investment advisory activities. These subsidiaries of service corporations were partially owned by investors that were not S&Ls. The applicable statute, section 5(c)(4)(B) of the Home Owner's Loan Act ("HOLA"), permitted federal S&Ls to invest in service corporations, but required that the corporation be organized under the laws of the state in which the home office of the S&L is located, and that its stock be available for purchase only by S&Ls in that state. No mention of, or provision for, subsidiaries of service corporations was contained in the statute.

The parties to the lawsuit agreed as to the material facts, that the federal S&Ls in question could not themselves engage in the securities brokerage and investment advisory activities, nor could they directly own the out-of-state jointly-owned subsidiaries which were engaged in this business. The court nevertheless held that the federal S&Ls' service corporations could own those subsidiaries. It observed that "[e]xcept in unusual circumstances," courts will not disregard the separate identities of a parent and its subsidiary, even a wholly-owned subsidiary. 62 Such separate existence will not be disregarded "merely because the corporate arrangement allows an affiliate or subsidiary to engage in activities which an affiliated or parent corporation is statutorily prohibited from doing." 63

The court accepted the Bank Board's ruling that the activities of the service corporations' subsidiaries were "reasonably related to the activities" of federal S&Ls. 64 It also observed that the Board "must be permitted to adapt the regulatory structure of HOLA to the changing needs of the economy" and that the Board's determination with respect to the S&Ls' service corporations was "consistent with HOLA." 65

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64 Id. at 754.

65 Id. See also Rettig v. Arlington Hgts. Fed. Sav. & Loan Ass'n, 405 F. Supp. 819, 824 (N.D. Ill. E.D. 1975) (Subsidiaries of federal S&Ls can engage in the insurance agency business even though the parent S&Ls cannot engage in the business themselves).
In conclusion, affiliates and operating subsidiaries of national banks may engage in activities different from those permitted for a national bank under certain circumstances. However, those activities must still qualify as part of or incidental to the business of banking or be permissible for national banks or their subsidiaries under other statutory authority. As explained above, the proposed activities of the Subsidiary clearly are part of the business of banking and are allowed for an operating subsidiary under section 20 of the Glass-Steagall Act. In making this determination, the OCC has weighed the form and specificity of the restriction applicable to the bank, why the restriction applies to the bank, and whether it would frustrate the purpose underlying the restriction on the bank to permit the subsidiary to engage in the proposed activity. For the reasons discussed above, the OCC concludes that the restriction applicable to national banks in section 16 of the Glass-Steagall Act does not apply to operating subsidiaries. By its terms, section 16 only applies to the national bank itself. Congress specifically provided a different standard for affiliates of national banks, including subsidiaries of national banks, in section 20 of the Glass-Steagall Act. Thus, it would not frustrate the purposes of section 16, or the Glass-Steagall Act generally, to permit the Subsidiary to engage in the proposed activity to the extent permitted under section 20. Accordingly, the OCC finds that the activities are legally permissible for an operating subsidiary of a national bank.

IV. SAFETY AND SOUNDNESS CONSIDERATIONS

In reaching its determination to approve the proposed municipal revenue bond activities, the OCC also has carefully considered whether the activities pose an undue risk to the Bank and the Subsidiary or would result in unsafe and unsound banking practices. The OCC believes that, under the conditions and limitations set forth below, the proposed activities present limited risk to the Bank and the Subsidiary and will be conducted in a safe and sound manner.

A. Limited Expansion of Activities

As noted above, the proposed municipal revenue bond activities represent an incremental expansion of activities already conducted by national banks and this Bank in particular. The revenue bonds which the Subsidiary proposes to underwrite and deal in are substantially equivalent to revenue bonds national banks are permitted to underwrite, deal, and invest in under

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66 The OCC notes that it submitted a report to Congress on its revisions to 12 C.F.R. Part 5, which includes the regulation governing operating subsidiaries, as required under the Small Business Regulatory Enforcement Fairness Act of 1996 ("1996 Act"), Pub. Law 104-121 (1996). The regulation, as noted above, provides that an operating subsidiary of a national bank may engage in activities different from that permitted for its parent bank as long as the activities are part of the business of banking or are otherwise authorized by law. Congress took no action, as is authorized under the 1996 Act, to negate the effectiveness of that regulation.

67 In 1982, Federal Reserve Board Governor J. Charles Partee testified that the Federal Reserve favors granting banks the authority to underwrite and deal in most state and government revenue bonds, noting that the activity is a "natural extension of activities already being done by banks." See Statement of J. Charles Partee, Member, Board of Governors of the Federal Reserve System before the Senate Banking Committee. February, 1982.
section 16 of the Glass-Steagall Act. Moreover, the proposed activities pose comparable risks to national banks as those associated with underwriting, dealing and investing in bank-eligible securities. These risks are mitigated by the Bank’s substantial experience and expertise as a municipal securities dealer. The OCC notes that many of the same individuals now associated with the Bank’s government securities activities will be employed by the Subsidiary. Moreover, as noted above, other regulators that have experience with bank affiliates engaged in the proposed types of activities indicated that they have not had significant or unusual compliance or supervisory concerns with those affiliates. Accordingly, the OCC has determined that the proposed activities will not result in significant or excessive risk to the Bank or the Subsidiary.

B. Corporate Separateness

In order to minimize any potential that securities underwriting and dealing risk may negatively affect the Bank, the Bank will be insulated, both structurally and operationally, from the Subsidiary. For example, under the OCC’s regulation governing operating subsidiaries, 12 C.F.R. § 5.34, there are a number of requirements intended to ensure the Subsidiary’s independent legal and corporate existence. Specifically, the Subsidiary is required to: (1) be physically separate and distinct in its operations from the Bank; (2) be held out as a separate and distinct entity from the Bank in its written materials and direct contact with outside parties, with all written materials clearly stating that the Subsidiary is a separate entity from the Bank and the obligations of the Subsidiary are not obligations of the Bank; (3) not have the same name as its parent Bank, and if the Subsidiary has a name similar to its parent Bank, to take appropriate steps to minimize the risk of customer confusion, including clarifying the separate character of the two entities and the extent to which their respective obligations are insured or not insured by the FDIC; (4) maintain separate accounting and corporate records; (5) conduct its operations pursuant to independent policies and procedures that are also intended to inform customers that the Subsidiary is an organization separate from the Bank; (6) contract with the Bank for any services only on terms and conditions substantially comparable to those available to or from independent entities; (7) observe appropriate separate corporate formalities, such as separate board of directors’ meetings; (8) maintain a board of directors at least one-third of whom shall not be directors of the Bank and shall have relevant expertise capable of overseeing the Subsidiary’s activities; and (9) have internal controls appropriate to manage the financial and operational risks associated with the Subsidiary. These internal controls must also be maintained by the Bank.

In addition to these limitations, section 5.34(f) requires that the Subsidiary be adequately capitalized according to relevant industry measures and maintain capital adequate to support its

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68 The Federal Reserve has previously determined that municipal revenue bond underwriting and dealing is “substantially similar to operations safely and soundly being conducted presently by member banks [and] would not result in significant or excessive risk.” See Citicorp, J.P. Morgan & Co. Incorporated/Bankers Trust Corporation, 73 Federal Reserve Bulletin 473, 493 (1987).

69 See 12 C.F.R. § 5.34(f)(2).
activities and to cover reasonably expected expenses and losses. When the Subsidiary is engaged in a principal capacity in activities authorized under section 5.34(f), as in this case, certain additional supervisory requirements will protect the financial soundness of the Bank. For example, section 5.34(f) provides that for purposes of determining a bank's regulatory capital adequacy, the bank must deduct from its capital and total assets equity investments made in an operating subsidiary engaged in an activity different from that permitted for the bank, and the subsidiary's assets and liabilities shall not be consolidated with those of the bank. For risk-based capital purposes, 50% of the equity investment is deducted from Tier 1 capital and 50% from Tier 2 capital. In addition, the OCC may require the Bank to calculate its capital on a consolidated basis for purposes of determining whether the Bank is adequately capitalized under 12 C.F.R. Part 6 (prompt corrective action). The regulation also provides that a national bank must be well-capitalized before commencement of the activity. The Bank clearly satisfies this requirement. If the Bank ceases to be well-capitalized for two consecutive quarters, it must submit a plan to the OCC detailing how it will become well-capitalized.

Moreover, transactions between the Bank and the Subsidiary will be subject to the limitations in sections 23A and 23B of the Federal Reserve Act. Under the regulation, the standards of sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c and 371c-1, are made applicable to transactions between a bank and a subsidiary engaged in activities different from those permitted for the bank. The application of these sections will limit the Bank's subsequent investments in and extensions of credit to the Subsidiary to 10% of the Bank's capital, require extensions of credit to be fully collateralized, and apply arm's-length safeguards to transactions between the Bank and the Subsidiary. The arm's-length standards also address concerns regarding inappropriate subsidization by the Bank of its Subsidiary.

In addition, in order to avoid customer confusion and minimize reputation risk in the Bank, the Subsidiary also will be required to provide each of its retail customers the same written and oral disclosures, and obtain the same customer acknowledgments, required by the Interagency Statement on Retail Sales of Nondeposit Investment Products. Further, no Bank director, officer, or employee may express an opinion on the revenue bonds underwritten or dealt in by the Subsidiary unless he or she notifies the customer of the Subsidiary's role. The Bank also has committed to disclose its relationship with the Subsidiary to its customers when it acts as agent in the sale of securities underwritten or dealt in by the Subsidiary. Together, these disclosures minimize the risk that customers may confuse the activities and obligations of the Subsidiary with those of the Bank.

See 12 C.F.R. § 5.34(f)(3).


Federal legislation in recent years also has provided the federal banking agencies with additional supervisory tools to address promptly supervisory concerns that may arise in connection with activities engaged in by banks or their subsidiaries. For example, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 provided substantial civil money penalties for national banks engaging in unsafe and unsound banking practices or for
C. Supervision of Subsidiary

The Subsidiary will be subject to comprehensive supervision and functional regulation by securities regulatory authorities. The OCC, as the primary federal banking regulator, will be responsible for ensuring the safe and sound operation of the Bank and full compliance with the regulatory and supervisory conditions applicable to the Bank and the Subsidiary. The OCC has extensive experience and expertise in supervising national banks involved in underwriting, dealing and investing in government securities. Moreover, it is uniquely qualified to assess whether the activities are conducted in a safe and sound manner without undue risk to the Bank.

In addition, the Subsidiary will be subject to functional regulation under the Federal securities laws. In particular, the Subsidiary is registered with the SEC as a broker-dealer and will be subject to financial reporting, anti-fraud and financial responsibility rules applicable to broker-dealers. The Subsidiary must comply with the SEC's net capital rule, which imposes capital requirements on broker-dealers that vary with the degree to which a broker-dealer acts as a principal. The Bank represents that the Subsidiary will maintain capital in excess of these requirements. The Subsidiary also will be subject to the rules and regulations of the NASD and

violations of conditions imposed in writing in connection with the grant of an application or other request by a national bank. Likewise, the Federal Deposit Insurance Corporation Improvement Act of 1991 (Pub. L. 102-242, Dec. 19, 1991, 105 Stat. 2236), established a framework for prompt corrective action when banks fail to meet specified capital requirements, including the ability of the OCC to require an undercapitalized institution to divest any subsidiary that may pose a significant risk to the parent bank or that is likely to cause a significant dissipation of the institution's assets or earnings. These and other available supervisory actions provide the OCC with a substantial array of tools -- not available until relatively recently -- to address risks presented by national bank operating subsidiaries.

When the OCC proposed revisions to its regulation governing operating subsidiaries, the Securities and Exchange Commission did not object, but requested OCC confirmation that: (1) securities activities conducted in operating subsidiaries would be subject to regulation under the Federal securities laws, and (2) the OCC's regulation would not allow activities previously not permitted for a bank itself to be shifted from an operating subsidiary to the bank. In the final rule, the OCC confirmed that operating subsidiaries that conduct securities activities are fully subject to the Federal securities laws and that the new rule would not be used to authorize national banks to directly conduct activities not previously permitted for national banks. See 61 FEDERAL REGISTER at 60351, n. 1.

In its comment letter, the SEC expressed concern that aspects of the Bank's proposal may not comply with certain regulatory requirements under the Securities Exchange Act of 1934. The Bank and the Subsidiary have committed to comply with all applicable federal securities laws and regulations, including the SEC's financial responsibility regulations. The OCC notes that the Subsidiary must notify and obtain the approval of the NASD prior to commencing the proposed activities. Through that process, the NASD reviews the proposal to assure compliance with the federal securities laws. Another concern expressed by the SEC related to the extent to which securities regulatory and self-regulatory authorities will be able to supervise the Subsidiary and to examine, investigate and, if necessary, discipline the Bank for activities related to the Subsidiary's operation. As noted at the outset of this section, the Subsidiary will be subject to full functional regulation under the federal securities laws, and the SEC does have the authority to examine, investigate, and, if necessary, discipline the Bank for activities in connection with the Subsidiary's revenue bond activities. The OCC will, of course, cooperate with the SEC and appropriate self-regulatory authorities in connection with their oversight of the Subsidiary and any connected activities of the Bank.
D. Safety and Soundness Conditions

As detailed above, the Subsidiary and the Bank also are subject to a number of conditions and safeguards pursuant to 12 C.F.R. § 5.34(f). That section imposes numerous safeguards that apply to the parent bank and/or the subsidiary when the subsidiary engages in an activity authorized under 12 C.F.R. § 5.34(d), but different from that permitted for the bank. Collectively, these conditions will help to contain risk, reduce potential conflicts of interest, and ensure the safe and sound operation of the parent bank and the subsidiary.

In addition, the OCC recognizes that particular activities may give rise to the need for particular safeguards and conditions that are tailored to the activity in question. Accordingly, the OCC has included a number of conditions designed to further minimize the risk of securities underwriting and dealing to the Bank, its customers and the Subsidiary. For example, the Bank is required to establish internal controls to govern its participation in transactions underwritten or arranged by the Subsidiary. In addition, all intra-day extensions of credit by the Bank to the Subsidiary must be consistent with Section 23B of the Federal Reserve Act.

Other supervisory conditions are intended to protect consumers and address potential conflicts of interest. For example, the Bank is prohibited from lending to customers for the purpose of buying securities underwritten by the Subsidiary during the underwriting period. In addition, the Subsidiary is required to make the disclosures required under the Interagency Statement on Nondeposit Investment Products to ensure that customers of the Subsidiary do not confuse the Subsidiary with the Bank. Bank employees, officers and directors are also prohibited from expressing opinions about securities underwritten by the Subsidiary unless the customer is notified that the Subsidiary is the underwriter.

Several of these conditions are patterned after the Federal Reserve's new operating standards applicable to section 20 subsidiaries engaged in underwriting and dealing in securities. The Federal Reserve recently eliminated many of the conditions it formerly applied to section 20 subsidiaries engaged in underwriting and dealing and consolidated the remaining restrictions in a series of operating standards. These new operating standards are tailored to address the risks of affiliation with an insured bank not addressed by other laws.

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75 See 62 FEDERAL REGISTER 45295 (August 27, 1997).

76 See, e.g., 12 C.F.R. § 5.34(f)(2)(iii) and (iv). Standards identical to the Federal Reserve's operating standards already apply to operating subsidiaries of national banks as a result of the conditions and requirements set forth in 12 C.F.R. § 5.34(f). Section 5.34(f) also contains certain requirements that exceed those contained in the new operating standards. For example, a bank that owns a subsidiary engaged in an activity as principal must be well-capitalized both before and after the activity commences and must have a CAMEL rating of "1" or "2," a CRA rating of "Outstanding" or "Satisfactory," and must not be subject to a cease and desist order, consent order, formal
The OCC will conduct a review of the Subsidiary prior to commencement of the proposed activities to ensure compliance with all supervisory conditions in the Application and the conditions set forth in 12 C.F.R. § 5.34(f).

V. ADDITIONAL REGULATORY AND POLICY REVIEWS

A. Bank Holding Company Act

As the administrator of national banks, the OCC has broad authority under 12 U.S.C. § 24(Seventh) to determine the permissible activities of national banks and their subsidiaries. One commenter asserts, however, that this authority does not extend to subsidiaries of banks that propose to engage in activities such as underwriting and dealing in securities. The commenter contends that the Bank Holding Company Act (“BHCA”) provides the exclusive means by which bank holding company affiliates, including subsidiaries of banks, can engage in such activities. Specifically, the commenter asserts that the Subsidiary must apply under section 4(c)(8) of the Bank Holding Company Act for approval from the Federal Reserve to engage in the proposed activities.

The courts have specifically held, however, that the BHCA does not govern the permissible activities of banks or their subsidiaries. In Independent Insurance Agents of America, Inc. v. Board of Governors of the Federal Reserve System, 890 F.2d 1275 (2d Cir. 1989) (Merchants II), cert. denied, 498 U.S. 810 (1990), the Second Circuit upheld a Federal Reserve Board order concluding that the BHCA’s activity restrictions did not apply to the activity of a bank subsidiary of a bank holding company.

written agreement, or prompt corrective action order. See 12 C.F.R. §§ 5.3(g) and 5.34(f)(3)(iii). In addition, the subsidiary must be adequately capitalized according to relevant industry measures and maintain capital adequate to support its activities and cover reasonably expected expenses. See 12 C.F.R. § 5.34(f)(2)(iv).

77 The commenter also contends that the OCC does not have authority under section 93a of the National Bank Act to permit a national bank to engage in ineligible securities activities through an operating subsidiary, because section 93a provides that the OCC may not issue rules and regulations concerning the securities activities of national banks under the Glass-Steagall Act. This Application would not confer authority on national banks (or their operating subsidiaries) that they do not have under existing law, however. As explained in this decision, the proposed activity is part of the business of banking under 12 U.S.C. §24(Seventh) and is allowed under section 20 of the Glass-Steagall Act. Section 93a is simply inapplicable, and the OCC is not prohibited by section 93a from approving the proposed transaction.

78 Section 4(c)(8) of the BHCA authorizes the Federal Reserve to approve the acquisition and retention by a bank holding company of shares of a company engaged in activities that are "so closely related to banking ... as to be a proper incident thereto." 12 U.S.C. §1843(c)(8).

79 The Eighth Circuit, in Norwest Bank Minnesota, N.A. v. Sween Corporation, et. al., 1997 U.S. App. LEXIS 16602 (8th Cir. 1997), recently followed the reasoning in Merchants II in a case involving a dispute between a national bank and a company advised by the bank. The company refused to pay the bank an agreed upon advisory fee for its services contending, among other things, that the bank could not collect the fee for its services because it
Shortly thereafter, in *Citicorp v. Board of Governors of the Federal Reserve System*, 936 F.2d 66 (2nd Cir. 1991), *cert. denied*, 502 U.S. 1031 (1992), the same court vacated a Federal Reserve Board order that required a state bank owned by a bank holding company to terminate certain activities conducted through the state bank’s subsidiary. The court applied the reasoning of *Merchants II*, concluding that “once the BHCA has been construed to leave the regulation of a holding company’s subsidiary banks to their chartering authorities, the Act cannot sensibly be interpreted to reimpose the authority of the Fed on a generation-skipping basis to regulate the subsidiary’s subsidiary.”

It therefore held that the BHCA does not extend to the subsidiary of a holding company’s bank subsidiary. The activities of the bank’s subsidiary in question were, according to the court, appropriately the responsibility of the bank’s chartering authority to address.

Accordingly, the Subsidiary is not required to obtain approval under section 4(c)(8) of the BHCA to engage in the proposed activities.

**B. Consumer Protection Issues**

In addition to the safeguards and conditions discussed above, the extensive regulatory scheme presently governing the Subsidiary’s and Bank’s municipal securities activities will provide additional protection for purchasers of the proposed general obligation securities and revenue bonds. The Subsidiary already has registered with the SEC as a broker-dealer and is a member of the NASD. Consequently, the Subsidiary’s brokerage activities are subject to federal securities law and NASDR and SEC oversight. As a registered broker-dealer, the Subsidiary’s underwriting of municipal securities and its sales of those securities also will be fully subject to federal securities law.

The Subsidiary’s employees who broker municipal securities products to retail customers are registered as General Securities Representatives with the NASDR pursuant to federal

did not have prior approval from the Federal Reserve under the BHCA to engage in advisory services. The court held that the BHCA, and the Federal Reserve’s regulation interpreting the BHCA (12 C.F.R. § 225.21(a)), do not apply to a bank subsidiary of a bank holding company.

80 *Citicorp v. Federal Reserve*, supra, at 68.

81 Although the case involved a state bank, the court’s reasoning would apply equally to national banks.

82 Furthermore, section (4)(c)(5) of the Bank Holding Company Act, 12 U.S.C. § 1843(c)(5), would expressly exempt the Bank’s operating subsidiary from any applicable restrictions in the BHCA. Section (4)(c)(5) provides that the investment restrictions contained in section 4 of the Act do not apply to “shares which are of the kinds and amounts eligible for investment by national banking associations under section 24 of the National Bank Act.” As explained in this decision, section 24 of the National Bank Act provides authority for national banks to invest in an operating subsidiary engaged in the business of banking. Thus, the plain language of the BHCA expressly preserves the authority of the Bank to own shares in the operating subsidiary as authorized in the National Bank Act.
securities law requirements. To be registered as a General Securities Representative, one must pass an examination that tests for adequate product and regulatory knowledge of the securities being recommended and sold.

Because banks are not “brokers” or “dealers” under the Exchange Act, and thus not subject to certain provisions of the federal securities laws, one commenter has stated that the Bank would avoid essential investor protection rules if the Bank, rather than the Subsidiary, sold the revenue bonds. However, the Bank’s municipal securities activities are subject to the same comprehensive regulatory scheme as other registered municipal securities dealers. That regulatory scheme affords the bank customers with important protections. While the Bank is not a general securities broker-dealer, the Bank is registered as a municipal securities dealer under the Exchange Act. Consequently, the Bank’s municipal securities activities are subject to the rules of the MSRB.

These rules include extensive consumer protection provisions, such as suitability requirements (MSRB Rule G-19), price and commission limits (MSRB Rule G-30), disclosures in connection with new issues (MSRB Rule G-32), employee qualification requirements (MSRB Rules G-2 and G-3), and recordkeeping requirements (MSRB Rule G-8). In addition, the Bank’s securities activities are subject to federal securities law antifraud provisions.

V. CONCLUSION

For the reasons set forth above, including the representations and commitments made by the Bank and the Subsidiary and their representatives, we find that the proposed expansion of activities in the Subsidiary is legally authorized. Accordingly, this Application is hereby approved

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84 See Series 7 Examination.

85 See Section 3(a)(4) and (5) of the Exchange Act, 15 U.S.C. § 78c(a)(4) and (5).

86 The Bank is also a registered government securities dealer, subjecting the Bank to an additional, parallel regulatory scheme. See Sections 3(a)(44) and 15C of the Exchange Act, 15 U.S.C. §§ 78c(a)(44) and 78o-5.


88 See MSRB Rule G-1 (defines a “separately identifiable department or division of a bank” and the municipal securities dealer activities that must take place there).

89 See Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5.
subject to the following conditions which shall be applicable to the Bank and the Subsidiary, as
indicated, in addition to the conditions and requirements set forth in 12 C.F.R. § 5.34(f):

1. The Bank shall adopt policies and procedures, including appropriate limits on exposure, to
govern its participation in transactions underwritten or arranged by the Subsidiary. The Bank shall ensure that an independent and thorough credit evaluation has been undertaken in connection with its participation in such transactions, and that adequate documentation of that evaluation is maintained for review by the OCC.

2. The Subsidiary shall provide each of its retail customers the same written and oral
disclosures, and obtain the same customer acknowledgments, specified by the Interagency
Statement on Retail Sales of Nondeposit Investment Products.

3. A director, officer, or employee of the Bank may not express an opinion on the value or the advisability of the purchase or the sale of a bank-ineligible security that he or she knows is being underwritten or dealt in by the Subsidiary unless he or she notifies the customer of the Subsidiary’s role.

4. The Bank shall not knowingly extend credit to a customer secured by, or for the purpose of purchasing, any bank-ineligible revenue bond that the Subsidiary is underwriting or has underwritten within the past 30 days, unless: (i) the extension of credit is made pursuant to, and consistent with any conditions imposed in a preexisting line of credit that was not established in contemplation of the underwriting; or (ii) the extension of credit is made in connection with clearing transactions for the Subsidiary.

5. Any intra-day extension of credit by the Bank to the Subsidiary shall be on market terms consistent with section 23B of the Federal Reserve Act.

6. The Bank and the Subsidiary shall submit quarterly to the OCC any FOCUS report filed with the NASD or other self-regulatory organizations, and any additional information required by the OCC to monitor compliance with the representations and commitments made by the Bank and the Subsidiary, these conditions, and the conditions provided in 12 C.F.R. § 5.34(f).

7. In the event that the Subsidiary is required to furnish notice concerning its capitalization to the SEC pursuant to 17 C.F.R. § 240.17a-11, a copy of the notice shall be filed concurrently with the OCC.

8. The Subsidiary’s gross revenues derived from underwriting and dealing in revenue bonds shall not exceed 25% of its total gross revenues.
9. Prior to commencing the proposed activity, the OCC will conduct a review of the Subsidiary. Any deficiencies disclosed during this review must be satisfactorily resolved prior to commencing the activity. The Bank should notify its EIC to schedule the review.

Please be advised that all conditions of this approval are "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. § 1818.

Julie L. Williams
Chief Counsel

Application Control Number: 97-WO-08-0003

Date: 12-11-97
Date
Press Release

Release Date: December 18, 1997

For immediate release

The Federal Reserve Board today requested comment on proposed comprehensive revisions to its Regulation K governing international banking operations.

The proposals are intended to improve the international competitiveness of U.S. banking organizations by expanding permissible activities abroad and reducing regulatory burden associated with the conduct of such activities.

The Board also requested comment on proposed revisions to Regulation K that are intended to reduce regulatory burden on foreign banks operating in the United States by streamlining the application and notice process.

Comment is requested by March 14, 1998.

The proposed revisions include:

• expansion of authority for U.S. banking organizations to engage in equity securities underwriting and dealing outside the United States;

• relaxation of limits on the ability of U.S. banking organizations to make venture capital investments in non-bank organizations outside the United States;

• a streamlined and expedited review process for U.S. banking organizations to branch abroad, and for foreign banking organizations to establish offices in the United States;

• expedited review of proposals by well-run U.S. banking organizations to make investments abroad;

• increased flexibility in the standard for determining whether a foreign banking organization would qualify for certain nonbanking exemptions from the Bank Holding Company Act;

• implementation of statutory changes with respect to increased investments by U.S. banks in Edge corporation subsidiaries and the interstate operations of foreign banks operating in the United States; and

• other changes to eliminate unnecessary regulatory burden and to streamline and modernize Regulation K.

I - 85
IN HOUSE

1998 REGULAR SESSION

HOUSE BILL NO. 429

AN ACT relating to insurance.
Amend KRS 287.030 to provide that Kentucky-chartered banks or their subsidiaries are specifically authorized to engage in the sale of non-credit-related insurance; delete provision that prohibits a person who owns or acquires more than one-half of the capital stock of a bank from acting as an insurance agent or broker; create a new section of Subtitle 9 of KRS Chapter 304, the insurance code, to establish requirements to be met by financial institutions authorized to engage in insurance agency activities; prohibit an officer or employee of a financial institution from delaying or impeding completion of a loan transaction for the purpose of influencing a consumer’s selection or purchase of any insurance; establish standards for compensating an employee of a financial institution for referral of a consumer to a licensed person.

HB 429 - AMENDMENTS

HFA (1, J. Bruce) - Amend to allow banks to sell non-credit related insurance.
HFA (2, P. Hatcher Jr) - Allow an employee of a general agency to receive compensation for referral of a consumer to a licensed person.
SCA (1, D. Seum) - Amend definition of “financial institution”.

Jan 27-introduced in House
Jan 28-to Banking and Insurance (H); posted in committee
Feb 5-reported favorably, 1st reading, to Calendar
Feb 6-2nd reading, to Rules
Feb 10-posted for passage in the Regular Orders of the Day for February 11, 1998; floor amendment (1) filed
Feb 11-floor amendment (2) filed
Feb 19-3rd reading, passed 89-0 with Floor Amendments (1) and (2)
Feb 20-received in Senate
Feb 23-to Banking and Insurance (S)
Mar 4-reported favorably, 1st reading, to Consent Calendar with Committee Amendment (1)
Mar 5-2nd reading, to Rules
Mar 13-3rd reading, passed 37-0 with committee amendment (1)
Mar 16-received in House; posted for passage for concurrence in Senate amendment
Mar 24-House concurred in Senate committee amendment (1); passed 95-1
Mar 25-enrolled, signed by each presiding officer, delivered to Governor

Includes all legislative and executive action through March 31, 1998
AN ACT relating to insurance.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 287.030 is amended to read as follows:

(1) As used in this section, "person" includes a natural person, partnership, corporation, association, business trust, voting trust, or similar organization.

(2) No persons, except corporations, shall engage in the business of private banking in this state.

(3) No bank incorporated under the laws of another state or national bank having its principal place of business outside this state shall transact any banking business in this state except to lend money, unless specifically authorized by law or administrative regulation, or except as permitted following a merger transaction within the meaning of Section 44 of the Federal Deposit Insurance Act pursuant to 12 U.S.C. sec. 1811 et seq., approved after June 1, 1997.

(4) Kentucky chartered banks, or their subsidiaries, are specifically authorized to engage in the sale of [No person who after July 13, 1984, owns or acquires more than one half (1/2) of the capital stock of a bank shall act as insurance agent or broker with respect to any insurance except credit life insurance, credit health insurance, insurance of the interest of a real property mortgagee in mortgaged property, other than title insurance.

(5) No bank incorporated under the laws of the Commonwealth of Kentucky shall make any loan or discount on the security of the shares of its own capital stock, or the shares of stock of a bank holding company which controls the bank to the extent that such loan or discount secured by such shares exceeds the amounts permitted by Section 23(A) of the Federal Reserve Act (12 U.S.C. sec. 371c) as that section reads on July 15, 1986, nor be the purchaser or holder of any such shares, except that a bank may take property of any kind to satisfy or protect a loan previously made in good faith and in the ordinary course of business; and stock so purchased or
acquired, shall, within six (6) months from the time of its purchase or acquisition, be sold or disposed of at public or private sale. This subsection shall not affect or modify in any way KRS 386.025, but said section shall remain in full force and effect.

SECTION 2. A NEW SECTION OF KRS CHAPTER 304 IS CREATED TO READ AS FOLLOWS:

(1) As used in this section:

(a) "Financial institution" means a bank or bank holding company as defined in the Bank Holding Company Act of 1956, as amended, 12 U.S.C. sec. 1841, a savings bank, savings and loan association, trust company, or any depository institution as defined by the Federal Deposit Insurance Act in 12 U.S.C. sec. 1813(c)(1), any affiliate or subsidiary of any of the above, and any other individual, corporation, partnership, or association authorized to take deposits and make loans in the Commonwealth;

(b) "Insurance agency activities" means any activity relating to insurance other than credit life insurance, credit health insurance, forced placed or voluntary credit property, credit involuntary unemployment insurance, or insurance of the interest of a real property mortgagee in mortgaged property, other than title insurance, for which a license as agent, solicitor, broker, or consultant is required under this chapter; and

(c) "Insurance information" means any information provided by a consumer in order to obtain insurance.

(2) A financial institution authorized by law to engage in insurance agency activities in this state shall, in addition to any other applicable requirements, comply with the following requirements:

(a) The financial institution or officer, agent, representative, or employee thereof shall qualify for licensure under all applicable provisions of this
chapter and abide by all applicable provisions of this chapter and applicable
administrative regulations;

(b) A financial institution shall provide a written statement, signed or initialed
by the consumer, to evidence compliance with KRS 304.12-150;

(c) If the consumer voluntarily discloses or authorizes, in a written statement
that is signed or initialed by the consumer, the disclosure of insurance
information about the consumer to any person, the statement shall be an
acknowledgment that the disclosure is not to the detriment of the consumer;
and

(d) A financial institution licensed by the department to engage in insurance
agency activities shall:

1. Not violate the anti-tying provisions of the Bank Holding Company
   Act, 12 U.S.C. sec. 1971 et seq. in effect as of December 31, 1997; and

2. Notify the department in writing within ten (10) days of any final
   judgment or any final administrative action, by a federal agency
   authorized to enforce the anti-tying provision, that finds that the
   financial institution or any of its employees committed a violation of
   the Bank Holding Company Act. Any such final and unappealable
   judgment or final and unappealable administrative action shall be
   deemed a violation of this chapter;

(e) Prior to the sale of any policy of insurance to a consumer, a financial
   institution shall provide to the consumer a written statement, signed or
   initialed by the consumer, that:

1. The insurance offered by the financial institution is not a deposit;

2. The insurance offered by the financial institution is not insured by the
   Federal Deposit Insurance Corporation or other government agency
   that insures deposits;
3. The insurance offered by the financial institution is not guaranteed by the financial institution;

4. The insurance is optional or, if required, may be purchased from any insurance agent or insurer selected by the consumer if that agent or insurer provides the same or equivalent coverage; and

5. By not purchasing the insurance if it is optional, or by purchasing the insurance from another insurance agent or insurer if the insurance is required, will not in any way affect current or future credit decisions; and

(f) The commissioner shall promulgate administrative regulations in accordance with KRS Chapter 13A that specify the disclosure forms required by subsections (b), (c), and (e) of this section.

(3) An officer or employee of a financial institution shall not directly or indirectly delay or impede the completion of a loan transaction or any other transaction with a financial institution for the purpose of influencing a consumer's selection or purchase of any insurance.

(4) An employee of a financial institution may receive compensation for the referral of a consumer, who seeks information about or wishes to purchase any insurance product, to a licensed person or for the provision of the telephone number of a licensed person who sells or provides information on the product only if:

(a) The employee receives the referral fee regardless of whether insurance coverage is sold;

(b) The referral compensation is a fixed amount;

(c) The referral compensation is a portion of a financial institution's program offering referral fees for other noninsurance products or services marketed by the financial institution; and

(d) The referral compensation is paid by the financial institution.
(5) All financial institutions not insured by the Federal Deposit Insurance Corporation or other government agency that insures deposits are not required to comply with subsection (2)(c) of this section.

SECTION 3. A NEW SECTION OF SUBTITLE 9 OF KRS CHAPTER 304 IS CREATED TO READ AS FOLLOWS:

An employee of a general agency may receive compensation for the referral of a consumer, who seeks information about or wishes to purchase any insurance product, to a licensed person or for the provision of the telephone number of a licensed person who sells or provides information on the product only if:

(1) The employee receives the referral fee regardless of whether insurance coverage is sold;

(2) The referral compensation is a fixed amount; and

(3) The referral compensation is paid by the general agency.
Sec. 1. Short Title; Table of Contents. “Financial Services Act of 1998”.

TITLE I—FACILITATING AFFILIATIONS AMONG SECURITIES FIRMS, INSURANCE COMPANIES, AND DEPOSITORY INSTITUTIONS

Subtitle A—Affiliations


Sec. 103. Financial Holding Companies. Creates and sets standards for “financial holding companies” defined as bank holding companies that meet solvency, Community Reinvestment Act (CRA), and other requirements. Such an entity becomes a “financial holding company.” [In the version of H.R. 10 adopted by the House Committee on Commerce on 30 October 1997 (referred to as “Commerce version”), such an entity was a “qualified bank holding company.”] The Federal Reserve (Fed) will determine whether an activity is financial in nature or incidental to financial. Financial holding companies and Fed-supervised wholesale financial holding companies are allowed to engage in financial or incidental-to-financial activities.

Insurance underwriting and sales should be treated as financial in nature. The non-financial activities of financial holding companies will be “grandfathered” if the bank holding company is predominately financial (at least 85% of consolidated revenues in financial or incidental-to-financial activities” and had been engaging in such activities before 9-30-97. Designed to allow affiliations among financial institutions (banks, insurance companies, and securities firms) and limited affiliations with non-financial or commercial institutions. For the most part, financial holding companies can earn only 5% of revenues from affiliates in non-financial commercial businesses. The grandfather clause applies to insurance and securities companies that already have non-financial interests. Such firms can earn up to 15% of revenue from commercial affiliations as long as the firms remained structured as financial holding companies. [The 15% level for commercial affiliations of insurance and securities firms would probably cover every current combination except Berkshire-Hathaway and General Electric Corp. Not clear if divestiture would be required as the proposed substitute does not specify actions to be taken for those entities whose commercial affiliations exceed the 15% level.] The Fed is designated as the regulator of financial holding companies.

Sec. 104. Certain State Affiliation Laws Preempted. [Significant changes from Commerce version.] Sec. 104(a) preempts state laws or regulations that “prevent or restrict” affiliations, even those that apply to state-chartered financial institutions. Significantly more expansive than the Supreme Court’s Barnett Bank decision that said state laws may not “prevent or significantly interfere” with the insurance sales activities of national banks. The proposed substitute uses an
Illinois statute on bank insurance activities as a “safe harbor” for permissible state insurance regulation. Any state law “no more restrictive” than the Illinois statute would not be subject to OCC preemption. The Office of the Comptroller of the Currency (OCC) can challenge state laws and regulations that fall outside the “safe harbor,” but no presumption of preemption. (Sec. 307 would remove judicial deference for the OCC.) Also, the Barnett Bank standard, which applied only to insurance sales, now extended to underwriting activities. The NAIC, National Conference of State Legislatures, and the North American Securities Administrators Association believe that sec. 104(b)(1) is a much more expansive standard than Barnett Bank as the “prevent or restrict” language may apply to all state insurance regulatory and other state consumer protection activities. The proposed language would prohibit states from taking any action that would “prevent or restrict” a bank from engaging “directly or indirectly” in any insurance activity authorized by H.R. 10 or any other federal law. When read in conjunction with other provisions, this language could preempt states from regulating insurance underwriting activities, assuring the solvency of insurance entities, protecting consumers from fraud.

Subtitle B—Streamlining Supervision of Financial Holding Companies

Sec. 111. Streamlining Financial Holding Company Supervision. Requires the Fed to use exams of insurers conducted by states when examining the holding company, but the Fed may conduct its own exams of subsidiaries of financial holding companies. May allow states continued ability to regulate transactions within the holding company system that affect insurers. The Fed shall not impose capital standards on subsidiaries of financial holding companies, including insurers, that comply with capital requirements set by state insurance authorities or other federal regulators, including the Securities and Exchange Commission (SEC). The Fed shall defer to state insurance regulators regarding “all interpretations of, and the enforcement of, applicable State insurance laws relating to the activities, conduct, and operations of insurance companies and insurance agents.”

Sec. 113. Authority of State Insurance Regulator and Securities and Exchange Commission. The Fed cannot require a financial holding company to provide funds or assets for a subsidiary insured depository institution if state insurance regulator writes to Fed about the “material adverse effect on the financial condition of the insurance company.” The Fed shall “promptly notify” state insurance regulator if Fed plans to require financial holding company or an affiliate of a financial holding company to provide funds or assets to an insured depository institution subsidiary. If the Fed receives such notice, the Fed may order financial holding company to divest insured depository institution within 180 days.

Sec. 114. Prudential Safeguards. The Fed may impose restrictions or requirements on relationships or transactions between depository institution subsidiary of financial holding company and any affiliate or such depository institution.

Sec. 116. Limitation on Rulemaking, Prudential, Supervisory, and Enforcement Authority of the Board. Fed may not act against “regulated subsidiary” of financial holding company, including an insurance company or agency subject to state insurance supervision, unless necessary to prevent or redress unsafe practice or breach of fiduciary duty. Must pose material
risk to financial safety or affiliated depository institution or domestic or international payment system.

Subtitle C--Subsidiaries of National Banks

Sec. 121. Permissible Activities for Subsidiaries of National Banks. A subsidiary of a national bank may not engage in any activity in which the national bank may not engage directly. A national bank, if well-capitalized and well-managed, with a “satisfactory” CRA rating, may engage in general insurance agency activities with the Comptroller’s approval.

Subtitle D—Wholesale Financial Holding Companies; Wholesale Financial Institutions.

Sec. 131. Wholesale Financial Holding Companies Established. Establishes Fed oversight for wholesale financial holding companies. The Fed shall use “to the fullest extent possible” exams by state insurance regulators of subsidiaries of wholesale financial holding companies.

TITLE II--FUNCTIONAL REGULATION [Though the proposed substitute to H.R. 10 purports to be based on “functional regulation” of all financial services (as did the Commerce version), this title appears to pertain only to bank security activities and the relationship between banking and securities regulation. A separate title (Title III) largely addresses insurance issues.]

Subtitle D—Study

Sec. 241. Study of Methods to Inform Investors and Consumers of Uninsured Products. [Same as in Commerce version.] Requires the General Accounting Office to study the usefulness, costs, and benefits of a logo or seal to inform bank customers that they are purchasing a non-federally-insured security or insurance product.

TITLE III—INSURANCE

Subtitle A--State Regulation of Insurance

Sec. 301. State Regulation of the Business of Insurance. [Same as in Commerce version.] Reaffirms the McCarran-Ferguson Act.

Sec. 302. Mandatory Insurance Licensing Requirements. Requires appropriate state license, as required by state law, to provide insurance as principal or agent. Note: Unlike Commerce version, now subject to sec. 104 preemption.

Sec. 303. Functional Regulation of Insurance. All insurance sales activity “shall be functionally regulated” by states. [No definition of “functional regulation.”] Note: Unlike Commerce version, now subject to sec. 104 preemption.

Sec. 304. Insurance Underwriting in National Banks. [Same as in Commerce version.] National banks and subsidiaries of national banks cannot underwrite insurance except for
authorized products. A product is authorized if: (1) the Comptroller determined in writing that national banks may provide as principal or national banks were lawfully providing as principal as of 1-1-97; (2) no final judgment overturning Comptroller's determination; and (3) not title insurance or annuity contract where income subject to tax treatment under sec. 72 of the Internal Revenue Code (IRC). Added definition of "insurance." Products regulated as insurance as of 1-1-97 will continue in that manner. For future products (those offered after 1-1-97), classified as insurance if a state determines that it is insurance because the product "insures, guarantees, or indemnifies against liability, loss or life, loss of health, or loss through damage to or destruction of property." Includes list of types of insurance. Future products that are traditional bank products (deposit, loan, discount, letter of credit, other extension of credit, trust or other fiduciary service, qualified financial contract, or financial guaranty) are explicitly protected for banks, unless there is an insurance component and treated as life or property and casualty insurance under the IRC, which would then be regulated as insurance. Insurance also includes any annuity contract the income on which is treated under sec. 72 of the IRC.

Sec. 305. New Bank Agency Activities Only Through Acquisition of Existing Licensed Agents. [Same as in Commerce version.] If not providing insurance as an agent as of enactment, afterwards, national bank or subsidiary may only perform agency function by acquiring company licensed for not less than two years before acquisition.

Sec. 306. Title Insurance Activities of National Banks and Their Affiliates. [Same as in Commerce version.] National banks and subsidiaries may not engage in title activities after enactment unless engaged actively and lawfully before then. Parity provision provides that national banks and subsidiaries may sell title insurance in states where state-chartered banks may sell title insurance as of 1-1-97.

Sec. 307. Expedited and Equalized Dispute Resolution for Financial Regulators. Creates "expedited judicial determination" of any dispute between a state insurance commissioner and federal regulator regarding whether a product is insurance as defined in sec. 304 or whether federal law preempts state law or regulation. [Commerce version had defined "Federal financial regulator" as any federal banking agency and SEC]. Either regulator may bring case in appropriate U.S. Court of Appeals or U.S. Court of Appeals for the District of Columbia Circuit [not district courts], with court required to act within 60 days. Appeals as "soon as practicable" to U.S. Supreme Court. The courts shall decide on merits "without unequal deference." [Does not include injunctive relief against financial regulators or others as in Commerce version.]

Sec. 308. Consumer Protection Regulations. Amends Federal Deposit Insurance Act to require federal banking agencies jointly to develop regulations within one year pertaining to "retail sales, solicitations, advertising, or offers of any insurance product by any insured depository institution or wholesale financial institution or any person who is engaged in such activities at an office of the institution or on behalf of the institution." Federal banking agencies shall develop regulations after "consultation with the State insurance regulators." Shall include "anticoercion" rules prohibiting any practice leading a consumer to believe an extension of credit is conditional upon purchase of an insurance product or agreement by consumer not to obtain insurance from an unaffiliated entity. Shall include provisions on disclosures and advertising. Shall include
provisions deemed appropriate by federal banking agencies "to ensure that the routine acceptance of deposits and the making of loans is kept, to the extent practicable, physically segregated from insurance product activity." Modifies amendment added in Commerce version by Rep. Diana DeGette (D-Colo.) that would apply to insurance products sold by any insured depository institution or any affiliated person that discriminates against victims of domestic violence. Sense-of-the-Congress provision that the states should adopt laws at least as strict as the federal regulations [not the NAIC model acts] within 30 months. Defines "domestic violence" in similar fashion as NAIC model acts. Federal banking agencies shall jointly establish a consumer complaint mechanism. [Does not include state insurance departments in joint consumer complaint mechanism.] [No private right of action included.] Federal banking regulations shall not apply to sales by insured depository institution, wholesale financial institution, or affiliated person in states with "inconsistent" or "contrary" laws or regulations. [Not intended to limit state insurance authority, but development of federal banking regulations may be inconsistent with claim of functional regulation and reaffirmation of McCarran-Ferguson Act.]

Sec. 309. Certain State Affiliation Laws Preempted for Insurance Companies and Affiliates. [Same as in Commerce version.] States may not (1) "prevent or restrict" any insurer or affiliate from becoming a financial holding company or controlling an insured depository institution or (2) limit an insurer's assets invested in the securities of an insured depository institution except a state of domicile may limit such investment to "not less than 5 percent" of the insurer's admitted assets.

Subtitle B--Redomestication of Mutual Insurers [Entire subtitle appears to be same as Commerce version.]

Sec. 311. General Application. The version of H.R. 10 adopted by the House Committee on Banking and Financial Services (referred to as "Banking version") on 20 June 1997 applied only to mutual life insurers.] This subtitle only applies to a mutual insurer in a state that has not enacted a law with "reasonable terms and conditions" for reorganization of mutual insurers into mutual holding companies.

Sec. 312. Redomestication of Mutual Insurers. Allows a mutual insurer to transfer its domicile as a step in reorganizing. Sets a number of procedural requirements. No redomestication unless insurance regulator of new domicile determines there is approval by board of directors and policyholders; ownership or control by policyholders; and sale of stock in the former mutual insurer at "fair value as determined under State law." Sale of any stock or grant of any option to any officer, director, or employee of former company must be approved by state insurance regulator of new domicile. Contractual rights of policyholders must be preserved and adequate corporate governance to protect rights of shareholders developed. Insurance regulator of new domicile must approve reorganization as "fair and equitable to the policyholders."

Sec. 313. Effect on State Laws Restricting Redomestication. Preempts state laws that would impede, or act against any insurer or affiliate that plans to redomesticate or has redomesticated under this subtitle. Prohibits states from treating a redomesticating or redomesticated insurer
differently than other insurers in that state. Exempts redomesticating or redomesticated insurer from state laws prohibiting operations.


Sec. 315. Definitions. Defines: “court of competition jurisdiction,” “domicile,” “insurance licensee,” “institution,” “licensed state,” “mutual insurer,” “person,” “redomesticated insurer,” “redomesticating insurer,” “redomestication or transfer,” “state insurance regulator,” “State law,” “transferee domicile,” and “transferor domicile.”

Sec. 316. Effective Date. Effective upon enactment.

Subtitle C--National Association of Registered Agents and Brokers [Entire subtitle appears to be same as Commerce version.]

Sec. 321. State Flexibility in Multistate Licensing Reforms. Subtitle becomes effective three years after enactment unless a majority of states have enacted uniform laws and regulations on licensing or reciprocal laws and regulations for nonresident individuals and entities. Deemed to be uniform if States establish uniform criteria for integrity, personal qualifications, education, training, and experience of licensed insurance producers, uniform continuing education requirements, uniform ethics course requirements, uniform criteria to ensure that an insurance product “sold to a consumer is suitable and appropriate for the consumer based on financial information disclosed by the consumer,” and do not limit or condition producer’s activities because of residence or place of operations. Sets conditions for deeming States to have established required reciprocity. At end of three-year period, NAIC and chief insurance regulatory officials will determine whether required uniformity or reciprocity achieved. Appropriate U.S. district court shall have exclusive jurisdiction over challenge to that determination. If required uniformity or reciprocity no longer exists at any time, this subtitle takes effect within three years.


Sec. 323. Purpose. Mechanism for uniform licensing, appointment, continuing education, and other insurance producer sales qualification requirements and conditions on a multistate basis while preserving rights of states to license, supervise, and discipline insurance producers and prescribe and enforce consumer protection and unfair trade practice laws and regulations.

Sec. 324. Relationship to the Federal Government. NARAB is subject to NAIC supervision and oversight. Not an agency or instrumentality of the U.S.

Sec. 325. Membership. Any State-licensed producer is eligible for NARAB membership unless a State insurance regulator has suspended or revoked license in three-year period before membership application. NARAB shall have authority to establish membership criteria and may establish separate classes of membership, with separate criteria. NARAB membership entitles
members to receive license in each State in which requisite fee is paid. Renew membership on an annual basis. NARAB shall establish continuing education requirements comparable to or greater than in a majority of states. NARAB may examine members and suspend and revoke membership. NARAB shall establish office of consumer complaints.

Sec. 326. Board of Directors. NAIC shall appoint seven board members. Three members shall have “significant experience with the regulation of commercial lines of insurance in at least 1 of the 20 States in which the greatest total dollar amount of commercial-lines insurance is placed.” If NAIC has not acted within two years, initial board shall be seven state insurance regulators from states with greatest amount of commercial-lines insurance. Three-year term, with 1/3 appointed each year. If fewer than seven NAIC members participate, then NARAB established without NAIC oversight.

Sec. 327. Officers. Chair, vice chair, president, secretary, and treasurer, and other officers and assistant officers as necessary. Chair must be NAIC member.

Sec. 328. Bylaws, Rules, and Disciplinary Action. File bylaws with NAIC. Subject to public notice and opportunity to participate in public hearing.

Sec. 329. Assessments. NARAB may establish necessary application and membership fees. NAIC may assess NARAB for costs incurred.

Sec. 330. Functions of the NAIC. NAIC required to give appropriate notice and opportunity for hearing and for submission of views of interested parties. NAIC may examine and inspect NARAB. NARAB shall provide written report to NAIC after each fiscal year, which shall be submitted to President and Congress. [In Banking version, the proposed National Council on Financial Services had oversight responsibility. In Commerce version, NAIC supervises.]

Sec. 331. Liability of the Association and the Directors, Officers, and Employees of the Association. NARAB shall not be treated under State law as insurer or insurance producer. No liability for actions taken or omitted in good faith.

Sec. 332. Elimination of NAIC Oversight. If two years after effective date, NAIC has not acted, NARAB shall be established without NAIC oversight. President, with advice and consent of U.S. Senate, shall appoint board from list recommended by NAIC. If no advice from NAIC, President appoints. [Suggests that NARAB would be an independent federal agency, if no NAIC participation.]

Sec. 333. Relationship to State Law. Certain State laws are preempted that discriminate against NARAB members based on non-residency or impose additional licensing requirements on non-resident NARAB members. No preemption of state unfair trade practices and consumer protection laws.

Sec. 334. Coordination With Other Regulators. NARAB shall have authority to issue uniform insurance producer applications and renewal applications, establish central clearinghouse, and
establish or use national database for collecting regulatory information. NARAB shall coordinate with National Association of Securities Dealers.

Sec. 335. Judicial Review. Appropriate U.S. district court shall have exclusive jurisdiction. Aggrieved persons must exhaust all administrative remedies before NARAB and NAIC.

Sec. 336. Definitions. Defines: “insurance,” “insurance producer,” “State law,” “State,” and “home State.” For this subtitle only, “insurance” is “any product defined or regulated as insurance by the appropriate state insurance regulatory authority.”

TITLE IV--MERGER OF BANK AND THRIFT HOLDING COMPANIES, REGULATORS, AND BANKING AND THRIFT INSURANCE FUNDS [Consolidates the Office of Thrift Supervision, the federal regulator of federally-chartered savings institutions, in the OCC. Combines the Bank Insurance Fund and the Savings Association Insurance Fund. (A separate deposit insurance fund would remain for credit unions.) Thrifts would have to place 10% of assets in home mortgages. The Fed would regulate unitary thrift holding companies, which are holding companies with one savings-and-loan subsidiary. Unitary thrift holding companies would have broad power, including affiliation with commercial entities. No unitary thrift charters would be granted for applications after 9-16-97.]

Sec. 412. Savings and Loan Holding Companies. Grandfather provisions for savings associations as of 9-16-97 that convert to national or State-chartered banks. [Presumably would include insurance-related powers.]
SEC. 104. CERTAIN STATE LAWS PREEMPTED.

(a) AFFILIATIONS.—No State may by statute, regulation, order, interpretation, or otherwise, prevent or restrict an insured depository institution or a wholesale financial institution from being affiliated with an entity (including an entity engaged in insurance activities) as authorized by this Act or any other provision of Federal law.

(b) ACTIVITIES.

(1) Except as provided in paragraphs (2) and (3) and subject to section 18(c) of the Securities Act of 1933, no State may by statute, regulation, order, interpretation, or otherwise, prevent or restrict an insured depository institution or a wholesale financial institution from engaging, directly or indirectly or in conjunction with an affiliate, in any activity authorized under this Act or any other provision of Federal law.

(2) As stated by the United States Supreme Court in Barnett Bank of Marion County, N.A. v. Nelson, 116 S.Ct. 1103 (1996), no State may, by statute, regulation, order, interpretation, or otherwise, prevent or significantly interfere with the ability of an insured depository institution or wholesale financial institution to engage, directly or indirectly, or in conjunction with an affiliate, in any activity authorized under this Act or any other provision of Federal law.

(A) State statutes and regulations governing insurance sales and solicitations which are no more restrictive than provisions in the Illinois "Act Authorizing and Regulating the Sale of Insurance by Financial Institutions, Public Act 90-41" (215 ILCS 5/1400-1416), as in effect on October 1, 1997, shall not be deemed to prevent or significantly interfere with the ability of an insured depository institution or wholesale financial institution to engage, directly or indirectly, or in conjunction with an affiliate, in any insurance sales or solicitation activity;

(B) subparagraph (A) shall not create any inference regarding State statutes, and regulations governing insurance sales and solicitations which are more restrictive than any provision in the Illinois "Act Authorizing and Regulating the Sale of Insurance by Financial Institutions", (Public Act 90-41; 215 ILCS 5/1400-1416), as in effect on October 1, 1997.

(3) State statutes, regulations, orders, and interpretations which are applicable to and are applied in the same manner with respect to insurance underwriting activities of an affiliate of an insured depository institution or a wholesale financial institution as they are applicable to and are applied to an insurance underwriter which is not affiliated with an insured depository institution or a wholesale financial institution shall not be preempted under paragraph (1).
Kentucky Statutory and Regulatory License Requirements
For Persons Accepting Insurance Commissions

-- Kentucky Revised Statutes 304.9-421 --
-- Kentucky Department of Insurance Bulletin --

304.9-421. Sharing of commissions prohibited.
No agent, solicitor, consultant, adjuster, or surplus lines broker shall
directly or indirectly share his commission or other compensation received
or to be received on account of a transaction under his license with any
person not also licensed as agent, solicitor, consultant, adjuster, or surplus
lines broker under this subtitle as to the kinds of insurance involved in the
transaction. This provision shall not affect personal use of such commissions
or compensation, payment of the regular salaries due employees of the
agent, consultant, adjuster, or surplus lines broker, or distribution in the
regular course of business of compensation and profits among members or
stockholders of licensee firms or corporations.
(Enact. Acts 1984, ch. 322, § 9, effective July 13, 1984.)
The Department has investigated several complaints recently involving persons acting as agents without being licensed as such. The Department would like to re-emphasize what it considers to be acting as an agent, requiring the appropriate license.

KRS 304.9-020 defines an agent as:

An "agent" is an individual, firm or corporation appointed by an insurer to solicit applications for insurance or annuity contracts or to negotiate insurance or annuity contracts on its behalf, and if authorized to do so by the insurer, to effectuate and countersign insurance contracts.

Also, Attorney General Opinion, 1956 OAG 38.760 concluded an automobile dealership that ". . . aids and assists prospective purchasers in the selection of insurance and filling out applications of insurance, and further who for the finance factor or insurer secures the payment of insurance premiums or charges, and (either directly or indirectly remits same to the finance factor or insurer) . . ." was acting as an agent.

KRS 304.9-090 provides exceptions to the definition of an agent. The exceptions are as follows:

1. Salaried employees in the office of a general lines agent, which employees devote full time to clerical and administrative services, with incidental taking of insurance applications and receiving premiums in the office of the employer agent if the employee does not receive any commissions on such applications and his compensation is not varied by the volume of applications or premiums taken or received by such employee;
(2) The supervising managing general agent (except as defined in KRS 304.9-085) or supervising officer or employee of an insurer who solicits only with duly licensed resident agents of the insurer;
(3) Newsboys and managers of newspaper distribution offices who incidentally take applications of so-called "newspaper accident insurance" and receive premiums in connection therewith;
(4) Employees or other representatives of a group policyholder engaged in enrolling certificate holders and performing other activities in the administration of the group policy.

The Department considers a person engaged in any of the following activities to be acting as an agent: 1) collecting or even holding premium in any manner; 2) explaining coverages or benefits to insureds or prospective insureds; 3) quoting rates; 4) actively seeking insureds for a particular insurer; or 5) taking/filling out applications. Anyone found to be engaging in one or more of the named activities is in violation of KRS 304.9-020, unless that person is excepted from the definition of an agent pursuant to KRS 304.9-090. Bulletin 86-11 clarifies the exception found in KRS 304.9-090(4). In that Bulletin the Department stated that the exception is a narrow one. A distinction was made between, "... the term 'enroll,' which means 'to register; to make a record; to enter on the rolls of a court; to transcribe (Black's Law Dictionary, 475, 5th ed. 1979) and solicitation which requires a discussion of the terms and conditions of the product with the prospective certificate holder." However, this Bulletin is only clarifying the definition of solicitation found in the statute. It should be noted that Bulletin 97-5 further explains the definition of solicitation found in Bulletin 86-11 and applies it to every instance not involving KRS 304.9-090(4). The definition of solicitation includes the five activities listed above.

If an insurer accepts insurance from a person violating KRS 304.9-020, the insurer is in violation of KRS 304.9-080(5); and the insurer is subject to a penalty pursuant to KRS 304.3-200 and 304.99-020.

An unlicensed person may refer someone who inquires about insurance to a licensed agent. However, if a referral fee is paid, the following conditions must be met: 1) the referral fee is paid regardless of whether insurance is sold; 2) the referral compensation is a fixed amount; 3) the referral fee is not directly or indirectly charged to the insured or prospective insured in any manner; and 4) the referral fee is part of a program offering referral fees for other noninsurance products or services. A referral fee not paid in the prescribed manner would constitute illegal sharing of commission and payment of commission to or receipt of commission by an unlicensed person in violation of KRS 304.9-421 and 304.9-425, respectively.

Please note that the Department is stepping up its investigation of unlicensed agent activity due to the increasing number of complaints.
OCCASIONAL BUSINESS

There have also been some questions raised concerning occasional business. KRS 304.9-410(1)(a) allows a general lines agent to, "[o]ccasionally place an insurance coverage with an insurer as to which he is not then appointed as an agent, and such insurer may accept such business only when placed through a licensed resident agent, of the insurer."

Similarly, KRS 304.9-410(2) provides:

A life or health insurance agent may, occasionally, place with another insurer as to which he is not licensed as agent, a particular risk or portion thereof which has been rejected by the insurers as to which the agent is licensed or is known to the agent to be unacceptable to such insurers, and without then being licensed as to such other insurer. (Emphasis added).

This exception to the appointment requirement is limited to risks which are unacceptable to all of the agent's companies. And it is only these unacceptable risks which the agent may occasionally place with companies with which the agent has no appointments.

806 KRS 9:200 defines what "occasionally" is pursuant to KRS 304.9-410(1)(a) and (2). 806 KAR 9:200 Section 2 (1) states, "A general lines agent shall not place insurance with a premium of more than twenty (20) percent of the agent's total premium for the preceding calendar year with insurers for which the agent holds no appointment."

Also, 806 KAR 9:200 Section 2(2) limits a life and health agent to placing no more than twenty (20) percent of the agent's total premium with insurers in which the agent does not hold appointments.

Any agent violating the 20% limit is subject to sanction pursuant to KRS 304.9-440(1)(b) and KRS 304.99-020(1).

This Bulletin has been issued industry-wide and is intended as notice to all insurers and agents that such practices will not be tolerated. Insurers are charged with notifying each of their appointed agents of this Departmental policy. Professional associations are charged with notifying their memberships. Any questions concerning these matters should be directed to Shaun T. Orme, Counsel for the Department.
Licensing Procedures For Insurance Agents In Kentucky

COMMONWEALTH OF KENTUCKY
LICENSING PROCEDURES AND INFORMATION
RESIDENT AGENTS

All licensing transactions are done through the sponsoring admitted companies. Generally, we correspond only with the insurer, and not the agent, if something is remiss in the submission of licensing forms. The sponsoring company should have for distribution all necessary forms for resident agents.

Applicant Information and Education
An applicant must be 18 years of age and have completed graduation requirements from high school or have a GED. Each applicant must have 40 hours of classroom instruction by an instructor approved by the Kentucky Department of Insurance for the lines of insurance they wish to sell. Our CPL-01 (Certificate of Pre-Licensing Course Completion) must be submitted with the License Application (form 8301).

First-Time Resident Agents
The sponsoring company sends form 8301 (Application), our Certificate of Pre-Licensing Course Completion (CPL-01), and the appropriate fees. Each exam carries a $50.00 fee. The licensing fees for a life and health agent would be $40.00 in odd years or $20.00 in even years. For a general lines agent the fee would be $20.00 in odd years, $40.00 in even years. This is done only after the applicant has had the 40 hours of Pre-Licensing education by a training school whose course(s) have been approved by the Kentucky Department of Insurance.

If all is in order, the applicant will receive a notice to sit for the exam. At that time, he must call the Department of Insurance at (502) 564-6005, to schedule an appointment for the exam. He has 120 days to take the exam no more than three (3) times. If he takes an exam and does not pass it, he must submit another $50.00 for the failed test along with our retake form (which will be included with results) and make another appointment. Please be advised that if an applicant schedules an appointment for an examination in a regional location and does not show for that examination, he will be required to take any future examinations in the Frankfort location. (This does not apply to cancellations prior to exam date).

ALL APPLICANTS MUST HAVE A YELLOW NOTICE TO TEST.
All test results are good for one year. The agent will receive his test scores as soon as he completes the exam. Once the exam has been passed, and providing the agent can furnish proof of financial responsibility, he will then be licensed with the sponsoring company submitting the Application (form 8301). The agent will receive his license at that time, also. The Department will send a notice to the sponsoring company advising the test scores and including the approved appointment, providing everything is in order.

Financial Responsibility
In order for an agent to be licensed as soon as he passes his exam(s), he will be required to show proof of financial responsibility in the form of either a $10,000 Errors and Omissions policy (form 99-1); a $10,000 Letter of Credit (form 99-2); a $10,000 Surety Bond (form 99-3); or, his company may assume the legal liability as long as he is an exclusive agent, and the company has filed the proper assumption (form 99-4). Although proof of financial responsibility does not have to be submitted in order to take the exam, it is to the agent's benefit if proof is submitted with the application or prior to testing, so that he may be licensed as soon as he passes the exam(s).

Continuing Education
Any resident Life, Health, Property, Casualty, or General Lines agent licensed after July 1, 1988, is subject to Continuing Education, as are Fraternals licensed on or after January 1, 1989. All agents licensed for HMO or Prepaid Dental after July 1, 1994, are also subject to continuing education requirements. If an agent's license has not been active for a period of more than 60 days, for any reason, they become subject to Continuing Education requirements upon reinstatement of the license. A requirement of 24 hours must be met by July 1 of each even year. No more than 12 hours of correspondence will be accepted. Only courses approved by the Kentucky Department of Insurance will be accepted as approved credit hours. Contact the Education Section (502-564-6144) for a list of approved providers and courses.

License Renewals
Renewals are done biennially through the insurers (sponsoring company). A list is mailed every other year to the designated companies with agent's names, addresses, and social security numbers shown. The company will indicate whether or not they wish to renew the agent and return the list to the Department of Insurance paying the biennial renewal fee for each agent renewed. Life and health are renewed on odd years, $40.00 for residents and $50.00 for non-residents. Property and casualty are renewed on even years, $40.00 for residents and $50.00 for non-residents.
Certification and Clearance Letters
Certification letters (needed to license a Kentucky resident agent as a non-resident agent in another state) and Clearance letters (needed to license a former Kentucky resident agent as a resident agent in another state) must be requested in writing with the agent's full name, social security number, type of request, and where the processed paperwork should be mailed. A self-addressed envelope would be appreciated. A check for $5.00 made payable to the "Kentucky State Treasurer" should be remitted for each letter requested.

Address Changes and Name Changes
Address changes should be submitted on form 8303 (Record Correction form). KRS 304.2-120 requires that an agent notify the Department of Insurance immediately, in writing, of any change in residence or business address. Agent is subject to a penalty of $1,000 for failure to do so.

Name changes should be submitted, in writing, with a copy of documentation approving the name change. In order to have a new license issued with the name change, a $5.00 fee is required with a written request. You should include your name, social security number, and return mailing address. A new license will then be mailed to the address you indicate.

* * * * *

Because there is so much involved in the licensing of an insurance agent, we suggest that a "Kentucky Insurance Laws and Regulations" be purchased for $30.00 through the Department of Insurance. This gives a better understanding of our laws and procedures as defined herein. If you have questions on any of the above information, you may contact the Agent Licensing Division at (502) 564-6004.
INDEPENDENT PRE-LICENSING TRAINING PROGRAMS
PROPERTY AND CASUALTY

CINCINNATI INS BOARD
315 W. Court
Cincinnati, OH 45202
(513) 621-0034
Alvarez, Beda E., Jr.
Dassel, F. Richard
Kelley, Martha E.
Ruscher, Cathleen B.
Schneider, Paul E.

PROFESSIONAL TRAINING
INSTITUTE
P. O. Box 6302
Evansville, IN 47719-0302
(812) 422-4068
Baker, Ronald Louis
Burden, Gary Lee

COMMONWEALTH SCHOOLS
OF INSURANCE, INC.
P. O. Box 22414
Louisville, KY 40252-0414
(502) 425-5987
Banet, Donald H.
Davis, Robert G.
Davis, James F.
Elder, Thomas M.
Gustafson, Alford V., Jr.
Harler, Gerald O.
Maynard, Billy R.
Meadows, Thomas H.
Moon, John M.
Osborne, Gerald D.
Sheffer, David H.

PROFESSIONAL INS.
AGENTS OF KENTUCKY
P. O. Box 4205 (40604-4205)
107 Consumer Lane (40601)
Frankfort, KY
(502) 875-3888
Birchfield, Harold W.
Brown, Jeffrey A.
Burkholder, John, III
Hall, Randy
Hammons, Gary
Hocker, David L.
Kroggel, Gerald N.
LaFavers, Mike
Meadows, Thomas
Murphy, Carolyn
Partin, Bobby R.
Phillips, Curt
Porter, Linda
Probus, James
Reindl, Jacklyn
Robertson, Ray A.
Smedley, Ron
Wheatley, Joseph L.
Wilkerson, James C.

EASTERN KY UNIVERSITY
(ONLY FULL SEMESTER COURSES)
College of Business
214 Combs Building
Richmond, KY 40475-0940
(606) 622-1579
Halloran, Michael R.
Kensicki, Peter R.

SOUTHEAST COMMUNITY COLLEGE
Office of Continuing Education
Chrisman Hall
Cumberland, KY 40823
(606) 589-2145
Welch, Raymond

INSURANCE SYSTEMS OF KY, INC
Approved for P & C (40 hrs.)
Property Instruction (40 hrs.)
Casualty Instruction (40 hrs.)
293 Plus Park Blvd. #201
Nashville, TN 37217
1 (800) 28 EXAMS
Hoek, Thomas V.
Kozich, Stan

THOROUGHBRED
INSURANCE SCHOOL
P. O. Box 436498
Louisville, KY 40253-6498
(502) 245-7841
Gustafson, Alford V., Jr.
COMMONWEALTH OF KENTUCKY
DEPARTMENT OF INSURANCE

INDEPENDENT PRE-LICENSING TRAINING PROGRAMS
LIFE AND HEALTH

ADLER INSURANCE SCHOOL
(Gives in-house training only)
8642 Running Fox Circle
Louisville, KY 40291
Phone: (502) 239-3867
Klein, John R.

AMERICAN ACADEMY
830 South Second Street
P. O. Box 648
Louisville, KY 40201
Shaw, Happy S.
Shaw, Irving H.
Shaw, Jonathan A.

AMERICAN MEDICAL SECURITY
1900 Embassy Square
Louisville, KY 40299
(317) 254-0489
Condon, Richard B.

CINCINNATI COLLEGE OF MORTUARY SCIENCE
645 W. North Bend Rd.
Cincinnati, OH 45224-1462
Phone: (513) 745-3631
Budd, William H.
Huxhold, David M.

CINCINNATI INSURANCE BOARD
2727 Madison Road, Suite 203
Cincinnati OH 45209
Phone: (513) 533-1200
Alvarez, Beda E., Jr.
Dassel, Fred R.
Schneider, Paul E.
Somers, Thomas J.

COMMONWEALTH SCHOOL OF INSURANCE, INC.
P. O. Box 22414
Louisville, KY 40252-0414
Phone: (502) 425-5987
Arbogast, Charles G.
Banet, Donald H.
Bauman, Ellen S.
Bucy, Terry B.
Burke, Michael Wayne
Calkins, Phillip D.
Davis, James F.
Davis, Robert G.
Elder, Thomas M.
Esham, Drennon C.
Harler, Gerald O.
Lax, Jerry L.
Lay, W. Sherman
Maynard, Billy R.
Medley, James W.
Moon, John M.
Newton, Mary S.
Osborne, Gerald D.
Schwartz, Max T.
Trammell, Sue M.
Williams, Carolyn

EASTERN KENTUCKY UNIVERSITY
(ONLY FULL SEMESTER COURSES)
Coates Box 25A
108 Miller Hall
Richmond, KY 40475-3101
Phone: (606) 622-1579
Hill, Bruce A.
Kensicki, Peter R.

EDUCATIONAL CENTERS
32969 Hamilton Ct., Suite G-100
Farmington Hills, MI 48334
Phone: (800) 626-6844
Witherington, Nancy J.
Witherington, Charles D.
FAMILY STYLE SCHOOL OF PROFESSIONAL LICENSING
7711 Beulah Church Rd.
Louisville, KY 40228
Phone: (502) 968-2241
Sellinger, William R.

INDEPENDENT INSURANCE AGENTS OF KENTUCKY
10221 Linn Station
Louisville, KY 40223
(502) 426-0610
Wilts, Keith

INSURANCE CAREER DEVELOPMENT
509 South English Station Road
Middletown, KY 40299
Phone: (502) 895-7145
Berry, Dott A.
Bowling, Lowell T.
Russell, Valerie M.
Thompson, Judy L.

INSURANCE SCHOOLS
5480 Big Tyler Rd, Ste 100
Charleston, WV 25356
(800) 333-3926
Bevins, Jimmy M.
Covington, Jacqueline
Dupay, Michael P.
Heller, Richard C.
Joslin, David Clark
McCoy, James A.
Schleiauf, Richard C.
Showalter, Charles Marc
Sullivan, Jamie Warner

KY ASSOC. LIFE UNDERWRITERS
1301 Clear Springs Trace
Louisville, KY 40223
Phone: (502) 425-8195
Carey, David
Harler, Gerald
Loving, Gail Ann
McNeil, Robert Jr.
Wimberly, Darrell L.

KY TECH - HARLAN CAMPUS
(formerly Cumberland Valley Vo-Tech)
21 Ball Park Rd.
Harlan, KY 40831-1796
Phone: (606) 575-1200
Boggs, Ernest

PROFESSIONAL TRAINING INSTITUTE
P. O. Box 6302
Evansville, IN 47719-0302
Phone: (812) 422-4068
Baker, Ronald L.
Burden, Gary L.
Pettys, Gregory S.

PROFESSIONAL INSURANCE AGENTS OF KENTUCKY
107 Consumer Lane
Frankfort, KY 40601
Phone: (502) 875-3888
Burkholder, III, John
McKinney, Tracy D.
Murphy, Carolyn E.
Partin, Bobby R.
Pope, Kenneth H.
Probus, James W.

SOUTHEAST COMMUNITY COLLEGE
Chrisman Hall
Office of Continuing Education
Cumberland, KY 40823
Phone: (606) 590-2145
Hillen, Rudolph C.
Welch, Raymond C., Jr.

WILLIS CORROON CORPORATION
(In-house training only)
Nashville, TN 37230-5148
Allen, John M.
Cowles, James L.
Davis, Joseph M.
Dowd, Anson M.

KENTUCKY TECH - CENTRAL CAMPUS
104 Vo-Tech Road
Lexington, KY 40510
Phone: (606) 255-8501
Kaufman, Ben
HELPFUL NUMBERS

DEPARTMENT OF INSURANCE
DIRECT NUMBER ............. (502) 564-3630

TOLL-FREE ................. 1-800-595-6053

AGENT LICENSING .......... (502) 564-6004

EXAMINATIONS ............. (502) 564-6005

CONTINUING ED ............ (502) 564-6144

INSURANCE FRAUD ........ (502) 564-1461
Insurance Licensing Procedures For Banks Under Kentucky Law

COMMONWEALTH OF KENTUCKY
DEPARTMENT OF INSURANCE

LICENSING A STATE OR NATIONAL BANK AS A CORPORATION

NON-CREDIT RELATED INSURANCE LICENSES FOR BANKS
A bank can obtain a corporate agent’s license if it meets the requirements set forth below.

LICENSE REQUIREMENTS
KRS 304.9-130. KRS 304.9-430.

1. File an application and pay appropriate fees.

2. Be sponsored by an authorized insurer.

3. File a copy of the Articles of Incorporation, Articles of Association or Charter of the bank. This document must show that it has been filed and approved.

4. The bank must maintain a place of business in Kentucky.

5. Individuals to act for the bank shall be licensed for the same lines of insurance for which the bank is applying.

6. The bank must have at least one individual designated or acting on its behalf. However, all agents that are acting must be listed on the application.

7. All OFFICERS of the bank must be designated under the corporate license unless a corporate resolution provides that the officer is prohibited from acting as an agent. 806 KAR 9:005.

8. If the bank’s license is broader than an individual’s that is to be designated to act under the license, the bank must have a resolution prohibiting the individual from acting on behalf of the bank in areas in which the individual does not hold a license.

9. Each person acting for the corporation or firm must meet the residence requirements of KRS 304.9-120.

10. A bank domiciled in another state cannot apply for a non-resident general lines license.

11. KRS 271B.15-010 requires the non-resident bank to obtain a Certificate of Authority from the Kentucky Secretary of State unless it qualifies for an exception. A copy of this certificate or a copy of a claim for an exception must accompany the application for a license.
12. All designated agents must have their own individual proof of financial responsibility on file with the Commissioner. HOWEVER, if the agent and the bank are licensed with the same company and that company assumes the agent's financial responsibility, then we will need a corporate resolution to that effect. It should state that the agent and the bank will not be licensed with any other company.

13. Pay the applicable fees:
   - Life and Health:
     - Resident: $100.00 odd years, $50.00 even years
     - Non-Resident: $120.00 odd years, $60.00 even years
   - General Lines:
     - Resident: $100.00 even years, $50.00 odd years

   *Kentucky does not license non-resident general lines corporations.

SUMMARY - Submit the following:

- Application form 8301 in duplicate
  Must indicate the Kentucky business address for the bank
  This form is obtained from the bank's sponsoring company.

- Appropriate Fee (see above)

- Articles of Incorporation (approved by the Secretary of State) or the Bank Charter

- Resolution
  This is needed only if there are officers that are not licensed.
  The resolution should prohibit all officers who are not licensed from acting as an agent on behalf of the bank.

- Certificate of Authority
  This is obtained from the Kentucky Secretary of State’s office.
  (If required)

- Certificate of Assumed Business Name
  This is needed only if the bank is doing business in a different name than its actual corporate or charter name.
Sample Consumer Disclosures
On Purchasing Insurance From a Bank-Affiliated Agent

NOTICE OF FREE CHOICE OF AGENT
AND/ OR INSURER

The Kentucky Insurance Code, KRS 304.12-150, provides that when insurance is required according to the terms of a debt or loan you have the right to choose the agent and/ or insurer through or by which your insurance is to be placed. Your free choice of an agent and/ or insurer and an adequate insurance policy cannot be refused. If you, as a consumer, are denied your right to choose or if an adequate insurance policy is refused, you should notify the Commissioner of Insurance at PO Box 517, Frankfort, KY 40602 or 1-800-595-6053.

FINANCIAL INSTITUTION DISCLOSURES

The regulations of the Kentucky Department of Insurance require that the following disclosures be provided to you, in writing, prior to the sale of insurance to you by a financial institution.

- The insurance offered by this financial institution is not a deposit.
- The insurance offered by this financial institution is not insured by the Federal Deposit Insurance Corporation or other government agency which insures deposits.
- The insurance offered by this financial institution is not guaranteed by the financial institution.
- The insurance offered by this financial institution is optional or, if required, the insurance may be purchased from any insurance agent or insurer selected by you which provides the same or equivalent coverage.
- Not purchasing the insurance offered by this financial institution if it is optional, or purchasing the insurance from another insurance agent or insurer if the insurance is required, will not affect current or future credit decisions concerning you which will be made by this financial institution.

I have seen and understand the foregoing:

_____________________________________
Signature

_____________________________________
Date
CONSUMER ACKNOWLEDGMENT FORM

When you, as a consumer, purchase insurance personal information is disclosed. The Kentucky Insurance Code prohibits the use of such information to the agent's or insurer's advantage and to your detriment. Your signature indicates your acknowledgment that this financial institution may use your personal information for any lawful business purpose, and that such a use is not to your detriment.

________________________________________
Signature

________________________________________
Date
Kentucky Department of Insurance
Regulations Concerning Advertising of Insurance Products

Chapter 12
TRADE PRACTICES AND FRAUDS

806 KAR 12:010 Advertising

RELATES TO: KRS 304.12-010, 304.12-060, 304.12-120,
304.12-130

STATUTORY AUTHORITY: KRS 304.2-110

NECESSITY AND FUNCTION: KRS 304.2-110 provides that
the Commissioner of Insurance shall make reasonable
rules and regulations necessary for or as an aid to the effectua-
tion of any provision of the Kentucky Insurance Code. This
administrative regulation clarifies the minimum standards for
advertising as set forth in KRS 304.12-010 and 304.12-020.

Section 1. (1) An advertisement for the purpose of the
advertisement regulations shall include:
(a) Printed and published material and descriptive litera-
ture of an insurer used in newspapers, magazines, radio and
TV scripts, billboards and similar displays; and
(b) Descriptive literature and the sales aids of all kinds
issued by an insurer for presentation to members of the public,
including but not limited to circulars, leaflets, booklets, depic-
tions, illustrations, and form letters; and
(c) Prepared sales talks, presentations and material for use
by agents and brokers, and representations made by agents
and brokers in accordance therewith.
(2) Policy for the purpose of the advertisement regulations
shall include any policy, plan, certificate, contract, agreement,
statement of coverage, rider, or endorsement which provides
accident or sickness benefits or medical, surgical or hospital
expense benefits, whether on a cash indemnity, reimburse-
ment, or service basis, except when issued in connection with
another kind of insurance other than life, and except disability
and double indemnity benefits included in life insurance and
annuity contracts.
(3) Insurer for the purpose of the advertisement regulations
shall include any corporation, association, partnership,
reciprocal exchange, interinsurer, Lloyds, fraternal benefit
society, and any other legal entity engaged in the advertise-
ment of a policy as herein defined.

Section 2. The advertisement regulations shall apply to
agents and brokers to the extent that they are responsible for
the advertisement of any policy.

Section 3. (1) Advertisements shall be truthful and not
misleading in fact or in implication. Words or phrases
the meaning of which is clear only by implication or by familiarity
with insurance terminology shall not be used.
(2) Words, phrases, or illustrations shall not be used in a
manner which misleads or has the capacity and tendency to
deceive as to the extent of any policy benefit payable, loss
covered or premium payable. An advertisement relating to any
policy benefit payable, loss covered or premium payable shall
be sufficiently complete and clear as to avoid deception or the
capacity and tendency to deceive, to wit:
(a) The words and phrases “all,” “full,” “complete,” “com-
prehensive,” “up to,” “as high as,” “this policy will pay your
hospital and surgical bills,” or “this policy will replace your
income,” or similar words and phrases shall not be used so as
to exaggerate any benefit beyond the terms of the policy, but
may be used only in such manner as fairly describes such
benefit.
(b) A policy covering only one (1) disease or a list of
specified diseases shall not be advertised so as to imply cov­
age beyond the terms of the policy. Synonymous terms shall
not be used to refer to any disease so as to imply broader
coverage than is the fact.
(c) The benefits of a policy which pays varying amounts for
the same loss occurring under different conditions or which
pays benefits only when a loss occurs under certain conditions
shall not be advertised without disclosing the limited condi-
tions under which the benefits referred to are provided by the
policy.
(d) Phrases such as “this policy pays $1,800 for hospital
room and board expenses” are incomplete without indicating
the maximum daily benefit and the maximum time limit for
hospital room and board expenses.
(3) When an advertisement refers to any dollar amount,
period of time for which any benefit is payable, cost of policy,
or specific policy benefit or the loss for which such benefit is
payable, it shall also disclose those exceptions, reductions and
limitations affecting the basic provisions of the policy without
which the advertisement would have the capacity and tendency
to mislead or deceive; to wit:
(a) The term “exception” shall mean any provision in a
policy whereby coverage for a specified hazard is entirely eli-
minated; it is a statement of risk no assumed under the policy.
(b) The term “reduction” shall mean any provision which
reduces the amount of the benefit; a risk of loss is assumed but
payment upon the occurrence of such loss is limited to some
amount or period less than would be otherwise payable had
such reduction clause not been used.
(c) The term "limitation" shall mean any provision which restricts coverage under the policy other than an exception or a reduction.

(d) When a policy contains a time period between the effective date of the policy and the effective date of coverage under the policy or a time period between the date of coverage under the policy or a time period between the date a loss occurs and the date benefits begin to accrue for such loss, an advertisement shall disclose the existence of such periods.

(e) An advertisement shall disclose the extent to which any loss is not covered if the cause of such loss is traceable to a condition existing prior to the effective date of the policy. When a policy does not cover losses traceable to preexisting conditions no advertisement of the policy shall state or imply that the applicant's physical condition or medical history will not affect the issuance of the policy or payment of a claim thereunder. This limits the use of phrase "no medical examination required" and phrases of similar import.

Section 4. An advertisement which refers to renewability, cancelability, or termination of a policy, or which refers to a policy benefit or loss or illustrates time or age in connection with eligibility of applicants or continuation of the policy, shall disclose the provisions relating to renewability, cancelability and termination and any modification of benefits, losses covered or premiums because of age or for other reasons, in a manner which shall not minimize or render obscure the qualifying conditions.

Section 5. All information required to be disclosed by the advertisement regulations shall be set out conspicuously and in close conjunction with the statements to which such information relates or under appropriate captions of such prominence that shall not be minimized, rendered obscure or presented in an ambiguous fashion or intermingled with the context of the advertisement so as to be confusing or misleading.

Section 6. Testimonials used in advertisements must be genuine, represent the current opinion of the author, be applicable to the policy advertising and be accurately reproduced. The insurer, in using a testimonial makes as its own all of the statements contained therein, and all the advertisement including such statements is subject to all of the provisions of the advertisement regulations.

Section 7. An advertisement relating to the dollar amounts of claims paid, the number of persons insured, or similar statistical information relating to any insurer or policy shall not be used unless it accurately reflects all of the relevant facts. Such advertisement shall not imply that such statistics are derived from the policy advertised unless such is the fact.

Section 8. An offer in an advertisement of free inspection of a policy or offer of a premium refund is not a cure for misleading or deceptive statements contained in such advertisement.

Section 9. (1) When a choice of the amount of benefits is referred to, an advertisement shall disclose that the amount of benefits provided depends upon the plan selected and that the premium will vary with the amount of the benefits.

(2) When an advertisement refers to various benefits which may be contained in two (2) or more policies, other than group master policies, the advertisement shall disclose that such benefits are provided only through a combination of such policies.

Section 10. An advertisement shall not directly or indirectly make unfair or incomplete comparisons of policies or benefits or otherwise falsely disparage competitors, their policies, services or business methods.

Section 11. (1) An advertisement which is intended to be seen or heard beyond the limits of the jurisdiction in which the insurer is licensed shall not imply licensing beyond these limits.

(2) Such advertisements by direct mail insurers shall indicate that the insurer is licensed in a specified state or states only, or is not licensed in a specified state or states, by use of some language such as "This company is licensed only in State A" or "This company is not licensed in State B."

Section 12. The identity of the insurer shall be made clear in all of its advertisements. An advertisement shall not use a trade name, service mark, slogan, symbol or other device which has the capacity and tendency to mislead or deceive as to the true identity of the insurer.

Section 13. An advertisement of a particular policy shall not state or imply that prospective policyholders become group or quasi-group members and as such enjoy special rates or underwriting privileges, unless such is the fact.

Section 14. An advertisement shall not state or imply that a particular policy or combination of policies is an introductory, initial or special offer and that the applicant will receive advantages by accepting the offer, unless such is the fact.

Section 15. (1) An advertisement shall not state or imply that an insurer or a policy has been approved or an insurer's financial condition has been examined and found to be satisfactory by a governmental agency, unless such is the fact.

(2) An advertisement shall not state or imply that an insurer or a policy has been approved or endorsed by any individual, group of individuals, society, association or other organization, unless such is the fact.

Section 16. An advertisement shall not contain untrue statements with respect to the time within which claims are paid or statements which imply that claim settlements will be liberal or generous beyond the terms of the policy.

Section 17. An advertisement shall not contain statements which are untrue in fact or by implication misleading with respect to the insurer's assets, corporate structure, financial standing, age or relative position in the insurance business.

Section 18. (1) Each insurer shall maintain at its home or principal office a complete file containing every printed, published, or prepared advertisement of individual policies and typical printed published or prepared advertisements of blanket, franchise and group policies hereafter disseminated in this or any other state whether or not licensed in such other state, with a notation attached to each such advertisement which shall indicate the manner and extent of distribution and the form number of any policy advertised. Such file shall be subject to regular and periodical inspection by this department. All such advertisements shall be maintained in said file for a period of not less than three (3) years.

(2) Each insurer required to file an annual statement which is now or which hereafter becomes subject to the provisions of the advertisement regulations must file with this department together with its annual statement, a certificate executed by an authorized officer of the insurer wherein it is stated that to the best of his knowledge, information and belief the advertisements which were disseminated by the insurer during the preceding statement year complied or were made to comply in all respects with the provisions of the insurance laws of this state as implemented and interpreted by the advertisement regulations. It is requested that the chief executive officer of each
insurer to which the advertisement regulations are addressed acknowledge its receipt and indicate its intention to comply therewith.

Section 19. (1) The purpose and intent of this administrative regulation is to prohibit the transmission of information in the form of advertisements or otherwise which might be deceptive, misleading or untrue. The general intent, therefore, and the provisions of this administrative regulation not expressly limited to a particular type of insurance, shall be applied to all insurance on subjects of risk located in or to be performed in this state.

(2) The use of advertising material previously filed with and approved by the department shall not subject the filer to any disciplinary action or penalty by this department, as long as such prior approval remains in effect.

(3) Any person, firm, corporation, or association who knowingly aids and abets an insurer in the violation of this administrative regulation or the applicable provisions of the Insurance Code shall be subject to the penalties provided by law. (1-12.02; 1 Ky.R. 863; eff. 5-14-75.)
USURY REVISITED - AGAIN

M. Thurman Senn
Morgan & Pottinger, P.S.C.
Louisville, Kentucky
DEDICATION

This outline is an update of an outline entitled "Usury Revisited" which was prepared by my father, M. Brooks Senn, for the 9th Annual Legal Issues for Financial Institutions Conference in March 1989. His materials have served for nearly a decade as, to my knowledge, the sole comprehensive attempt to make sense of usury law in Kentucky. This outline is dedicated to my father and his hard work in developing his 1989 materials. I only hope that this outline is as useful to today's practitioners as my father's was to practitioners in 1989.

M. Thurman Senn
USURY REVISITED-AGAIN

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(1) The type of credit extension, e.g., is it a simple interest loan, short term single payment loan, precomputed interest installment loan, purchase of dealer paper, manufactured home financing, credit card or other revolving credit transaction?

(2) The amount of the credit transaction, e.g., is it in excess of $15,000?

(3) The identity of the debtor, e.g., is the credit extended to an individual, corporation, business?

(4) The purpose of the credit transaction?

(5) Federal pre-emption of state usury limitations, the applicability of “most favored lender” status, and other federal preemption of state law.

(6) Is the lender a multistate entity?

B. WHETHER THE CREDIT TRANSACTION FALLS WITHIN ONE OR MORE OF THE FOREGOING CHARACTERISTICS DETERMINE WHETHER THE INTEREST RATE IS CONTROLLED BY (SEE APPENDIX):

(1) KRS 360.010 - Fixing the “legal” and “contract” rate of interest in Kentucky.

(2) KRS 360.025 and 360.027 - Removing the defense of usury from corporations, limited liability companies (after 7/15/98) and certain limited partnerships and business trusts.

(3) 12 U.S.C. §85 - Authorizing national banks to charge interest at the greater of the amount permitted by the laws of the state where the national bank is located or 1% in excess of the discount rate, i.e., “most favored lender” status.

(4) KRS 287.214 - Authorizing Kentucky state banks to charge interest on contracts or obligations of $15,000 or less at any rate permitted national banks by the laws of the United States.


(8) KRS 287.215 - Fixing rates on discount and add-on installment loans.

(9) KRS 287.710 to 287.770 - Relating to revolving credit plans

(10) KRS 371.210 to 371.330 and KRS 190.090 to 190.140 - Relating to real installment contracts covering consumer goods and motor vehicles.

(11) KRS 360.150 - Relating to manufactured home financing transactions.

C. OTHER PROVISIONS AFFECTING LOAN COSTS.

(1) In addition to interest rates, numerous overlapping statutes regulate other terms affecting loan costs such as prepayment fees, refunds of unearned interest, late fees, etc.

D. TRANSACTION SPECIFIC STATUTES.

(1) KRS 368.010 to 368.990 - Relating to check cashing services by entities other than licensed financial institutions.

(2) SB 392 - Relating to title lien pledging.

II. GENERAL USURY STATUTE (KRS 360.010).


B. STATUTORY RATES.

(1) **Legal Rate** - 8% per annum.

(2) **Contract Rate** -

   (a) If original principal amount is $15,000 or less - the **lessor** of 19% or 4% in excess of the discount rate.

   (i) The discount rate at March 26, 1998 was 5%.

   (b) If original principal amount is **more** than $15,000 - any rate if agreed to in writing.

(3) **Minimum Interest** - $10 “if the legal interest does not account to that sum.”

C. LOANS NOT SUBJECT TO KRS 360.010 LIMITATIONS.
(1) Loans of more than $15,000 (KRS 360.010). Duff v. Bank of Louisville & Trust Co., Ky., 705 S.W.2d 920 (1986).

(2) Lines of Credit and Master Notes over $15,000 - The Attorney General has indicated that a “master note” device is basically a line of credit and that the actual amount advanced to the borrower under the line of credit or master note determines the applicable rate of interest under KRS 360.010. Thus, if a borrower executes a master note for $16,000 but is advanced only $8,000 at the time of executing the note, the maximum interest rate under KRS 360.010 is 4% above the “discount rate,” or 19%, whichever is less. See OAG 79-169 (March 12, 1979).

A contrary position is arguable where the future advances will exceed $15,000 and are obligatory and not discretionary with the bank.

(3) Loans to corporations, limited (but not general) partnerships and business trusts - other than a limited partnership or business trust, the principal asset of which is a one or two-family dwelling - (KRS 360.025 and 360.027).


(b) What is the status of a loan to a limited liability company under KRS Chapter 275 (enacted in 1994)?

(i) HB 666 enacted by the 1998 General Assembly in §48 amended KRS 360.027 to add limited liability companies to the list of entities that cannot plead usury as a defense. Statute should take effect approximately July 15, 1998.

(ii) For loans extended prior to that date, the correct resolution of the issue is less clear:

(1.) “Corporation” is not defined in KRS Chapter 360.

(2.) KRS Chapter 275 differentiates between (i) “limited liability company” which is defined as “an unincorporated association form under this chapter” and (ii) “corporation” which is defined as “a profit or nonprofit corporation formed under the laws of any state or a foreign country.” See KRS 275.015.

Note: HB 666 passed by the 1998 General Assembly amends KRS 275.015(8) to define limited liability company as “a limited liability company formed under
this chapter having one (1) or more members.”

(3.) On the other hand, KRS 446.010(8) provides that “[a]s used in the statute laws of this state, unless the context requires otherwise . . . (8) ‘Corporation’ may extend and be applied to any corporation, company, person, partnership, and joint stock company or association.”

(4.) By codifying in 1998 the usury exemption for limited liability companies in KRS 360.027 instead of KRS 360.025, did the General Assembly indicate that it does not consider limited liabilities as “corporations” for purposes of pre-1988 KRS 360.025? Could the General Assembly have considered “limited partnership” in pre-1988 KRS 360.027 to include limited liability companies?


(5) HUD, FHA and VA Guaranteed Loans. Lenders making loans guaranteed or insured through HUD, FHA, or the VA are not subject to state laws “prescribing or limiting interest rates”. KRS 386.050(3).

D. LOANS ($15,000 OR LESS) SUBJECT TO KRS 360.010.

(1) Computation of Interest:

The general view is that the “per annum” interest rate limitation in KRS 360.010 requires use of either the 365/365 or 360/360 method of computation when a loan of $15,000 or less is involved. Use of the 365/360 method has been held usurious if the maximum rate of interest is charged. American Timber & Trad. Co. v. First Nat’l Bank of Oregon, 511 F.2d 980 (9th Cir. 1973). But see THC Financial Corp. v. Manages Investment Corp., 643 P.2d 549 (Haw. 1982). If the original principal amount exceeds $15,000, use of the more favorable 365/360 method should be specifically agreed to by the borrower in writing by, for example, describing the computation method in the note.

(a) 365/365: Under this method, the rate of interest is divided by 365 to
produce a daily interest factor. The number of days that the loan is outstanding is then multiplied by this daily interest factor. Under this method, a different amount of interest is charged for months of different lengths.

(b) **360/360**: Under this method, each month is treated as having 30 days. Thus, interest for each month is the same. However, for a calendar year, the interest is exactly the same as that calculated by using the 365/365 method.

(c) **365/360**: This method is a combination of the first two: the interest rate is divided by 360 days (30 days for each month) to create a daily factor. The number of days that a loan is outstanding is then multiplied by this daily factor. Thus interest charged for months of different lengths is different and interest charged for a calendar year is greater than interest charged under either the 365/365 or 360/360 method.

(2) **Determination of Interest.**

Amounts paid to and retained by a bank which has the effect of increasing the bank’s “yield” will be considered “interest” for usury purposes. Thus, “points”, “stand-by”, commitments, loan fees or other sums paid to a bank, however denominated, will be in my judgment, deemed “interest” for usury limit computations. See Union Cent. Life Ins. Co. v. Edwards, 219 Ky. 748, 294 S.W. 502 (1927); Commonwealth Farm Loan Co. v. Caudle, 203 Ky. 761, 263 S.W. 24 (1924).

(3) **Closing Costs and Other Fees.**

(a) Closing costs paid to third parties permitted, i.e., title search, appraisal and title insurance fees. Palmer v. Bank of Louisville & Trust Co., Ky. Ap., 682 S.W.2d 789 (1985);

(b) Moreover, at common law, a bank could, in addition to interest at the maximum rate, properly charge its borrower with the necessary, reasonable expenses incident to the loan without being guilty of usury. Such expenses included the cost of ascertaining whether the security offered was adequate, title examination costs, appraisals, recording fees and the expenses of preparation of the loan and security documents. Union Cent. Life Ins. Co. v. Edwards, 219 Ky. 748, 294 S.W. 502 (1927); Ashland Nat. Bank v. Conley, 231, Ky. 844, 22 S.W.2d 270 (1929);

(c) In like manner, fees imposed for the privilege of prepaying a debt are not deemed to be usurious, Hamilton v. Kentucky Title Savings Bank
& Trust Co., 159 Ky. 680, 167 S.W. 898 (1914); Webb v. Southern Trust Co., 227 Ky. 79, 11 S.W.2d 988 (1928); and

(d) Although the Kentucky court have never ruled on the status of a “late charge,” the Kentucky Department of Financial Institutions has historically taken the position that such charges are in the nature of liquidated damages and are permitted so long as they are reasonably related to the expenses incurred by the lender. June 16, 1981, Letter of Rhonda S. Paul to William H. Mohr. The Department is also of the view that the right to impose “late charges” must be included in the loan documents. Also see: April 14, 1970 Memorandum of E. Frederick Zopp, General Counsel to the Department of Banking, to Executive Management of [Various] Financial Institutions, pg. 3, item 8 (“Kentucky statutes support the majority view that a borrower’s default and resulting late charges do not make a loan usurious”); OAG 70-276 (May 6, 1970) (“... [I]f the consideration is for services actually rendered to the borrower and the agreement for services is made in good faith, and is not a cloak to conceal usury, the transaction is not an usurious loan.”).

(4) Discounting Notes - interest in advance at the highest rate.

(a) KRS 287.180(1) empowers banks to “discount” notes.


What is “short term paper” is an open question. See November 12, 1981 Memorandum for Ronda Paul, Attorney for Department of Banking, to all Examiners (“the Departmental position is that short-term (one year or less) notes may be discounted even though the resultant Annual Percentage Rate (APR) would be greater than the rate allowed by KRS 360.010.”).

(5) Penalties (KRS 360.020).

(a) If an usurious rate of interest is knowingly charged, the entire interest is forfeited.

(b) Where a greater rate of interest has been paid, the debtor may, if the action is brought within two years from the time the usurious
E. RENEWAL (EXTENDING THE TIME OF PAYMENT) OF LOANS.

(1) Position of Department of Financial Institutions.

(a) If a $15,000 or less fixed-rate loan is renewed and the maximum rate permissible under KRS 360.010 has changed (either increased or decreased) since the loan was made, the renewal is viewed as a new contract and the decreased maximum rate must be used. (Similarly, any increased maximum rate may be used.) See June 26, 1984 Memorandum from Ballard W. Cassady, Jr., Commissioner.

Example: Bank makes a 6-month $10,000 loan to X at 11%, which is 4% above the discount rate of 7%. Six months later, the loan is renewed (i.e., the time of payment is extended for an additional six months) and the discount rate has decreased to 6 1/2%. The maximum rate of interest which may be charged is 10 1/2%.

(b) If a bank makes a demand loan of $15,000 or less bearing interest payable in installments at the maximum rate permitted by KRS 360.010 at the time the loan is made, it is required to reduce the interest rate on such loan on the next succeeding interest installment payment date after a decline in the maximum interest rate permitted under KRS 360.010 - notwithstanding the fact that the bank has not demanded payment of the loan’s principal. This conclusion is apparently on the basis that a demand loan bearing interest payment in installments is in some manner “continued” or “renewed” on every interest payment date.

(2) Changes in usury law. Although there apparently is no Kentucky decision directly on point, where the “renewal” only extends the time of payment of the original note and makes no change in the principal thereof or in any of its other terms, a strong argument can be made that the rule in Kentucky is that the rate of interest originally agreed to between the parties may continue to be charged on the basis that:

(a) It is long been established that a note bearing lawful interest at the time it is entered into is not made usurious by a subsequent change in the law reducing the permitted rate of interest. See Lee v. Davis, 8 Ky. 397, 1 A.K. Marsh 397 (1818); Jump v. Johnson, 12 Ky. Law Rep. 100, 13 S.W. 843 (1890); Abner v. York, 19 Ky. Law Rep. 643, 41 S.W. 309 (1897); Mix v. Fidelity Trust & Safety Vault Co., 103 Ky. 77, 44 S.W. 393 (1898); Holland v. Holman, 21 Ky. Law Rep. 105, 50 S.W. 1102 (1899); Curry v. Adams' Adm't', 22 Ky. Law Rep. 256, 57 S.W. 8 (1900); Foard v. Grinter's Ex’rs, 14 Ky. Rep. 5, 18
(b) Where a note is given merely in renewal for another note and not in payment, the renewal does not extinguish the original debt or in any way change the debt except for postponing the time of payment, even though the first note is surrendered. See Cantrell Construction Company v. Carter, 418 F.2d 705 (6th Cir. 1969); White v. Winchester Land Development Corp., Ky. App., 584 S.W.2d 56 (1979); George v. First National Bank of Louisville, Ky. App., 557 S.W.2d 442 (1977), In re Zemansky, 39 F.Supp. 628 (D.C.S.D. Cal. 1941); Dufresne v. Hammersten, 106 P.2d 861 (1940).

(3) The Department's second position on the "renewal" of a demand note appears to be inconsistent with Mastin v. Cochran's Ex'r., 25 Ky. L. Rep. 712, 76 S.W. 343 (1903).

F. ENFORCEABILITY OF PARTICULAR LOAN TERMS NOT OTHERWISE EXPRESSLY PROHIBITED BY STATUTE.

(1) Late Charges. A late fee of 4% of the installment was approved of in a $6.4 million commercial credit facility in Travelers Ins. Co. v. Corporex Properties, Inc., 798 F. Supp. 423 (E.D. Ky. 1992) (Bertelsman, C.J.), in the face of an argument that the fee is an unenforceable liquidated damages penalty. But see Man O' War Restaurants, Inc. v. Martin, Ky., 932 S.W.2d 366 (1996) (construing as an unreasonably excessive liquidated damages clause a contract provision by which corporate employee and shareholder was required upon termination of employment to return stock for original purchase price).

(2) Post Default Increase In Interest Rate. A provision increasing the interest rate from 11% to 15.75% in the event of default was also approved of in Travelers Ins. Co. v. Corporex Properties, Inc. and Eyde Brothers Dev. Co. v. The Equitable Life Assurance Society, 1989 WL 130632 (6th Cir. (Mich.) 1989).

(3) Prepayment Premium Triggered By Default. A provision deeming acceleration on account of default as triggering a prepayment penalty was also approved of in Travelers Ins. Co. v. Corporex Properties, Inc.

(a) A prepayment fee or penalty provision in a consumer credit transaction would appear to be preempted by federal law in a precomputed loan context (and possibly all contexts). See 15 U.S.C. §1615 [discussed in Part VI below].

(b) A prepayment fee or penalty provision in a non-consumer credit transaction might be viewed as an unenforceable penalty under Capitol Cadillac Olds, Inc. v. Roberts, Ky., 813 S.W.2d 287, 292
(1991) ("To avoid misunderstanding and recognizing our limitations when using the arcane language of the world of finance, we simply say that a creditor may include in its computation of the amount due only such interest as has been earned and actually accrued as of the date of acceleration.").

III. FEDERAL PREEMPTION - RESIDENTIAL REAL PROPERTY.

A. General Rule. Sec. 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (Pub. L. 96-221) (codified at 12 U.S.C. 1735f-7a) provides that state constitutions or laws limiting the rate or amount of interest, discount points, finance charges or other charges are preempted and do not apply to loans secured by a first lien on:

1. "residential real property,"

2. "all stock allocated to a dwelling unit in a residential cooperative housing corporation," or

3. a "residential manufactured home" so long as the loan documents contain certain consumer protection provisions prescribed by regulations of the Federal Home Loan Bank Board.

B. Purpose of Credit Irrelevant. Sec. 501 focuses upon the type of collateral and the priority of the lender’s interest in the collateral. If a first lien is taken on residential real property, a residential manufactured home or a dwelling unit in a residential cooperative housing corporation, the test is met.

(1) Thus, a corporate loan secured by a first mortgage on a shareholder’s residential real property is preempted under Sec. 501. Similarly, a loan to purchase a car secured by a first mortgage is preempted. Smith v. Fidelity Consumer Discount Co., 898 F.2d 907 (3rd Cir. 1990).

(2) Similarly, it is not necessary that the loan be a “purchase money” loan. So long as the requisite type of collateral and a first lien interest therein is obtained, Sec. 501’s preemption provisions are applicable.

C. Residential Real Property is defined in FHLBB Regulations issued under Sec. 501 of the 1980 Act [12 C.F.R. 590.2(f)] as:

"... real estate improved or to be improved by a structure or structures designed primarily for dwelling, as opposed to commercial use."

D. Not All Charges Preempted. Sec. 501 only relates to “interest, discount points, finance charges or other charges.” Other provisions of state law, (i.e., “laws on prepayment charges, attorneys’ fees, late charges or other provisions designed to
protect borrowers”) are not preempted and will apply to the loan. See 12 C.F.R. §590.3(c).

(1) New Hampshire law requiring an first mortgage home loan to provide for calculation of interest on a simple interest basis was not preempted. Grunbeck v. Dime Sav. Bank of New York, FSB, 74 F.3d 331 (1st Cir. 1996) (statute does not limit “rate or amount of interest” but only limits manner of calculation).

(2) Illinois law permitted borrowers to pledge an interest bearing account in lieu of having lender escrow real estate taxes prohibited Illinois lender from charging a fee for having the pledge and the fee was not preempted by DIDMCA. Stern v. Norwest Mortgage, Inc., 688 N.E.2d 99 (Ill. 1997).

(3) Loan origination fee preempted. DIDMCA preempts “those limitations which are included in the calculation of the annual percentage rate” under Truth In Lending Act. Currie v. Diamond Mortgage Corp., 859 F.2d 1538 (7th Cir. 1988).

E. Opt-Out Options.

(1) 12 U.S.C. §1735f-7a(b)2) permitted a state, between April 1, 1980 and April 1, 1983 to “adopt a law or certifies that the voters of such State have voted in favor of any provision, constitutional or otherwise” which “states explicitly and by its terms” that the federal preemption does not apply.

(a) Kentucky did not opt-out.

(2) 12 U.S.C. §1735f-7a(b)(4) permits a State “at any time after March 31, 1980” to “adopt a provision of law placing limitations on discount points or such other charges on any loan, mortgage, credit sale, or advance described in subsection (a)(1) of this section.”

(a) How “explicit” does this override have to be? What are “such other charges”?

(b) Autrey v. United Companies Lending Corp., 872 F. Supp. 925 (S.D. Ala. 1995) (Alabama law enacted in 1983 limiting “points” charged in real estate loan to 5% of original principal balance arguably fell within the scope of this opt-out so removal to federal court on the basis of federal preemption was denied).

F. “Residential Manufactured Home” Loans. Sec. 501 of the 1980 Act preempts state usury laws with respect to loans secured by a first lien on a “residential manufactured home” (which includes mobile homes) only if the consumer protection provisions of the OTS regulations (12 C.F.R. §590) are complied with:
(1) Covering balloon payments, prepayment penalties, late charges and defenses;

(2) Requiring the creditor to give 30 days prior notice of any action leading to repossession or foreclosure (except in the case of abandonment or other extreme circumstances.

(3) Requiring the creditor, upon repayment in full, to refund the unearned portion of any pre-computed finance charge in an amount not less than the amount which would be calculated by the actuarial method (not the “rule of 78's”) except that the debtor is not entitled to a refund which is less than $1.

IV. FEDERAL PREEMPTION - ALTERNATIVE MORTGAGES.

A. General Rule: Alternative Mortgage Transaction Parity Act of 1982 (part of the Garn-St. Germain Depository Institutions Act of 1982) provides that “An alternative mortgage transaction may be made by a housing creditor in accordance with this section, notwithstanding any State constitution, law, or regulation. 12 U.S.C. §3803(c).


(1) Loan or credit sale secured by an interest in residential real property, a dwelling, all stock allocated to a dwelling unit in a residential cooperative housing corporation, or a residential manufactured home.

(2) Made by a “housing creditor”
   (a) a “depository institution” as defined in 12 U.S.C. §1735f-7a(a)(2);
   (b) a HUD approved lender;
   (c) any person who regularly makes loans, credits sales, or advances secured by interests in the properties listed in (1); or
   (d) any of their transferees.

(3) Having any of the following terms:
   (a) in which the interest rate or finance charge may be adjusted or renegotiated;
   (b) involving a fixed-rate, but which implicitly permits rate adjustments by having the debt mature at the end of an interval shorter than the term of the amortization schedule; or
   (c) involving any similar type of rate, method of determining return, term,
repayment, or other variation not common to traditional fixed-rate, fixed-term transactions, including without limitation, transactions that involve the sharing of equity or appreciation.


(1) **Rate Index.** If the transaction is secured by a consumer’s principal dwelling, the term exceeds 1 year, and the APR may increase, then:

   (a) Loan documents must specify an index;

   (b) Index must be readily available to, and verifiable by, the borrower and beyond the control of the lender.

   (c) Index may be either single values or a moving average calculated over a specified period.

(2) **Prepayment Fees.** May be imposed, “notwithstanding any State law limitations to the contrary”.

D. Credit unions must comply with NCUA regulations. See 12 U.S.C. §3803(a)(1).

E. Savings banks, thrifts, and all other housing creditors must comply with OTS regulations codified at 12 C.F.R. §560.220.


G. **Inapplicability of DIDMCA Preemption.** 12 U.S.C. §3806 provides that Section 501(c)(1) of the Depository Institutions Deregulation and Monetary Control Act of 1980 shall not apply to transactions which are subject to this chapter.

V. **FEDERAL PREEMPTION - ADJUSTABLE RATE MORTGAGE CAPS**

A. **General Rule:** The Competitive Equality Banking Act of 1987 added 12 U.S.C. §3806 which provides that “Any adjustable rate mortgage loan originated by a creditor shall include a limitation on the maximum interest rate that may apply during the term of the mortgage loan.”

B. **Creditor:** “a person who regularly extends credit for personal, family, or household purposes”. [12 U.S.C. §3606(d)(1)].

C. **Adjustable Rate Mortgage Loan:** “any consumer loan secured by a lien on a one-to-four family dwelling unit, including a condominium unit, cooperative housing unit, or mobile loan, where the loan is made pursuant to an agreement under which the creditor may, from time to time, adjust the rate of interest.” [12 U.S.C. §3606(d)(2)].
D. **Penalty.** Violation is deemed a violation of the Truth In Lending Act subject to administrative enforcement and civil damages. [12 U.S.C. §3806(c)].

VI. FEDERAL PREEMPTION - UNEARNED INTEREST REFUNDS.

A. Section 933 of the Housing and Community Development Act of 1992 (Pub. L. No. 102-550), created 15 U.S.C. §1615 which regulates unearned interest rebates in connection with consumer credit transactions and prohibits the use of the "Rule of 78's" in calculating such rebates in certain cases.

B. **Right To Prepay.** "If a consumer prepays in full the financed amount under any consumer credit transaction, the creditor shall promptly refund any unearned portion of the interest charge to the consumer".

   (1) Right applies both in "the refinancing, consolidation, or restructuring of the transaction" and "any prepayment made as a result of the acceleration of the obligation".

   (2) Statute adopts the Truth In Lending Act's definitions of "consumer" and "creditor". See 15 U.S.C. §1502(h) and (t). In addition, the statute expressly states that "creditor" includes any "assignee" and "subassignee" of any creditor.

C. **Manner of Calculating Refund.** In calculating the amount of the rebate in a precomputed consumer credit transaction of a term exceeding 61 months which is consummated after September 30, 1993, the creditor "shall compute the refund based on a method which is at least as favorable to the consumer as the actuarial method." This prohibits the use of the Rule of 78's.

   (1) No refund is required if the total refund would be less than one dollar.

D. **Information Requirements.** Creditor required, upon oral or written request, to provide a statement of (A) the amount necessary to prepay the account in full and (B) the amount of any refund.

   (1) The statement must be provided before the end of the 5-day period beginning on the date the request is received.

   (2) If the request is in writing, the statement must be in writing.

   (3) A customer is entitled to receive one free annual statement, and the creditor may impose a reasonable fee to cover the cost of producing additional statements provided the charge is disclosed to the consumer in advance.
VII. "MOST FAVORDED LENDER" STATUS

A. NATIONAL BANKS.

(1) General Rule: 12 U.S.C. 85 grants most favored lender status to national banks by giving them a choice:

(a) They may charge interest at the highest rate allowed by state law to lenders generally in the state where the bank is located, i.e., national banks may "borrow" competing lenders' rates; or

(b) They may charge interest at 1% over the discount rate on 90-day commercial paper in effect at the district federal reserve bank.


(2) If no rate is fixed by the laws of the state, territory or district, a national bank may charge a rate not exceeding the greater of 7% or 1% in excess of the discount rate on 90-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located.

(3) What is "interest"?

(a) Defined by OCC in 12 C.F.R. §7.4001(a) as:

... includes any payment compensating a creditor or prospective creditor for an extension of credit, making available a line of credit, or any default or breach by a borrower of a condition upon which credit was extended. It includes, among other things, the following fees connected with credit extension or availability: numerical periodic rates, late fees, not sufficient funds (NSF) fees, overlimit fees, annual fees, cash advance fees, and membership fees. It does not include appraisal fees, premiums and commissions attributable to insurance guaranteeing repayment of any extension of credit, finders' fees, fees for document preparation or notarization, or fees incurred to obtain credit reports."

(b) Supreme Court upheld OCC's regulation in Smiley v. Citibank (South Dakota), N.A., 116 S.Ct. 1730 (6/3/96) (term "interest" encompasses credit-card late-payment fees permissible in national
bank's home state but impermissible in state of borrower's residence).

(c) **Home Equity Loan Fees.**

(i) **Prepayment Fees.** In Interpretive Letter No. 744 (10/96), the OCC expressed its opinion that a home equity loan prepayment fee fell within the definition of "interest" for purpose of exportation of allowable charges.

(ii) **Account Opening Fee; Fixed Rate Option Exercise Fee; Early Account Closure Fee; and Rejected Draw Request Fees.** In Interpretive Letter No. 803, the OCC expressed its opinion that all of the fees, except for rejected items after termination of the account, are "interest". After account is terminated, there is no debtor/creditor relationship, so the fee is not "interest".

(d) Compare current attempts to broaden definition of "interest" for exporting purposes with attempts in the 1970's to narrow definition of "interest" for usury rate limitation purposes. *Northway Lanes v. Hackley Union National Bank & Trust Company*, 464 F.2d 855, 864 (6th Cir. 1972) ($30,000 prepayment penalty "not generally considered interest and that when charged in addition to maximum interest do not make an otherwise nonusurious loan usurious.

(4) Where is a national bank "located"?

(a) Completely intrastate banks. *Marquette National Bank v. First of Omaha Service Corp.*, 439 U.S. 299 (1978) (located in state of its main office); *Wiseman v. State Bank & Trust Co.*, 854 S.W.2d 725 (Ark. 1993) (national bank located in one state may use that state's rates in making loans to a resident of a second state even though national bank's parent company was incorporated in that second state).


(a) "Knowingly" taking interest greater than allowed by 12 U.S.C. §85 is "a forfeiture of the entire interest".
(b) When a greater rate of interest has been paid, the debtor may, if the action is brought within two years from the time the usurious transaction occurred, recover twice the amount of interest paid.

B. FEDERAL THRIFTS - 12 U.S.C. §1463(g) also grants most favored lender status to federal savings associations which is equivalent to that granted to national bank under 12 U.S.C. §85. OTS regulations are codified at 12 C.F.R. §560.110.

C. KENTUCKY STATE INSURED BANKS.

(1) KRS 287.214 and 12 U.S.C. 1831d grant “most favored lender” status to Kentucky state banks - with KRS 287.214 granting such status independent of the deposit insurance status of the bank.


(2) KRS 287.214 states:

“Notwithstanding the provisions of any other law, a bank or trust company may take, receive, reserve and charge on money due or to become due on any contract or other obligation in writing, where the original principal amount is fifteen thousand dollars ($15,000) or less, interest at any rate allowed national banking associations by the laws of the United States of America. A trust company shall not make extensions of credit for its own account, but may make extensions of credit for trust assets under management.”

(3) Two changes to KRS 287.214, effective approximately July 15, 1998, are being made by the 1998 General Assembly with the enactment of HB 516:

(a) Section 12 of 1998 HB 516 will delete the phrase “or trust company” in the first sentence of this statute.

(b) KRS 287.214 is tied to the “rate allowed national banking associations”, and the definition in KRS 287.010(2) was amended by Section 1 of HB 516 to include federal “savings and loan associations”.

D. KENTUCKY SAVINGS AND LOAN ASSOCIATIONS.

1. KRS 287.705 authorizes the Commissioner of the DFI to “prescribe, amend and repeal regulations authorizing state-chartered savings and loan
associations to make any loans . . . under the same terms, conditions, limitations, restrictions and safeguards which such associations could make or do were they operating as federal savings and loan associations at the time such authority is granted . . . “

2. KRS 289.680 permits federal savings and loans to “possess all of the rights, powers, privileges, benefits, immunities and exemptions provided for” state savings and loan associations “unless federal laws or regulations provide otherwise”.

E. OTHER PROVISIONS - If a bank “borrows” a competing lender’s rates, it must also comply with other provisions of state law relating to that class of loans that are material to the determination of the interest rate, e.g., provisions relating to the amount of the loan, the term, method of repayment, delinquency and other charges, and the like. See Northway Lanes v. Hackley Union Nat. Bank & Trust Co., 464 Fed.2d 855 (6th Cir. 1972); August 11, 1988, letter from Robert B. Serino, Deputy Chief Counsel, Comptroller of the Currency to Ms. Linda T. Lowe, Assistant Attorney General of the State of Iowa.

VIII. “BORROWING” CREDIT UNION, PETTY LOAN COMPANY, AND SAVINGS AND LOAN ASSOCIATION RATES.

A. GENERAL CONSIDERATIONS

Under its “most favored lender” status discussed under Section Vii above, a national bank or state insured bank may, with respect to loans of $15,000 or less, elect to “borrow” the rates and charges permitted state chartered credit unions, petty loan companies, or state savings and loan associations. A bank wishing to do so should obtain competent counsel to advise it with respect to the technical issues which arise when “most favored lender” status is sought. Generally, if a bank “borrows” the higher rates permitted by KRS Chapter 288, 289, or 290, it must also comply with the other provisions of those chapters relating to loan amount, maturity, methods of payment, delinquency and other charges, and the like.

The general departmental policy of the Kentucky Department of Financial Institutions “permit[s] use of the interest rate structure found in both KRS Chapter 288, the consumer Loan Company Act, and KRS Chapter 290, the Credit Union Act.” See February 8, 1985 letter of James M. Baker, General Counsel, Department of Financial Institutions, to Joseph A. Cleves, Jr.

However, the Department requires, for examination and evaluation purposes, that loans made by status insured banks pursuant to their “most favored lender” status:

“... be segregated on... [the bank’s] books according to the statutes under which they are made... It is suggested that... [the bank’s] EDP servicer provide a special numeric coding for this.”

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B. CREDIT UNION LOANS AND CHARGES (KRS CH. 290).

(1) Loan Conditions, Rates and Charges

(a) A credit union may loan to members for such purposes and upon such conditions as the bylaws may provide (KRS 290.425) "Interest rates on loans shall be determined by the board of directors, not to exceed two percent (2%) per month on unpaid balances" (KRS 290.435).

(2) Types of Loans

(a) KRS Ch. 290 does not contain any restrictions upon the types of loans which a credit union may make and authorizes the credit union’s board of directors to “[c]establish the policies of the credit union with respect to the granting of loans and the extending of lines of credit, including the maximum amount which may be loaned to any one (1) member” [KRS 290.225(4)], with the only limitations being that (i) a member’s loan may not exceed 10% of the credit union’s capital and (ii) aggregate loans secured by first mortgages on real estate may not exceed 50% of the credit union’s unimpaired capital (KRS 290.465 and 290.505).

(b) Thus, national and state insured banks in Kentucky may establish demand, single payment and simple interest installment loan programs of $15,000 or less and charge not more than 2% per month on the unpaid balances of such loans. In order to conform to the provisions of KRS Ch. 290, the board of directors of a bank electing to “borrow” the state chartered credit union rate should adopt resolutions establishing the loan programs, the policies to be followed in connection with such programs, the interest rates to be charged and other conditions to be complied with in implementing such programs (see KRS 290.225(4), 290.425, 290.435, 290.465 and 290.505).

(c) The Kentucky Department of Financial Institutions’ General Counsel has opined that:

“KRS 290.425 permits a credit union to make loans for such purposes and upon such conditions as its bylaws may provide. If a bank’s written loan policy permit demand, variable rate and short-term loans, these loans would be compatible with KRS 290.425 so long as the interest rate at no time exceeds two percent (2%) per month on the unpaid balance.”

(d) Since credit union rates can only be computed on “unpaid balances,” does the statute prohibit precomputed, add-on or discount loans? Even if the statute does, does a national bank have to comply with
these restrictions?

C. PETTY LOAN COMPANY LOANS AND CHARGES (KRS CH. 288)

(1) Location Of The General Prohibition On Usury For Loans Of Less Than $15,000 (KRS 288.420).

“No person, shall, without first obtaining a license from the commissioner, engage in the business of making loans in the amount or of the value of fifteen thousand dollars ($15,000) or less at a greater rate of interest, or consideration therefore than otherwise permitted by law.”

KRS 288.420 exempts banks, savings banks, trust companies, building and loan associations, cooperative marketing associations, credit unions, loan and investment companies or licensed pawnbrokers from this prohibition.

(2) Amount of Loans: Prior to 1998, petty loan company licensees were authorized to lend only up to $15,000 excluding charges [KRS 288.530(1); OAG 75-257]. However, House Bill 514 enacted during the 1998 General Assembly added KRS 288.470(3) which provides that “Nothing in this chapter shall be construed to limit the ability of any licensee to make a loan or loans in the principal amount greater than fifteen thousand dollars ($15,000) at the licensed location at the same rates as provided in KRS 360.010.” This change will take effect 90 days after adjournment of the 1998 session.

(3) Types of Loans:

(a) Over $15,000 — since there will be no limit on the interest rate after July 15, 1998, will there be limits on terms other than interest rate for these loans?

(b) Under $15,000 — No scheduled repayment of such loan may be more than 60 months and 15 days from the date of the loan if the amount of the loan is $3,000 or less, or 120 months if the amount of the loan is more than $3,000, and every contract of loan must “provide for repayment of the amount lent in substantially equal installments at approximately equal periodic intervals of time” [KRS 288.580(2)]

(i) Since KRS 288.580(2) does not require that the equal periodic installments be on a monthly or other specified period, it would appear that KRS Chapter 288 loans can be made on a quarterly, semiannual or other periodic installment basis so long as such installments are substantially equal as to amount and time. If the loan is made on other than a monthly installment basis, however, KRS 288.530(5) would appear to
limit any deferral charge on such loans to \$.02 for each dollar of deferred installment rather than \$.02 for each dollar of the installment times the number of months which the maturity of the contract is extended. See “Deferral Charges” discussed below.

(ii) On the other hand, the specific provisions of KRS 288.580(2), requiring that all loans must provide for repayment of the amount lent in substantially equal installments, would appear to limit petty loan companies to installment loans and preclude them from making demand and single payment loans on amounts below $15,000.

(c) No Splitting Of Loan Amounts. KRS 288.530(11) prohibits a petty loan company from splitting or dividing a loan or permitting a borrower to become indebted “under more than one (1) contract of loan at the same time” if, as a result, more interest or other consideration is received by the petty loan company that would otherwise be permitted by KRS Chapter 288. Thus, if a borrower desires to borrow $10,000, the petty loan company cannot divide the loan into ten $1,000 loans so as to charge 3% per month on each; rather, it is limited to a 2% a month since the loan exceeds $3,000.

Question? If the total number of loans to a borrower results in “the actual amount of the indebtedness” being in excess of $15,000, does this restriction apply in light of the 1998 amendment to KRS 288.470(3)?

(4) Permitted Charges: KRS 288.530(1) authorized a petty loan company to charge and receive:

(a) On loans of $3,000 or less — 3% per month on that part of the unpaid principal balance not in excess of $1,000 and 2% per month on that part of the unpaid principal balance exceeding $1,000 but not exceeding $3,000.

(b) On loans extending $3,000 — 2% per month on the unpaid balance of the principal amount of the loan [§3(1)].

Since KRS 288.530(1) provides that the foregoing changes shall “not [be] in excess” of the specified rates, variable rate loans appear to be authorized. It is understood that the Kentucky Department of Financial Institutions interprets KRS 288.580(2), requiring loan repayments to be in substantially equal installments, to only require the repayment of principal in substantially equal installments. See August 30, 1982 letter of J. Rick Jones, Attorney for Department of Financial Institutions, to David W. Harper, Greenebaum, Doll
and McDonald.

The foregoing charges may either be (1) computed in advance at the agreed rate on scheduled unpaid principal balances of the cash advance on the assumption that all scheduled payments will be made when due and then added to the original cash advance with the resulting sum being the face amount of the note [KRS 288.530(1)]; or (2) at the option of the petty loan company, computed on the unpaid principal balance of the loan from time to time outstanding, [KRS 288.530(b)].

It should be noted that under the first option, the interest calculation needs to be studied carefully since it is not the same method as would be employed if the loan were made under KRS 287.215 (add-on or discount installment loans made by banks).

If the charge is computed under the second option (a) the charge may not be paid, deducted, received in advance or compounded and must be computed only on unpaid principal balances for the time actually outstanding [KRS 288.530(8)]; and (b) no delinquency or deferral charges are permitted.

(5) **Other Charges**: In addition to the foregoing, a petty loan company is authorized to charge and collect the following:

(a) **Credit Investigations**: On loans actually extended, licensee may charge a credit investigation fee of $1 per $50 of the first $2,000 in principal amount (i.e., a $40 maximum fee). KRS 288.533(4) [added by 1988 HB 514 effective approximately July 15, 1998].

(b) **Closing Costs**: On loans secured by real estate mortgages, the following costs if they are not paid to the petty loan company or to a person "related" to the company:

1. Fees or premiums for title examinations, abstract of title, title insurance, survey or similarly purposes;
2. Fees for preparation of a deed, settlement statement, or other documents;
3. Escrows for future payment of taxes, including assessments for improvements, insurance and water, sewer and land rents;
4. Fees for notarizing deeds and other documents; and
5. Appraisal fees.

(c) **Filing Fees and Premiums**: Fees for filing and releasing liens and
instruments securing the loan and premiums for property damage and credit insurance [KRS 288.530(10)].

(d) **Delinquency Charges:** If ½ or more of any installment remains unpaid more than seven (7) days after it is due, a delinquency charge of $.02 for each dollar of the "scheduled installment" may be collected for each full month the installment remains unpaid [KRS 288.530(4)].

(e) **Deferral Charges:** If a wholly unpaid installment is deferred one or more full months, a deferral charge may be collected not exceeding $.02 for each dollar of the installment so deferred multiplied by the number of months the maturity of the contract is extended [KRS 288.530(5)]. However, the number of months by which the deferral charges is multiplied to arrive at the total deferral charge cannot exceed the number of installments which are due and wholly unpaid or due within 15 days from the deferral date.

(f) **Bad Check Charge.** A charge of the greater of $15 or the actual fee passed on from the financial institution may be imposed [KRS 288.533(2)].

(g) **Rebates:** KRS 288.530(6) requires precomputed charges to be refunded if the loan is prepaid in full; refund is required for partial prepayments. Although KRS 288.530(6) requires that the refund be of “the portion of the charges applicable to the full installment date nearest the date of prepayment”, KRS 288.530(2) provides:

“The portion of the charges applicable to any particular monthly installment period, as originally scheduled or following a deferment, shall bear the same ratio to the total charges, excluding any adjustments made pursuant to subsection (3) of this section, as the balance scheduled to be outstanding during that monthly period bears to the sum of all monthly balances scheduled originally by the contract of loan.”

This language appears to be the operational equivalent of the “rule of 78’s” and to sanction rebates on that basis. The Sixth Circuit has so held. Maddox v. Kentucky Finance Company, Inc., 736 F.2d 380 (6th Cir. 1984). However, the use of the Rule of 78's will be affected by the 1994 federal legislation discussed in Part VI, *infra*.

(h) **Collection Costs:** KRS 288.533 permits collecting a reasonable attorney’s fee in connection with the collection of a loan actually incurred by the licensee and paid to a non-employee attorney.

(6) **Collateral:** Loans made under KRS Chapter 288 may be either secured or
unsecured. If secured, any type of collateral (including first mortgages on real
estate) may be taken as security except that if the amount of the loan is $3,000
or less only second or more inferior real estate mortgages are permitted. [KRS
288.580(3)]. KRS 288.570(2) also permits loans made under KRS Chapter
288 to be secured by wage assignments so long as the amount collected from
the employer does not exceed 10% of the amount owed to the borrower for
each pay period.

(a) In lieu of perfecting a security interest, licensee may change a “fee” to
the extent it “does not exceed the fee payable to public officials for
perfecting the security interest”. [$8 per KRS 64.012].

(7) Insurance: Under KRS 288.560(1) as amended, a petty loan company may
request a borrower to insure tangible property, other than household goods,
offered as security for a loan exceeding $300 and may also request that life,
unemployment, health or disability insurance be obtained by the borrower or
any two of them if there are two or more borrowers as additional security for
the loan; however, only “one (1) policy of life insurance may be written in
connection with any loan transaction” [KRS 288.560(2)]. Premiums for such
insurance may be deducted from the loan proceeds and paid to the insurance
carrier [KRS 288.560(3)].

D. SAVINGS AND LOAN ASSOCIATIONS (KRS CH. 289)

(1) Amount and Types of Loans.

(a) Real Estate Loans. KRS 289.441(1) provides that “real estate loans
may be made only as authorized by this chapter.”

(i) “Every” real estate loan shall be secured by first mortgage.

(ii) Signed appraisal required by a “qualified person” on all real
estate loans. KRS 289.441(1).

(iii) May have “charge for late payment”. KRS 289.441(2).

(iv) No interest rate specified in KRS 289.441. However, KRS
289.461(1) provides that state S&L’s are authorized to make
loans secured by a first lien on real estate “at a rate or rates
not in excess of that provided by KRS 360.010 and 360.025.”

(v) Monthly escrowing of taxes, assessments, insurance premiums
and other charges are authorized by KRS 289.491(3).

(vi) KRS 289.501 authorizes collection of “all reasonable expenses
incurred in connection with the making, closing, disbursing,
expending, readjusting, or renewing real estate loans” and such charges “shall not be deemed interest.” In lieu of the actual charges, KRS 289.501(4) permits the State S&L to “make a reasonable charge, part or all of which may be retained by the association which renders such service, or part or all of which may be paid to others who renders such services.”

(b) Property improvement loans or financing of mobile homes. There are two separate statutes both addressing these types of loans — KRS 289.451(8) and KRS 289.461. It appears that the statutes contemplate both secured or unsecured loans. If secured, how do the statutes coordinate with KRS 289.461(1)?

(i) KRS 289.451(8) provides that loans may exceed interest rate allowed by KRS 360.010 only if permitted by Title I of the Federal Housing Act of 1934 (12 U.S.C. §1701 et seq.) or the Servicemen’s Readjustment Act of 1944 (38 U.S.C. §1801 et seq.)

(ii) KRS 289.461 provides that the loans either comply with Subchapter C of 12 C.F.R. Title 12, and if no interest rate is specified therein, then the provisions of KRS 287.215 apply.

(c) Loans On The Direct Reduction Plan. KRS 289.451(1) permits “loans on the direct reduction plan” and the “board of directors or the bylaws of the association shall prescribe interest rates which may be variable and may prescribe the duration of the loan, and the loan shall be payable in equal weekly or monthly instalments.” KRS 289.451(3) indicates that an instalment must be “unpaid for six (6) weeks after it has become due and payable” before a default can be declared. A written demand must be mailed to the borrower who has 30 days to pay.

(d) Loans An A Semi-Annual Reduction Plan. KRS 289.451(5) permits “loans on a reduction plan where the reduction of loan or credit upon loan shall be made at the end of every semiannual period.” The statute provide that the “bylaws shall prescribe the interest rate and duration of the loan”, but no maximum interest is stated.

(e) Loans On Sole Security Of Savings Accounts or Certificates. KRS 289.451(4) permits “loans on the sole security of savings accounts or savings certificates.” Loan may not exceed the withdrawal value of the pledged savings. No interest rate is specified in the section.

(f) Loans Federally Insured Or Guaranteed. Such loans are authorized
“without regard to the foregoing” provisions of KRS 289.451. [KRS 289.451(6)].

(g) Servicemen's Readjustment Act of 1994 Loans. State S&L are authorized by KRS 289.471 to make what are commonly known as VA loans.

(2) Default Penalty. KRS 289.281 provides that a state S&L “may charge a member any sum of money by the way of fine or penalty against borrowers for defaults or in payment of loans.”

IX. USURY IN A MULTI-STATE BANKING WORLD.


(1) Easy to apply when bank’s main office and all of its “branches” are in one location.

B. Multistate Branches Under Riegle-Neal.


“The laws of the host State regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches shall apply to any branch in the host State of an out-of-State national bank to the same extent as such State laws apply to a branch of a bank chartered by that State, except—

(i) when Federal law preempts the application of such State laws to a national bank; or

(ii) when the Comptroller of the Currency determines that the application of such State laws would have a discriminatory effect on the branch in comparison with the effect the application of such State laws would have with respect to branches of a bank chartered by the host State.

(2) Riegle-Neal §111 [12 U.S.C. §1811 note]:

“No provision of this title and no amendment made by this title to any other provision of law shall be construed as affecting in any way — . . . (3) the applicability of section 5197 of the Revised Statutes [12 U.S.C. §85] . . . .”
C. View of The OCC.

(1) "An interstate national bank may charge interest permitted by the laws of its home state unless the loan is made — that is, the loan is approved, credit is extended and funds are disbursed — in a branch or branches of the bank in a single host state. If one or two of those three functions occur in a host state, the bank may, alternatively, charge the interest permitted by that state if, based on an assessment of all of the facts and circumstances, the loan has a clear nexus to that state. Moreover, if a bank is permitted to charge the rates of a particular home or host state, it may . . . charge the most favored lender rates permitted by that state . . . ." See Letter dated February 17, 1998 from Julie L. Williams, OCC’s Chief Counsel, to Jeremy T. Rosenblum at 14 (Appendix 2).

(2) “We conclude that the mere presence of a host state branch does not defeat the ability of a national bank to apply its home state’s rates to loans made to borrowers who reside in that host state.” Id. at 9.

(3) It is “permissible for the lending bank to charge the rates permitted by the host state even if the borrower resided in another state. In doing so, the OCC recognized the significance of an appropriate disclosure to the borrower that the interest charged is governed by applicable federal law and the law of the relevant state.” Id. at 11.

(4) Selected bases for the OCC’s Conclusion:

(a) Statement of Senator Roth:

“In order to ensure that banks providing credit to out-of-State borrowers would be unaffected by structural changes brought about by interstate branching legislation, I offered the [usury] savings clause in committee, and it is now part of this conference report. The essential point of my amendment is that a branch of a bank that provides credit across state lines may impose its State law loan charges even though there is a branch of that same bank in the State of its customer.” See 140 Cong. Rec. S12789 (9/13/94).

(b) Statement Of Senator Roth:

“I immediately began to take steps to address this potential threat not only to Delaware’s credit card industry but to all banks that extend credit to borrowers who reside outside the State where the bank, or under this legislation, the branch making the loan or other extension of credit is located. . . . The savings clause means that the establishment of a branch in the borrower’s state does not defeat
the powers that a Delaware bank enjoys today under [section 85]."

Id.

D. Is The OCC Too Aggressive?

(1) House Conference Report No. 103-651 at p. 51:

"The laws of the host State regarding community reinvestment, consumer protection (including applicable usury ceilings), fair lending, and establishment of intrastate branches shall apply to any branch of a national bank in the host State to the same extent as such State laws apply to a branch of a bank chartered by that State, except when Federal law preempts, or when the Comptroller determines that the law has a discriminatory effect . . ."

(2) Id. at 53: "Congress does not intend that the Interstate Banking and Branching Efficiency Act of 1984 alters this [federal-state] balance and thereby weaken States' authority to protect the interests of their consumers, businesses, or communities."

(3) Id. at 64: "Section 111(3) specifically states that nothing in Title I affects [12 U.S.C. §85]. . . . According, the amendments made by the [Act] that authorize insured depository institutions to branch interstate do not affect existing authorities with respect to any charges under section [85] . . . imposed by national or state banks for loans or other extensions of credit made to borrowers outside the state where the bank or branch making the loan or other extension of credit is located."

E. Implications In A State Bordering Ohio — Kent v. Bank One, Columbus, N.A., 92. F.3d 384 (6th Cir. 1996).

(1) Plaintiffs argued that premiums on force-placed insurance added by national bank to the amount of their automobile loans violated various statutes including 12 U.S.C. §85. Bank defended by arguing "most favored lender" status and referring to O.R.C. §1151.21 and §1161.28 which the Sixth Circuit concluded "allows 'building and loan' banks as well as savings banks to charge unlimited dues, fines, interest and premiums on 'loans made.'"

(2) The Sixth Circuit states that "these contracts for loans are governed by the Most Favored Lender Doctrine, and there is no limit on the amount of interest the Bank could charge."

(3) If the OCC's exportation analysis under Riegle-Neal is correct, multistate banks with offices in Ohio will have no usury limits.
X. INSTALLMENT LOANS - PRE-COMPUTED INTEREST (KRS 287.215).

A. INTRODUCTION AND APPLICABILITY.

(1) KRS 287.215 is basically "rate" legislation - authorizing banks to make installment loans with precomputed ("add-on" or "discount") interest. KRS 287.215 is not limited to "consumer loans"; rather, it is applicable to all types of credit.

(2) Since Duffy v. Bank of Louisville & Trust Co., KY., 705 S.W.2d 920 (1986), KRS 287.215's applicability is effectively limited to loans of $15,000 or less although the statute has no explicit dollar limitation.

B. INTEREST RATE AND CALCULATION.

(1) "Add-on". KRS 287.215 (1)(a) permits an 8% "add-on" rate; that is, a rate which does not exceed $8 per $100 per annum upon the principal amount of the loan.

(2) "Discount". If the loan does not exceed 5 years and 32 days, the "$8 per $100 per annum" interest rate can be received (which has the effect of "discounting" the interest from the loan proceeds). KRS 287.215(1)(b).

C. OTHER PERMITTED CHARGES.

(1) KRS 287.215 contains very limited language on the types of other charges which a bank can directly or indirectly charge, contract for or receive. They are:

(a) An investigation fee equal to the lesser of $1 for each $50 or fraction thereof, or $16, KRS 287.215(2).

(b) Lawful fees actually paid to a public officer for filing, recording or releasing an instrument securing the loan, KRS 287.215(2).

(c) Delinquency charges, which cannot exceed $.05 for each dollar of each installment more than 10 days late (only one delinquency charge can be made on any one installment payment), KRS 287.215(3).

(d) Attorney's fees, which cannot exceed 15% of the unpaid balance, and court costs; provided the note is referred to an attorney who is not the salary employee of the bank for collection, KRS 287.215(3).

(2) In addition to the foregoing charges, the bank may collect from the debtor or add to the principal amount of the loan, charges for the title exam, appraisals and title insurance so long as such charges are not retained by the
D. OTHER PROVISIONS.

(1) **Wage Assignments.** Assignments, pledges or transfers of wages to be earned or paid in the future are prohibited, KRS 287.215(5).

(2) **First Mortgages on Real Estate.** First mortgages on real estate are prohibited (except (a) where created by virtue of a judgment or decree, (b) first mortgages on unimproved real estate not exceeding 10 acres, or (c) first mortgages on real estate on which there is located or to be located a residential mobile home), KRS 287.215(5).

(3) **Splitting-Up Loans.** A loan cannot be split up or divided to permit a person to become obligated to the bank under more than one loan at the same time for the purpose of obtaining a greater charge than otherwise permitted under KRS 287.215. (See OAG 74-304 (April 22, 1974), which takes the position that a bank cannot have in its loan files two or more loans at the same time involving the same person where one of the loans is made pursuant to KRS 287.215. The fact that the loans were made at different times is "inconsequential"), KRS 287.215(6).

(4) **Balloon Payments.** If any payment is more than twice as large as the average of the earlier scheduled payments, the debtor has the right to refinance without penalty the "balloon" payment of terms "no less favorable" to the debtor than the original loan, KRS 287.215(1)(c).

(5) **Prepayment and Rule of 78's.** The borrower has the right to prepay the loan in whole or in part at any time. If the loan is fully prepaid prior to maturity, a rebate must be made at a rate not less than in accordance with the Rule of 78's if the maximum financing charge permitted by the statute has been taken. If a lesser charge has been taken, a rebate at not less than a proportional rate must be made, KRS 287.215(4).

(a) In computing the rebate, a minimum charge of $10 can be retained to cover acquisition costs, and where the rebate is less than $1, no rebate need be made. (Note: the $10 charge cannot be taken before the Rule of 78's rebate computation is made. According to the Attorney General, the rebate computation must be based on the total finance charge. See OAG 82-260 (April 9, 1982)).

(6) **Provisions Required in Note.** Every note evidencing a loan under KRS 287.215 must contain the following information and provisions:

(a) the original principal amount of the loan excluding any charge made
under KRS 287.215;

(b) A statement of the total charges for the loan;

(c) The amount and the date of each installment;

(d) the date of final maturity; and

(e) An agreement that the debtor may repay the loan in whole or in part at any time, and that if the loan is paid in full before final maturity, the debtor will receive a refund of the unearned portion, KRS 287.215(7).

(7) **Copy to Debtor.** At the time of the loan, the debtor must receive either a copy of the note or a statement of the transaction containing the provisions and information required to be contained in the note, KRS 287.215(7).

(8) **Payment Receipts.** The bank must deliver a receipt for each payment received, KRS 287.215(7).

(9) **Advertising.** In advertising for a loan subject to KRS 287.215, every advertisement stating the amount of the loan must state the original principal amount and show in detail any charges to be made, KRS 287.215(8).

E. **PENALTY.**

If a willful violation of any provision of KRS 287.215 occurs, the loan is void and the bank loses its right to collect or receive any interest or charges whatsoever on the loan. However, the unpaid principal remains payable, KRS 287.215(10).

XI. **BANK CREDIT CARDS AND OTHER REVOLVING CREDIT (KRS 287.710 - 287.770)**

A. **COVERED TRANSACTIONS.**

(1) Prior to the 1998 General Assembly, KRS 287.710 to 287.770 authorized banks to engage in revolving credit transactions - the principal one being credit cards. However, other types of revolving credit - such as overdraft checking and home equity lines of credit - were also covered so long as the arrangement contemplated that:

(a) The bank “may extend credit by permitting the debtor to make purchases of goods or services, or obtain loans, from time to time, directly from the bank or indirectly by use of a credit card, check or other devise, as the plan may provide;”

(b) The unpaid balances of purchases made, the principal of loans obtained, and the finance and other appropriate charges are debited to
the debtor's account;

(c) A finance charge, if made, is computed on the outstanding unpaid balances of the debtor's account from time to time; and

(d) The bank renders statements to the debtor at the regular intervals and the amount of such statements is payment on a specified date or, at the borrower's option, may be paid in installments, KRS 287.710(6).

(2) Section 19 of House Bill 516 amends KRS 287.710(6) to delete the underlined language above which is part of the definition of "revolving credit plan".

(a) Indicates that only "credit card" revolving plans are now governed by the statute.

(b) Home equity lines of credit and other revolving credit plans secured by a mortgage on real property would now seem to be governed by KRS 382.385 (enacted in 1992) which does not have any limitation on the finance charge or specify any other payment terms except that the finance charge many not be "precomputed" but must be "computed on the outstanding unpaid balances of the debtor's account from time to time." See KRS 382.385(1)(b)(3).

(c) What is the basis for escaping the general usury limit of KRS 360.010 on non-credit card revolving credit lines of less than $15,000 to a consumer?

(i) Federal preemption.

(ii) Borrowing credit union or other lender's rates.

B. FINANCE CHARGES; PERIODIC RATE.

(1) A periodic rate not exceeding 1 ¼% per month of either the "average daily unpaid balance" of the debtor's account during the billing cycle, or of the "unpaid balance" of such account on the same day of each billing cycle, KRS 287.740.

(2) A variation of not more than four days from billing cycle to billing cycle is deemed "the same day for each billing cycle," KRS 287.640.

C. OTHER PERMITTED CHARGES.

If provided for in the revolving credit plan, the following additional fees, charges and costs may be collected:
(1) **Annual Fee.** An annual fee of $20, KRS 287.750.

(2) **Delinquency Charges.** Delinquency charges not exceeding $5 each month, if payments required by the revolving credit plan are not made when due, KRS 287.750(1).

(3) **Real Estate Closing Costs.** All fees and closing costs incurred in connection with the taking of a mortgage on real estate, if bonafide and not retained by the bank, can be collected, KRS 287.750(2).

(4) **Attorney's Fees.** Reasonable attorney's fees and court costs, if the account is referred to an attorney who is not a salaried employee of the bank for collection, KRS 287.750(3).

D. **MISCELLANEOUS.**

(1) **Initial Disclosure.** Before opening a revolving credit plan, the bank must deliver or mail to the debtor a statement of the provisions of the plan containing the disclosures required by KRS 360.210 to KRS 360.265, the requisite federal Truth-in-Lending disclosures, and a statement that the debtor may pay the unpaid balance of his or her account in whole or in part at any time. If two or more persons having the same residence are authorized to obtain credit under the plan, the disclosures and any subsequent periodic statements may be delivered or mailed to the one person designated by the plan, KRS 287.720.

(2) **Periodic Statements.** The information required by the federal Truth-in-Lending Act in the form of a periodic statement for each billing cycle is also required by KRS 287.730(1). A legend to the effect that the debtor may at any time pay the aggregate balance owed or any part thereof is also required, KRS 287.730(1).

(3) **Free ride Period.** Where the revolving credit plan involves the use of a credit card for the purchase of goods or services from a third-party, no finance charge can be imposed upon the debtor if payment in full of the entire outstanding unpaid balance owed on the debtor's account is received at the place designated by the bank by the date of the statement for the next billing cycle, KRS 287.730(2).

XII. **RETAIL INSTALLMENT SALES ACT (KRS 371.210 - 371.330).**

A. **SCOPE.**

(1) This act generally applies to consumer transactions, i.e., the sale of "goods" or "services" when purchased primarily for personal, family or household use.
The sale of "motor vehicles" are specifically excluded from coverage, KRS 371.210(3).

(a) With respect to KRS 371.210(3)'s exclusion of "motor vehicles," that term is defined to include a "mobile home . . . used primarily to transport persons or property on a public highway . . ." there has been some confusion over whether the "stationary" mobile home (as opposed to a motor home, which clearly is a "motor vehicle") is subject to the provisions of the Motor Vehicle Retail Installment Sales Act (KRS 190.090 et. seq.) or the Installment Sales Act (KRS 371.210, et seq.).

(b) In 1980, the Attorney General stated in a footnote to his opinion that retail installment sales of mobile homes "should not fall within the ambit of KRS Chapter 190 . . . Therefore, such contracts are covered by the provisions of KRS 371.210, et. seq, OAG 80-51 (January 14, 1980).

(c) Later, in another opinion, the Attorney General attempted to resolve the apparently conflicting statues by stating that stationary mobile homes with a base price of $5,000 or less were covered by the Motor Vehicle Retail Installment Sales Act, while stationary mobile homes having a cash price in excess of $5,000 were covered by the Retail Investment Sales Act. OAG 80-111 (February 8, 1980).

(d) In 1984, the General Assembly removed the "5,000 cash sale price" qualification from the definition of a "motor vehicle" in the Motor Vehicle Retail Installment Sales Act. As a result, the Attorney General's distinction between the two statues appears to be no longer applicable.

(e) Finally, also in 1984, the Attorney General again opined that a manufactured home financing transaction providing for a rate of interest that may be adjusted at certain regular intervals is governed by the provisions of KRS 360.150. The manufactured home financing transaction providing for a fixed rate of interest is governed by the Motor Vehicle Retail Installment Sales Act. KRS 190.090 et seq. (OAG 84-353).

(f) As a result, the most conservative approach is to finance stationary mobile homes transactions (i.e., purchase installment contracts) as if the more restrictive finance charge rates authorized by the Motor Vehicle Retail Installment Sales Act were applicable.

B. FINANCE CHARGE RATES.
(1) KRS 371.260(1) specifically permits the seller to receive a "time price differential" in retail installment contracts payable in substantially equal monthly installments, but places no limitation upon the amount of the time price differential.

(2) Thus, because of the traditional distinction between "interest" and a "time price differential", see Munson v. White, 309 Ky. 295, 217 S.W.2d 641 (1920), the Retail Installment Sales Act contains no limit on the amount of finance charge which can be collected.

C. OTHER PROVISIONS.

(1) Disclosure Requirements. There are specific disclosure requirements relating to type, size and the like, and a "NOTICE TO THE BUYER" provision which must be contained in the contract. The retail installment contract also must disclose certain information with respect to the sale, such as the cash sale price, the down payment, official fees, the amount of the time price differential and other similar information, KRS 371.220. In 1996, the disclosure requirements were liberalized to provide that an agreement can be "accepted" by the buyer as an alternative to being "signed" by the buyer. "Acceptance" is defined as including use by the buyer, or a person authorized by the buyer, after requesting the account.

(2) Prepayment and Rebates. The buyer must have the right to prepay the contract at any time without penalty. He is entitled to receive a refund of unearned charges under the Rule of 78's. Acquisition costs of $20 can be deducted before computing the rate. Rebates of less than $1 need not be made, KRS 317.260(2).

(3) Delinquency Charges. Delinquency charges for payments more than 10 days late are collectable in an amount not exceeding 5% of the installment or $10, whichever is less. However, a minimum delinquency charge of $1 may be collected, KRS 371.270(1).

XIII. MOTOR VEHICLE RETAIL INSTALLMENT SALES ACT (KRS 190.090 - 190.140)

A. SCOPE.

(1) Statutory Scope:

(a) Any sale of a motor vehicle for other than business or commercial use evidenced by a retail installment contract in which the buyer agrees to pay a "time sale price" payable in two or more installments, KRS 190.090(2).

(b) "Motor Vehicle" generally includes any devise in, upon, or by which
any personal property is or may be transported or drawn upon a highway, KRS 190.090 (4).

(i) Some exceptions exist for road machinery and farm implements.

(ii) Under a literal reading of this definition, a "stationary" mobile home could be a "motor vehicle" subject to the Motor Vehicle Retail Installment Sales Act, rather than "goods" covered by the more general Retail Installment Sales Act contained at KRS 371.210 et. seq. This is the view of the Kentucky Attorney General, see Section VIII, A(2)(a)4 above.

(iii) Formerly, the definition of a motor vehicle was limited to vehicles having a cash sales price of $5,000 or less. This dollar qualification was deleted by the 1984 General Assembly.

(c) “Retail instalment contract” is defined in KRS 190.090(3) as follows:

“Retail instalment contract” means any agreement, entered into in this state, evidencing a retail instalment sale of a motor vehicle, other than for the purpose of retail, pursuant to which title to, or a lien upon the motor vehicle is retained by the retail seller as security for the retail buyer’s obligation.

(2) Bank Direct Motor Vehicle Lending With Dealer Performing Some Services.

(a) Bank One, Lexington, N.A. v. Goodman, Clay Circuit Court, No. 96-CI-00231 (case pending) (is a direct loan to finance a motor vehicle which is executed by the borrower at the dealer’s lot governed by the substantive provisions of the MVRISA?).

(b) By letter dated August 26, 1991, and signed by DFI Commissioner Edward B. Hatchett, the DFI approved direct bank motor vehicle lending. The DFI specifically noted that “the customer [would] make application for credit to [the bank] through the dealer.” The DFI understood that the “credit application would be forwarded to the Bank, and the credit decision would be made by an officer of [the bank] at [the bank’s] offices.” The DFI was aware that “the note and other forms would be prepared at the automobile dealership, signed and the dealership by the customer and forwarded to [the bank] for entry on its books and further financing statements.” The DFI knew that “no bank employees will be located at the dealership and there will be no solicitation or origination of loans by bank employees at the dealership.” The DFI concluded that “the loan would be a direct
obligation with [the bank].” The DFI advised the bank that it “does not object to the Bank taking loan applications that have been filled out at the automobile dealership.” The DFI never advised the bank that it believed the substantive requirements of the MVRISA applied to the transaction.

B. FINANCE CHARGE RATES AND COMPUTATION.

(1) For any new or used motor vehicle sold in its model years, a $11/$100 "add-on" rate can be charged, KRS 190.110(1).

(a) The proper method of calculating the maximum permissible finance charge under KRS 190.110 is to multiply the principal balance (the cash sale price less any down payment plus any insurance or official fees) times the rate specified in KRS 190.110(1) times the number of years over which the principal amount will be repaid (i.e., $10,000 x $11/$100 x 5). Capitol Cadillac-Olds, Inc. v. Roberts, Ky., 813 S.W.2d 287 (1991).

(2) For any new motor vehicle not sold in its model year, $13/$100 "add-on" rate can be charged, KRS 190.110(1).

(3) For any used motor vehicle having a model year of one or two years prior to the year in which the sale is made, #13/#100 "add-on" rate can be charged, KRS 190.110(1).

(4) For all other motor vehicles, a $15/$100 "add-on" rate can be charged, KRS 190.110(1).

(5) At the seller's option, the finance charge can be computed on a simple interest basis, and at a fixed or variable rate, but in this event the amount of finance charge that may be collected cannot exceed the amount that could have been collected if the finance charge were pre-computed, KRS 190.110(4).

(6) Prejudgment Interest. In Capital Cadillac-Olds, the Supreme Court held that prejudgment interest is available on loans which have had the maturity accelerated, and thereby clarified a longstanding ambiguity created by Credit Alliance Corp. v. Adams Construction Corp., Ky., 570 S.W.2d 283 (1978).

C. MISCELLANEOUS PROVISIONS.

(1) Disclosure Requirements. KRS 190.100 contains requirements of what the retail installment contract must contain. At least 8 point type is required, and "all the agreements of the parties" must be included. The cash sale price, the amount of the down payment, official fees, the amount, if any, included for insurance and other benefits (together with a description of the type of

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coverage and benefits), the principal balance, the amount of the finance charge and the "time balance" must also be disclosed.

(2) **Collateral.** A motor vehicle installment sale contract cannot take a security interest in any goods other than the motor vehicles and its accessories, KRS 190.100(1)(b).

(3) **Prepayment and Rebates.**

(a) If the finance charge is pre-computed, the buyer may prepay the contract at any time and is entitled to receive a refund of a portion of the finance charge computed in accordance with the Rule of 78's. However, an acquisition cost of $25 can be deducted from the finance charge before computation of the refund is made. No refund of less than $1 need be made, KRS 190.120(1).

(b) If the finance charge is determined by the "simple interest" method, the right of repayment also exists without any rebate but a minimum finance charge of $25 can be collected in any event, KRS 190.120(2).

(4) **Deferred Payments.** The scheduled due date or a schedule payment can be deferred. Additional finance charges computed at the same rate and by the same method as set out in the original contract can be collected. A refinancing charge for such extension, deferment or renewal not exceeding $5 can also be collected, KRS 190.130.

(5) **Delinquency Charges.** When the finance charge has been determined by a pre-computed method, a delinquency charge on each installment not paid within 10 days of its due date, in an amount not exceeding 5% of each installment of $5, whichever is less, can be collected, KRS 190.100(1)(d).

(6) **Insurance.** Contract may include provisions for the purchase of insurance by the motor vehicle purchaser, and the amount may not exceed premiums chargeable in accordance with the applicable rate filings.

(a) Contract shall contain a definite statement, in 12 point bold type of larger, that the insurance, if any, included in the sale provides or does not provide coverage for personal liability and property damage caused to others.

(b) Within (30) days after execution of the contract, the retail buyer must be sent a copy of the policies.

(c) Buyer has the right to select insurance agent or broker.

(d) If policy is canceled, unearned premiums must be refunded and
credited to the contract balance.

(e) In 1994, KRS 190.100(4) was amended to clarify that single interest insurance insuring the retail seller or sales finance company is not considered insurance within the scope of this provision.

(7) **Attorney's Fees.** When the finance charge has been determined by the pre-computed method, attorney's fees not exceeding 15% of the amount due and payable under the contract, plus court costs, can be collected if the contract is referred to an attorney not a salaried employee of the holder of the contract for collection. KRS 190.100(1)(d). (Because of the statute's peculiar wording, a question exists as to whether attorney's fees can be collected where the finance charge is determined on a "simple interest" basis. Arguably, the more general "attorney's fees" provisions of KRS 453.250 should permit the collection of attorney's fees in a "simple interest" situation.)

(a) KRS 190.110(d)(1), which sets a maximum attorney's fees recovery of 15% of the "amount due and payable", permits a maximum recovery of 15% of the judgment amount (as opposed to the amount due at acceleration). However, a court has the inherent right to determine what is a reasonable attorney's fee (subject to the 15% cap) even if the note provides that 15% is deemed to be a reasonable attorney fee. *Capitol Cadillac-Olds, Inc. v. Roberts*, Ky., 813 S.W.2d 287 (1991).

(b) Two other attorney's fees statutes exist in Kentucky -- KRS 355.3-106 and KRS 287.215 -- which contain similar language and which will probably be similarly interpreted.

XIV. MANUFACTURED HOME FINANCING (KRS 360.150).

A. **SCOPE.**

First enacted in 1982, KRS 360.150 is limited to a "manufactured home financing transaction," which involves the sale of a "manufactured home" or a direct loan used to finance the purchase of a "manufactured home," if the transaction provides "that the rate of interest may be adjusted at certain regular intervals." Thus, KRS 360.150 is only applicable to variable rate transactions.

On the other hand, if the transaction provides "for a fixed rate of interest payable in substantially equal successive installments over a fixed term, KRS 360.150 is NOT applicable.

(1) **Manufactured Home.** As amended in 1984, the term includes the typical single family mobile home as well as a pre-fabricated dwelling that is manufactured in two or more modules at a location other than a homesite, and
which is designated to be used as a residence when the modules are transported to the homesite, and the modules are joined together and installed on a permanent foundation system. The term includes the plumbing, heating, air conditioning and electrical systems contained in the structure, KRS 360.150(1)(c).

(2) **Effect of Federal Preemption Laws.** To the extent that a "manufactured home financing transaction" will result in the taking of a first lien on "residential real property" or "residential manufactured housing," as defined in Section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980, the provisions of that statute, which preempt certain state laws to the contrary, may also apply.

(3) **Option to Comply with Federal Agencies' Regulations.** In lieu of complying with KRS 360.150, the debtor and lender may agree on terms authorized or permitted in any program for residential mortgage loans by the FHLBB, the Comptroller of the Currency, or any other federal department, agency or board, KRS 360.150(13).

B. **VARIABLE RATE TRANSACTIONS.**

(1) **Required Use Of Index.** If the transaction provides that the rate of interest may be "adjusted" at certain regular intervals, KRS 360.150 requires that specific indices be used. Further, the frequency with which such adjustments may be made, and limitations on the amount thereof, are specified, KRS 360.150(2).

(2) **Available Indices.** KRS 360.150(3) only permits the use of **two** indices:

(a) The monthly average yield on U.S. Treasury Securities adjusted to a constant maturity of 5 years; or

(b) An index approved by the FHLBB or by the Comptroller of the Currency for adjustable or variable interest rates on residential mortgage loans.

(3) **Minimum Interval Between Adjustment.** The rate of interest cannot increase or decrease during the six-month period following the loan transaction. Further, at least six months must elapse between subsequent changes, KRS 360.150(4).

(4) **Ceiling on Amount of Adjustment.**

(a) Where the stated regular interval between rate adjustments is six months, and adjustment may not result in a rate of interest which is more than 1% greater or less than the interest rate in effect prior to
such adjustment, KRS 360.150(6).

(b) If the stated regular interval between rate adjustments exceeds six months, then the maximum adjustment, either up or down, is 1%, multiplied by the number of whole consecutive six month period in the interval between rate adjustments, KRS 360.150(7).

(5) Decrease Mandatory. Any increases in the rate of interest permitted are optional with the creditor; however, decreases are mandatory whenever the total decrease in the index equals or exceeds one-quarter (1/4) of 1%, KRS 360.150(7).

(6) Prior Written Notice. The creditor must send written notification of any rate adjustment, by first class mail, postage pre-paid, at least one month before the date of the new rate of interest takes effect, KRS 360.150(12).

(7) Computation of Adjustment.

(a) First Adjustment. Adjustments, either up or down, to the rate of interest shall, for the first adjustment following the loan transaction, be equal to the difference between the index value in effect on the first day of the second calendar month preceding the particular adjustment date, and the value in effect on the first day of the month in which the loan transaction occurred, KRS 360.150(5).

(b) Subsequent Adjustments. Adjustments after the first adjustment must be equal to the difference between the index value in effect on the first day for the second month preceding the adjustment date and the index value in effect on the first day of the second month preceding the date of the immediately preceding rate of adjustment, KRS 360.150(5).

(8) Result of Adjustment on Payment Terms. By agreement, adjustment to the rate of interest may result in changes in the amount of regular installments payments due, or changes in the term of the financing, or a combination of both, KRS 360.150(10).

XV. ADVANCING AMOUNTS OF TAX REFUNDS.

A. OAG 82-231: Transaction by which person advanced 60% of expected federal tax refund in exchange for taxpayer’s agreement to have refund check sent to person supplying the funds and giving person advancing the money a power-of-attorney to endorse the refund check was a loan subject to Kentucky’s usury limits despite arguments that (1) transaction was the sale of a chose in action and not a loan and (2) the uncertainty as to actual amount of refund and time of receipt eliminated ability to state with reasonably certain the actual amount of return to be received by the party advancing funds.
B. Cades v. H&R Block, Inc., 43 F.3d 869 (4th Cir. 1994), cert. denied, 515 U.S. 1103 (1985). Delaware bank that provided customer with refund anticipation loan (RAL) in connection with tax service’s electronic filing and rapid refund program, thereby enabling consumer to borrow funds on short-term demand basis in amount of consumer’s expected federal income tax refund, was located in Delaware, not South Carolina where consumer and tax service was located, where loan was approved in Delaware and loan proceeds originated in Delaware.

XVI. CHECK CASHING SERVICES (KRS 368.010 - 368.990).

A. LICENSE REQUIREMENT.

(1) Enacted by the 1992 General Assembly, this chapter requires that a license be obtained from the Kentucky Department of Financial Institutions before any person “shall engage in the business of cashing checks for a fee or other consideration”. (KRS 368.020)

(2) Entities exempt from licensing requirement (KRS 368.030):

(a) Any bank, trust company, savings and loan association, savings bank, credit union, consumer loan company, industrial loan corporation, mortgage loan company, mortgage loan broker, or pawn broker which is chartered, licensed or organized under state or federal law and authorized to do business in Kentucky.

(b) Any person who cashes checks without receiving any consideration or fee.

(c) Retail seller of goods or services who “from time to time” cashes checks for a fee or other consideration.

B. CHECK CASHING FEE NEITHER “INTEREST” NOR LIMITED IN AMOUNT.

(1) KRS 368.100(2): “Any fee charged by a licensee for cashing a check shall be disclosed in writing to the bearer of the check prior to cashing the check, and the fee shall be deemed a service fee and not interest.”

(2) Does this “not interest” characterization apply to a fee charged by a person not required to have a license under KRS Chapter 368?


(1) Chapter 13 debtor brought adversary proceeding against check cashing service challenging $600 in fees when check cashing service held the check for
two separate two week periods.

(2) Court held that KRS 368.100(2) “seems to contemplate the first charge” and focused its analysis on whether the second “renewal” charge was permissible.

(3) “Since the fees and charges at issue here may be classified as finance charges, they are subject to the usury statute, KRS 360.010 and 360.020.” See 215 B.R. at 974.

(a) “For the defendants to argue that they are not extending credit is disingenuous. They are disbursing funds to people like the plaintiff on the promise of repayment of the sum plus the ‘service charge,’ at a later time. If this is not the extension of credit, this Court finds it hard to imagine any transaction that it.”

(b) Court concluded that “Any finance charge that the defendants required the plaintiff to pay in order to complete her transactions with them which was in excess of the legal rate of interest was usurious.”

D. Hamilton v. HLT Check Exchange, LLP, 1997 WL 769339 (E.D. Ky. 12/11/97) (Hood, J.)

(1) Plaintiffs brought suit challenging practice of charging 20% of amount of check to hold check for two weeks and to incur an additional one week “deferral” for 10% of the sum originally advanced.

(2) KRS 368.100(2) applies to “the service of processing and providing instant cash to unbanked people” but its “not interest” characterization does not apply to transactions where the person is holding a check for a period of time after the transaction. The latter transaction is a loan governed both by Kentucky general usury law and the federal Truth-In-Lending Act.


(1) Would establish limits on check cashing/deferred deposit fees. Fee could not exceed $15/$100 and the fee is for a period of 14 days. The maximum holding period would be 60 days with a limit of three rollovers. The maximum amount of a transaction could not exceed $500. An additional fee for returned checks could also be imposed.

(a) Effective interest rate would still be significant: $500 deferred for 14 days and three rollovers would result in a fee of $300 for 8 weeks on $500.

(2) Senate amendments would reduce fee to $10/$100 and only two rollovers.
XVII. TITLE PLEDGE LOANS (SB 392 - proposed new sections of KRS Chapter 368).

A. SB 392 is legislation which would create new sections of KRS Chapter 368 to regulate title pledge loans. Legislation was still pending as of the publishing deadline for this outline.

B. Currently, litigation is ongoing whether such loans are governed by the pawn broker rules of KRS Chapter 226.
Interest Rate Changes: 1967-97
February 17, 1998

Jeremy T. Rosenblum  
Ballard Spahr Andrews & Ingersoll  
1735 Market Street, 51st Floor  
Philadelphia, Pa 19103-7599

Dear Mr. Rosenblum:

I. Introduction

This is in response to your inquiry asking when an interstate national bank (a national bank with its main office in one state, the home state, and a branch in another state, the host state), may charge home state interest rates on its loans. You have represented that the bank desires to conduct interstate lending programs with uniform pricing policies based upon the interest allowed by its home state. You also have represented that if the bank determines to adopt such uniform pricing policies, it will include in its loan documents a choice-of-law clause disclosing to borrowers that loan charges will be governed by Federal and home state law.¹

II. Discussion

A. Summary of issues

Under 12 U.S.C. § 85, national banks may charge interest in accordance with the laws of the state in which they are "located." The question that you pose necessarily recognizes that an interstate national bank, as will be discussed, is considered to be "located," for purposes of applying section 85, in more than one state. Thus, the issue that arises is when the national bank should look to the laws of its home state and when it should look to the laws of a host state to determine the rates that it may permissibly charge with respect to its lending activities. This, of course, requires a review of relevant statutory provisions, case law and legislative history.

1. The statute: 12 U.S.C. § 85 and judicial interpretations

Title 12 U.S.C. § 85 (section 85) provides:

¹ You also have represented that where bank loan officers provide substantial assistance to borrowers in taking loan applications in person or closing loans in person at host state branches, the bank will provide clear disclosure to this effect either orally or in writing before the borrower becomes obligated on the loan.
Any [national] association may charge on any evidence of debt, interest at the rate allowed by the laws of the State where the bank is located. ²

Consequently, the first issue that arises is where an interstate bank is "located." In interpreting section 85, the Supreme Court has specifically recognized that a national bank is "located" in the state of its main office.³ Consequently, the Court concluded that a national bank, under section 85, could charge the interest rates permitted by its home state no matter where the borrower resides and despite the contacts that occur in another state.⁴ In addition, the Court of Appeals for the Fourth Circuit permitted a national bank to charge rates permitted by the home state even where face-to-face solicitation and signing of all loan documents by the borrower occurred in another state.⁵ Marquette, Cades and Wiseman did not address the issue of the rates that may be charged by an interstate national bank.⁶ Further, in both the Marquette and Cades decisions, the courts specifically noted that the bank did not have a branch in the state in which the borrower resided.⁷

2. For purposes of section 85, a national bank may be located in both its home state and its host states

Since the adoption of the Riegle-Neal Interstate Banking and Branching Act of 1994, (which for the first time paved the way for extensive interstate branching by national banks), the OCC has been called upon to determine whether an interstate national bank is also considered to be "located" in a host state as well as its home state for purposes of section 85.⁹

² Section 85 also provides several alternative rates that may be charged by the bank. Because you do not rely on any of these alternative bases for determining the applicable interest rate, this letter does not address interest that may be charged under these provisions.


⁴ Id. at pp. 313-319. Cf. Wiseman v. State Bank & Trust Co., N.A., 854 S.W.2d 725 (Ark. 1993) (Wiseman) (national bank located in one state may use that state's rates in making loans to a resident of a second state even though national bank's parent company is incorporated in that second state).


⁶ Marquette at p. 309; Cades at p. 874; Wiseman at pp.727-728.

⁷ The Supreme Court stated that the bank had no branches in the borrower's state. Marquette at p. 309 and fn. 20. The court in Cades took a similar approach determining first that a bank with its main office in Delaware did not have a branch in South Carolina before it determined that the Delaware interest rates applied. See Cades at p. 874. See also Christiansen v. Beneficial National Bank, 972 F. Supp. 681 (S.D. Ga. 1997).


While the courts never have specifically addressed the issue of whether a national bank is considered, for purposes of section 85, to be located in a state or states in which it operates branches, based on precedents construing 12 U.S.C. §§ 36 and 94 (respectively, section 36 and section 94), the OCC determined that, for purposes of section 85, a national bank is considered to be located in states in which it maintains branches. Notably, the Court in Marquette, citing Bank of California and Bougas, recognized that a bank could be considered to be “located” in a state in which it has a branch.

Consequently, an interstate national bank may be “located” for purposes of section 85 in both its home state and its host state or states. As a result, the issue that arises is when a national bank should apply the usury laws of its home state, and when it should apply the usury laws of a host state, to a loan. This analysis requires a consideration of relevant statutory provisions and legislative intent.

10 See Interpretive Letter 686 reaffirmed in Interpretive Letters 707 and 782 (relying on Seattle Trust & Savings Bank v. Bank of California, N.A., 492 F.2d 48, 51 (9th Cir.), cert. denied, 419 U.S. 844 (1974)) (Bank of California) (under 12 U.S.C. § 36(c), an interstate national bank with grandfathered branches in a state other than its home state is “situated” in the state of the grandfathered branches for purposes of establishing additional branches in that state); Citizens & Southern National Bank v. Bougas, 434 U.S. 35, 43-45 (1977) (Bougas) (for purposes of section 94 as it then existed, for venue purposes a national bank was “located” in a city or county in which it had a main office or a branch office).

11 Marquette at p. 309, fn. 21. See also Ghiglieri v. Sun World National Association, 117 F.3d 309, 316 (5th Cir. 1997). In addition, the relationship between section 94, addressing the “location” of national banks for venue purposes, as interpreted by the Supreme Court in Bougas, and section 85, addressing the “location” of national banks for usury purposes, is clear and direct. Section 94 was originally adopted as Section 57 of the Act of June 3, 1864, 13 Stat. 116-117, but was omitted in the Revised Statutes of 1873. See Mercantile National Bank at Dallas v. Langdeau, 371 U.S. 555, 561, 568 (1963). Congress reenacted it in 1875 as an amendment to section 5198 of the Revised Statutes, codified at 12 U.S.C. § 86 (section 86), which specifically provides the remedies for violations of section 85. Id. See also 18 Stat. 320; Michigan National Bank v. Robertson, 372 U.S. 591, 594 (1963) (Michigan National). As the Supreme Court recognized in Michigan National, “when [section 94] was re-enacted [in 1875], it was appended to the provisions dealing with usury actions against national banks.” Thus, the venue provisions, grounded on where a national bank was “located,” provided a forum to apply the remedy specifically for violations of section 85 which, of course, also were grounded on where a national bank was “located.” As noted, the Court in Bougas held that a national bank was “located” for purposes of section 94 wherever it had a main office or a branch and, even before Bougas, at least one Court of Appeals observed; “none of the cases [interpreting section 85 or 94] indicate that Congress gave one meaning to “locate” in § 94 and another meaning to the same word in § 85.” See Fisher v. First National Bank of Chicago, 538 F.2d 1284, 1289 (7th Cir. 1976), cert. denied, 429 U.S. 1062 (1977) (Fisher).
3. Where a national bank is located in more than one state, which state’s usury laws govern interest that may be charged by the bank?

a. The Riegle-Neal Act

The Riegle-Neal Act for the first time established a comprehensive federal statutory scheme permitting general interstate branching by national banks and by state banks. Thus, Congress permitted, for the first time, national banks and state banks, as a general matter, to have main offices in one state and branches in one or more other states. In doing so, Congress recognized that this new corporate structure would raise issues with respect to the applicability of usury laws to loans made by interstate national and state banks. Two provisions of the Riegle-Neal Act address interest rates that may be charged by interstate national banks.

(1) The applicable law clause

Section 103(b)(1) (the applicable law clause) of the Riegle-Neal Act provides that:

The laws of the host State regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches shall apply to any branch in the host State of an out-of State national bank to the same extent as such State laws apply to a branch of a bank chartered by that State, except--

(i) when Federal law preempts the application of such State laws to a national bank ....

See 12 U.S.C. § 36(f)(1)(A) (emphasis added). An exception also was provided if the Comptroller determines that the state law discriminates between an interstate national bank branch and state bank branches. Id. at (f)(1)(A)(ii). A similar provision, absent the preemption and discrimination exceptions, was adopted with respect to state banks. See 12 U.S.C. § 1828(j).

12 Prior to the adoption of the Riegle-Neal Act, branching by national banks and state banks that were members of the Federal Reserve System was constrained, with certain exceptions, by federal law to intrastate branching. 12 U.S.C. §§ 36, 321. But see 12 U.S.C. § 36(a) (permitting interstate grandfathered branches); Sun World at p. 315 (following relocation by a national bank of its main office from one state to another, permitting branch retention in the former main office state). In addition, while states could permit state banks that were not members of the Federal Reserve System to branch on an interstate basis, few did. Hearing before the Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance of the Committee on Banking, Finance and Urban Affairs, House of Representatives, 103d Cong., 1st Sess., p. 53, 56 (October 26, 1993) (Written Statement of Comptroller of the Currency Eugene A. Ludwig).

13 While the Riegle-Neal Act raised this issue with respect to both national and state banks, because only national banks are within the regulatory jurisdiction of the OCC, this response will address the impact of the Riegle-Neal Act only on interest rates that may be charged by national banks.

14 An exception also was provided if the Comptroller determines that the state law discriminates between an interstate national bank branch and state bank branches. Id. at (f)(1)(A)(ii). A similar provision, absent the preemption and discrimination exceptions, was adopted with respect to state banks. See 12 U.S.C. § 1828(j).
with respect to state usury ceilings, application of the preemption provision in clause (i) brings into play section 85 and the standards of section 85 then govern how state usury law is made applicable to a host state branch of a national bank. In other words, the state usury law of the host state of a national bank applies to particular loans made by the bank because section 85 sets forth the framework that determines the permissible rates of interest that national banks may charge and that framework makes the host state’s usury ceilings applicable (with limited exception\textsuperscript{15}) to particular loans made by a national bank that is considered to be “located” in that state.

However, the framework of section 85 does not expressly address two crucial questions that arise when section 85 is applied to an interstate bank’s lending operation:

1. May a national bank use the rates of one state in which it is “located” even when it is doing business with customers in a second state in which it is also “located”?

2. When a national bank is “located” in more than one state for purposes of section 85, what usury ceiling does section 85 make applicable to the bank’s lending activities?

(2) The usury savings clause

Because of these uncertainties about how section 85 would apply to interstate banks, Sen. Roth introduced a provision at section 111 of the Riegle-Neal Act (the usury savings clause) which provides:

No provision of this title and no amendment made by this title to any other provision of law shall be construed as affecting in any way--

\* \* \* \* \*

(3) the applicability of [section 85] . . . \textsuperscript{16}

As Sen. Roth stated in explaining the intent underlying this provision:

In order to ensure that banks providing credit to out-of-State borrowers would be unaffected by structural changes brought about by interstate branching legislation, I offered the [usury] savings clause in committee, and it is now part of this conference report.

\textsuperscript{15} As mentioned in fn. 2, supra, section 85 also provides for alternative rates. One such rate, that tied to the discount rate on commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, is not tied to state law.

The essential point of my amendment is that a branch of a bank that provides credit across State lines may impose its State law loan charges even though there is a branch of that same bank in the State of its customer.\(^{17}\)

With respect to the usury savings clause, the Conference Report is explicit that the clause was intended to preserve existing authorities related to the interest charges that may be imposed by interstate national banks under section 85 notwithstanding the state of residence of the borrower. As the Conference Report states, the Riegle-Neal Act:

[does] not affect existing authorities with respect to any charges under . . . [section 85] . . . imposed by national . . . banks for loans or other extensions of credit made to borrowers outside the state where the bank or branch making the loan or other extension of credit is located.\(^{18}\)

Moreover, as Sen. Roth noted, prior to the adoption of the usury savings clause, the Federal Deposit Insurance Corporation was “uncertain” whether interstate branching might prevent a bank from charging home state rates to customers in host states.\(^{19}\) As a result of his concern with the FDIC’s response, Sen. Roth offered the usury savings clause during Senate Banking Committee consideration of the legislation. As he subsequently told the Congress:

I immediately began to take steps to address this potential threat not only to Delaware’s credit card industry but to all banks that extend credit to borrowers who reside outside the State where the bank, or under this legislation, the branch making the loan or other extension of credit is located.

* * * * *

The savings clause means that the establishment of a branch in the borrower’s state does not defeat the powers that a Delaware bank enjoys today under [section 85] . . . .\(^{20}\)

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\(^{18}\) Riegle-Neal Act Conference Report at p. 63. Courts have long recognized that “Committee Reports represent the most persuasive indicia of congressional intent” and “are powerful evidence of legislative purpose.” 2A Sutherland Statutory Construction §§ 48.06 (5th ed.1992 & Supp. 1996).

\(^{19}\) Id. In response to a written question from Sen. Roth concerning the ability of an interstate bank to use home state interest rates in making loans to residents of host states, Andrew Hove, Jr. acting director, FDIC, explained that the effect of interstate banking in this respect was uncertain. See Nationwide Banking and Branching and the Insurance Activities of National Banks: Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs, 103d Cong., 1st Sess. 272 (1993) (Response to Written Questions of Senator Roth from Andrew C. Hove, Jr.). Governor John P. LaWare of the Federal Reserve Board also expressed similar uncertainty in response to Sen. Roth’s question. Id. at pp. 28-281.

\(^{20}\) Roth statement at S12789.
Thus, the usury savings clause answers the first question and assures that the Marquette doctrine, permitting a bank to utilize interest rates allowed by the law of the state where the bank is located regardless of the state of the residence of the borrower, is not defeated simply because a bank has a branch in the state where the borrower resides. This, then leads directly to the second question which you pose: under what circumstances may the bank use and export the interest rates permitted by its home state, as well as the corresponding question, under what circumstances may the bank use and export the interest rates permitted by a host state.

(3) Applicability of home state rates and host state rates

In discussing the interplay of the applicable law clause, the usury savings clause and section 85 in the context of interstate branching, Sen. Roth also addressed the issue of when a bank may look to home state and host state usury law in determining permissible interest rates that it may charge. He stated:

The statement of managers expressly refers to the potential of a "branch making the loan or other extension of credit ...." This language underscores the widespread congressional understanding that, in the context of nationwide interstate branching, it is the office of the bank or branch making the loan that determines which State law applies. The savings clause has been agreed to for the very purpose of addressing the FDIC's original concerns and making clear that after interstate branching, [section 85 is] applied on the basis of the branch making the loan.

21 It is likewise clear that the interest charges that may be imposed under section 85, as preserved by the usury savings clause, include those permitted to any lender in the state as determined by the Supreme Court in enunciating the most favored lender doctrine. Tiffany v. The National Bank of the State of Missouri, 85 U.S. 409, 413 (1874).

22 The Riegle-Neal Act Conference Report at p. 63 discussed loans made to borrowers outside the state where the "bank or branch making the loan is located."

23 Roth Statement at S12789. (Emphasis added.) In this regard, Sen. Roth’s comments were similar to those of Sen. Riegle with respect to the impact of interstate branching on interest charges that could be imposed by national banks. As Sen. Riegle had earlier stated:

During discussions of the interstate banking bill, Senator Pryor raised concerns about the applicability of State usury laws to out-of-state branches. He wanted to ensure that branches of out-of-State banks coming into Arkansas were subject to that State’s usury ceiling. My staff consulted with his staff and we addressed his concern in the committee report on S.1963 in which we made clear State usury laws would apply to interstate branches coming into the host state.

140 Cong. Rec. S4810 (April 26, 1994). S. 1963 had provided that:

Any branch of a national bank that is established as a result of a combination [under this legislation] shall be subject to the laws of the host State, including those that govern intrastate branching, consumer protection, fair lending, and community reinvestment, as if it were a branch of a national bank having its main office in that State.
Thus, Congress had a clear recognition in the dawning age of comprehensive interstate branching, that host state rates could apply to loans made by an interstate bank. Sen. Roth went on to identify circumstances under which host state rates would apply -- that is, when a branch or branches in a host state would be considered to be making a loan. He stated:

The conferees were very careful in drafting ... agency authority, whereby one bank may use an affiliated bank in another State as its agent with respect to some, but not all, aspects of an interstate loan.24 What the conferees intended was to allow the principal bank in State A to use an agent bank in State B to assist with deposits and loans in a way that the law of State A would be applicable even though the agent bank in State B helped in some respects. The statement of managers correctly characterizes these permissible functions of the agent as 'ministerial.' Excluded from the ministerial category are the decision to extend credit, the extension of credit itself, and the disbursal of the proceeds of a loan ...25 (These are referred to as the "non-ministerial functions.")

Sen. Roth applied these same principles to interstate branches.26 As he stated:

[I]t is clear that the conferees intend that a bank in State A that approves a loan, extends the credit, and disburses the proceeds to a customer in State B may apply the law of State A even if the bank has a branch or agent in State B and even if that branch or agent performed some ministerial functions such as providing credit card or loan applications or receiving payments.

* * * * *

S. Rep. No. 240, 103d Cong., 2d Sess., 30 (March 23, 1994) (emphasis added). The commentary, as did the commentary in the Riegle-Neal Act Conference Report, explicitly stated that consumer protection laws included "applicable usury ceilings." Id. at p. 17.

24 Under this provision, affiliated banks could, at their offices, provide certain services (agency banking services) for customers of each other without being considered to be branches. 12 U.S.C. § 1828(r). With regard to lending, the statute lists agency banking services as closing loans, servicing loans and receiving payments on loans. Id. The Riegle-Neal Act Conference Report and Sen. Roth's remarks elaborate on the activities that fall within these functions: providing loan applications, assembling loan documents, providing a location for returning documents necessary for making a loan, providing loan account information and receiving loan payments. Riegle-Neal Act Conference Report at p. 49; Roth statement at S12789-12790.

25 Id. at S12789. (Emphasis added).

26 As Sen. Roth explained:

Were it any other way, that is, if the branch in State B could not perform at least the ministerial functions of an agent in State B without affecting the authority of the bank in State A to apply the law of State A to the extension of credit to a customer in State B, then Congress would have constructed a significant disincentive to nationwide branching in authorizing agency powers for bank holding companies. . . .

Roth statement at p. S12790.
Thus, it is clear that a branch of a multistate bank located in State A that approves a loan application and extends credit to a customer in State B where the bank also has a branch may, under the savings clause, impose loan charges allowed by the law of State A and may, without affecting the applicability of State A’s law to such charges, use its State B facility to perform some ministerial functions regarding such extension of credit.27

In light of the above legislative history, we conclude that the mere presence of a host state branch does not defeat the ability of a national bank to apply its home state’s rates to loans made to borrowers who reside in that host state. However, as described by Sen. Roth, if a branch or branches in a particular host state approves the loan, extends the credit, and disburses the proceeds to a customer, Congress contemplated application of the usury laws of that state regardless of the state of residence of the borrower.

4. Loans where the non-ministerial functions occur in different states or in offices other than a bank’s main office or branches

As discussed, Sen. Roth clearly addressed loans by interstate banks that would be considered to be “made” in a host state because each of the three elements -- the three non-ministerial functions -- occurs at a branch or branches in that host state.

Sen. Roth’s three element test of where a loan is made by an interstate bank, however, creates unaddressed categories of interstate loans: that is, (1) loans where the three non-ministerial functions occur in the main office or branches in different states; or (2) loans where any of the three nonministerial functions occurs in an office not considered to be the main office or a branch of the bank.

In these circumstances, where the plain language and meaning of a statute, taking into consideration its legislative history, are silent as to a particular issue, the agency charged with interpreting the statute is required to render a reasonable interpretation.28 We conclude that, for the following reasons, in circumstances, such as those listed above, where a loan cannot be said to be “made” in a host state under the approach laid out in the Riegle-Neal legislative history, the loan must be considered to be a bank loan and the home state’s rates may always be applied.29

27 Id. We recognize that Sen. Roth’s formulation of where a loan is made for purposes of applying section 85 in the new world of comprehensive interstate branching, may not be relevant for other purposes, e.g., 12 C.F.R. § 7.1003 (interpreting 12 U.S.C. § 36(j)). Of course, depending on their underlying policies, analogous but unrelated statutes may be construed differently. See, e.g., 2A and 2B Sutherland at §§ 45.15, 51.1, and 53.05.

28 Sun World at p. 313-314.

29 Of course, if the three non-ministerial functions occur in the main office or in branches in the home state, under section 85, Marquette, and the Riegle-Neal Act legislative history, as discussed, the home state rates will apply.
First, nothing in the Marquette decision, specifically preserved by the usury savings clause, requires that a bank must conduct certain lending activities in the home state to use the home state’s rates notwithstanding the state of residence of the borrower. 30

Second, a determination that the rates permitted by a national bank’s home state may always be used, absent a statutory requirement that the laws of another state must apply, is fully consistent with the determination by the Supreme Court in Marquette that section 85 “not be interpreted so as to throw into confusion the complex system of modern interstate banking.” 31 Were it any other way, in circumstances where a loan is not considered to be “made” in any particular host state taking into consideration the three elements set forth in the Riegle-Neal Act legislative history, the bank would have no state to look to for determining the applicable rate of interest. The “confusion” that the Supreme Court sought to avoid in Marquette would be unavoidable. 32

Third, when a loan is made, the bank is always the lender regardless of where certain functions occur. As has been stated:

A branch is not a separate corporation or legal entity but is an office or agency operated by the legal entity which operates the main bank. It has no separate


31 Marquette at p. 312.

32 We note, too, that any interpretation leading to the conclusion that there was no state to which a national bank could look in determining permissible interest rates, would be the kind of result that the court in Sun World, in a different context, sought to avoid. Sun World at pp. 314-315, n. 5. In that case, plaintiff argued that following an interstate main office relocation, a national bank had to re-establish its branches in its former main office state. For a variety of reasons, the court in Sun World found the plaintiff’s interpretation, that when a bank relocated its main office it had to re-establish its branches, “nonsensical” and in “sharp contrast” to the opposite result urged by the Comptroller. Similarly, a result leaving a national bank without a reference point for determining appropriate state interest rate law would be equally “nonsensical” and, for the reasons stated, we believe the appropriate state law, if a loan is not “made” in a host state in accordance with the three elements set forth in the Riegle-Neal Act legislative history, is the law of the home state.

We further note that our conclusion that, absent a federal statutory requirement otherwise, a national bank may charge interest as permitted by home state laws, is consistent with the recognition by courts of the need for a company with far-flung operations to adopt a uniform law to govern its transactions and of the appropriateness of permitting those companies to adopt the law of their headquarters state. See, e.g., Kruzeit v. Okuma Machine Tool Inc., 40 F.3d 52, 56 (3d Cir. 1994); Sarnoff v. American Home Products Corp., 798 F.2d 1075, 1082 (7th Cir. 1986). See also Clarkson v. Finance Company of America at Baltimore, 328 F.2d 404, 406-407 (4th Cir. 1964) (Clarkson), which reached the same conclusion in a usury case noting the “convenience, uniformity and simplicity achievable by having one law govern the activities of [the lender] through the several states of its operations.” Notably, the rationale as set forth in these cases mirrors the concerns of Congress, as discussed, 130 years ago in enacting section 85 to apply to a national banking system operating in an interstate environment. Marquette at pp. 312, 314-318. Cf. Gray v. American Express Co., 743 F.2d 10, 17 (D.C. Cir. 1984) (upholding choice of law, based on principal place of business of the lender, governing contractual terms applying to cancellation of a credit card).
board of directors or capital structure, its deposits are pooled with those of the main bank, and its loan limits are based on the main bank's capital structure.\textsuperscript{33}

We note, however, that the situation arising where fewer than all three of the non-ministerial functions occur in a particular host state's branch or branches raises additional considerations. One scenario in which this could happen is if a loan is approved at a home state back office, but the proceeds of the loan are disbursed to the borrower at a host state branch. The OCC letters previously discussed have addressed this type of situation.\textsuperscript{34} In those situations, a loan would not be considered to be made in a host state based solely on the one or two non-ministerial functions that occurred in that state; on the other hand, non-ministerial functions beyond those ministerial functions contemplated by Sen. Roth would, in fact, be performed in the host state.\textsuperscript{35} Neither the statute nor the legislative history specifically address whether home state or host state rates apply in that situation. While, for the reasons discussed above, we conclude that home state rates may be used, the OCC, in the interpretive letters previously discussed, has reviewed the entire transaction to determine whether there was a clear nexus between the host state, the rates of which the bank sought to apply, and the loan to justify imposition of the host state's rates.\textsuperscript{36} In each of the letters, the OCC concluded that it was permissible for the lending bank to charge the rates permitted by the host state even if the borrower resided in another state. In doing so, the OCC recognized the significance of an appropriate disclosure to the borrower that the interest charged is governed by applicable federal law and the law of the relevant state.\textsuperscript{37}

\textsuperscript{33} See, e.g., Kenilworth State Bank v. Howell, 230 A.2d 377, 380 (N.J. 1967). See also Ramapo Bank v. Camp, 425 F.2d 333, 341-342 (3d Cir.), cert. denied, 400 U.S. 828 (1970) (recognizing that a bank's main office represents the legal existence of the bank). We further note that all of a bank's loans are aggregated and reported on its call report, and profits and losses arising from loans are profits and losses of the bank, a bank's directors are ultimately responsible for a bank's loan policies and standards, and compliance with restrictions on lending limits and loans to insiders and affiliates are based on relationships that borrowers have with the bank.

\textsuperscript{34} Interpretive Letters No. 686 and 707 (proceeds disbursed at branch in host state); Interpretive Letter No. 782 (approval in branch state).

\textsuperscript{35} Roth statement as S12789-12790.

\textsuperscript{36} See, e.g., Interpretive Letter No. 782.

\textsuperscript{37} Id. This determination is consistent with common law principles regarding choice of law provisions in usury and non-usury contexts. Courts have long held, even at the time of the adoption of section 85, that parties, within parameters, may choose the state whose laws will govern their transaction. See Miller v. Tiffany, 68 U.S. 298, 310 (1864) (choice of usury law among that of several states left to how parties structured their transaction). See also McAllister v. Smith, 17 Ill. 328, 333-335 (1856). This ability of the parties to make a choice of applicable usury law among jurisdictions with a nexus to the loan contract, while articulated in different ways in different jurisdictions, has been repeated over the years in both usury and non-usury cases. See, e.g., Seeman v. Philadelphia Warehouse Company, 274 U.S. 403, 407-409 (1927); Fahs v. Martin, 224 F.2d 387, 397-398 (5th Cir. 1955); Clarkson at p. 406-407 (4th Cir. 1964); Uniwest Mortgage Corp. v. Dadecor Condominiums, Inc., 877 F.2d 431, 435 (5th Cir. 1989).

Courts have recognized exceptions to this general rule if the contracts do not have sufficient links to the chosen forum or if the law chosen violates the public policy of the forum state whose law also could be applied to the transaction. See, e.g., Solman Distributors, Inc. v. Brown-Forman Corporation, 888 F.2d 170 (1st Cir. 1989); American Star Insurance Co. v. Girdley, 12 F.3d 49 (5th Cir. 1994); General Electric Co. v. Keyser, 275 S.E.2d
5. The definition of non-ministerial functions

You next ask what we consider to constitute the making of a loan as described by Sen. Roth\(^{38}\) -- that is, what constitutes approval, disbursal and the extension of the credit -- and where those actions occur.

a. Approval

You contend that a determination of where approval occurs may depend on whether a loan decision is made based on subjective underwriting criteria applied by bank personnel with the authority to exercise discretion or whether the decision is subjected to a credit-scoring model or other non-discretionary underwriting standard. You note that approval in the former situation can involve a host of factors including the circumstances underlying any past credit problems of the applicant, special strengths of the applicant, recent changes in circumstances and the nature of the relationships between the bank and the applicant and related parties. Under these circumstances, we agree that the approval cannot be considered merely a ministerial act, as described by Sen. Roth, and that the appropriate location of the approval is where the person is located who is charged with making the final judgment of approval or denial.

If, however, a loan is subject to non-discretionary criteria that will be applied mechanically, we agree with your analysis that the loan is approved where the decision to apply those criteria to that loan is made. The decision to use the credit-scoring system or other non-discretionary underwriting standard requires the exercise of skill and judgment and may have a significant effect on the credit quality of a loan portfolio. This action simply must be viewed as non-ministerial. Once that decision is made, however, the other steps in the underwriting process -- that is, the entry of the application data into a computerized or mechanistic underwriting formula -- are, to use Sen. Roth’s term, ministerial, since the mere application of the particular facts to the predetermined and automatic criteria cannot alter the pre-ordained credit decision.

Of course, where a credit scoring system is utilized, but bank personnel have discretion to review and change an automatically rejected loan application, the situation becomes similar to the former situation where a loan, from the time of initiation, is to be reviewed according to underwriting criteria involving discretion. In these situations, where that discretion is actually utilized with respect to a particular loan, and where the loan previously rejected by the non-discretionary underwriting criteria is then approved, we concur, for the reasons stated above, with your statement that the appropriate location of disbursement is where the person is located who is charged with making the final judgment of approval or denial.

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\(^{38}\) Roth statement at S12789.
conclusion that the act of final approval is non-ministerial and that the site of the final approval is the location in which it is granted.

b. Disbursement

With regard to disbursals, you contend that the relevant site is the site of "physical disbursal" of the funds or, if loan proceeds are deposited into an account of the borrower, the branch at which the account is booked. Sen. Roth distinguished between "the actual disbursal of proceeds" and "delivering previously disbursed funds to a customer." He characterized the former as non-ministerial -- "so closely tied to the extension of credit that it is a factor in determining, in an interstate context, what State's law applies." While it is not possible at this time to ascertain and analyze all of the different ways in which funds can be disbursed at a branch, it is clear that where a bank gives the proceeds of a loan in-person to a customer or credits the borrower's account at a branch, the funds are being "actually" disbursed at a branch and would constitute "disbursal" as contemplated by Sen. Roth. On the other hand, it appears equally clear, for instance, that if funds are disbursed by the bank to an escrow agent or title agent who, in turn, disburses them to the borrower, that would, to use Sen. Roth's formulation, constitute "delivering previously disbursed funds to a customer" and the disbursal to the customer would be a ministerial event regardless of where it occurred.

c. Extension of credit

Finally, Sen. Roth noted a third element in his formulation of the non-ministerial functions that constitute the making of a loan -- extension of credit. While it might be argued that the approval and disbursal constitute the extension of credit, you contend that Sen. Roth clearly added a third prong by separately referencing the "extension of credit" and that, in adding this, Sen. Roth was intending to incorporate the communication of the final approval by the bank to the borrower. You further contend that the relevant site is the site from which the first communication of final approval comes. We agree with your assessment. First, Sen. Roth clearly spoke of a test with three distinct elements. Second, it stands to reason that an approval of a loan or line of credit and disbursal of the proceeds in some form or fashion is of no significance if the bank does not communicate to the borrower that the loan has been approved. Approval of a credit card is irrelevant, for instance, if the applicant is never informed and never receives the card. Thus, in our view, communication from the bank to the customer that the loan has been granted complements the approval of the loan and the disbursal of the proceeds.

We also note that, while it may be argued that the closing of a loan could constitute the "extension of credit," as described by Sen. Roth, it is clear from his statement that his characterization of certain functions as either ministerial, not affecting what State's law applies, or non-ministerial, affecting what state's law applies, is based on the line that Congress drew in permitting "agency

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39 Roth statement at S12789-12790.

40 See 12 C.F.R. §§ 7.1003--7.1005 regarding the circumstances under which disbursal of loan proceeds by a bank requires branch authorization.
banking" activities without implicating branching concerns.\textsuperscript{41} In adopting "agency banking," Congress explicitly provided that the closing of loans, as long as that did not implicate approval or disbursal, was to be considered a ministerial function.\textsuperscript{42} Consequently, Sen. Roth could not have considered loan closings to be a non-ministerial function.

For these reasons, we conclude that the first communication of final approval constitutes the final element of Sen. Roth’s three-part test and that the relevant site is the site from which that communication comes.

\textbf{B. Conclusion}

Consequently, for the reasons set forth above, we conclude that an interstate national bank may charge interest permitted by the laws of its home state unless the loan is made -- that is, the loan is approved, credit is extended and funds are disbursed -- in a branch or branches of the bank in a single host state. If one or two of those three functions occur in a host state, the bank may, alternatively, charge the interest permitted by that state if, based on an assessment of all of the facts and circumstances, the loan has a clear nexus\textsuperscript{43} to that state.\textsuperscript{44} Moreover, if a bank is permitted to charge the rates of a particular home or host state, it may under section 85, the usury savings clause, and the Supreme Court’s decisions in \textit{Marquette} and \textit{Tiffany}, charge the most favored lender rates permitted by that state and may charge the permissible interest rates irrespective of the state of residence of the borrower.

I hope that this has been responsive to your inquiry.

Sincerely,

Julie L. Williams
Chief Counsel

\textsuperscript{41} Roth statement at S12789.

\textsuperscript{42} 12 U.S.C. § 1828(r)(1); Riegle-Neal Act Conference Report at p. 49.

\textsuperscript{43} For examples of what the OCC has recognized as a clear nexus supporting use of host state rates, see OCC Interpretive Letter Nos. 686, 707 and 782.

\textsuperscript{44} In any event, you have represented that the bank will include in its loan contracts choice-of-law provisions disclosing to borrowers that the interest rates are governed by federal law and the law of the relevant state.
KENTUCKY LAW OF ESCHEAT

APPLICABLE TO FINANCIAL INSTITUTIONS

Debra K. Stamper
Kentucky Bankers Association
Louisville, Kentucky

and

David L. Beckman, Jr.
Brown, Todd & Heyburn PLLC
Louisville, Kentucky

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SECTION K
KENTUCKY LAW OF ESCHEAT
APPLICABLE TO FINANCIAL INSTITUTIONS

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SECTION K
I. INTRODUCTION

The law of escheat in Kentucky is embodied in Chapter 393 of the Kentucky Revised Statutes as well as in Title 20, Chapter 1 of the Kentucky Administrative Regulations (20 KAR 1:020 et seq.), copies of which are attached hereto as Exhibit A. Although the concept that abandoned property would accrue to the benefit of the state is somewhat unpalatable in this day and age of antigovernment sentiment, courts long ago in Kentucky have accepted the propriety and constitutionality of such statutes. Anderson National Bank et al. v. Reeves, 172 S.W.2d 575 (Ky. 1943). Despite such acceptance, the escheat laws and jurisdiction of the Kentucky State Treasurer to enforce those laws has been the subject of much recent debate. Currently pending litigation, among other things, seeks to challenge the use by the Kentucky State Treasurer of nonemployee agents to investigate and audit persons and entities for compliance with Kentucky's escheat laws.

What follows is a general discussion of the escheat laws applicable to financial institutions in Kentucky, various problems and issues associated with such laws, and an update on currently pending litigation and proposed legislation seeking to change the nature and effect of such laws as they apply to financial institutions.

II. BASIC STATUTORY FRAMEWORK

A. Presumption of Abandonment. Generally KRS 393.060 provides that various property and assets held or owing by financial institutions are presumed abandoned if no actions are taken on the part of the property owner with respect to such property for certain statutorily mandated periods of time. Financial institutions holding funds or other assets presumed to be abandoned under KRS Chapter 393 must comply with the reporting requirements provided in KRS 393.110, which are discussed in further detail below. Financial institutions refusing to surrender property to the Treasury Department (the "Department") are subject to an equitable proceeding that may be brought at the instance of the Kentucky State Treasurer. KRS 393.230(1). According to the statute, financial institutions turning presumed abandoned property over to the Department are generally relieved of all liability with respect to such property whether or not it is ultimately and conclusively determined that such property is, in fact, abandoned under law. KRS 393.130. However, the statute further provides that a financial institution that has paid monies to the Department shall make payment to any person appearing to such financial institution to be entitled thereto, and upon proof of such payment and proof that the payee was entitled thereto, the Department shall reimburse the financial institution for the amount of such payment. KRS 393.130. Thus, the foregoing provisions of the statute dealing with liability relief do not alleviate the requirement that a financial institution actually pay the amount of abandoned property turned over to the Department directly to the rightful owner. Additionally, the impact of Section 19 of the Kentucky Constitution (which strictly prohibits any law impairing the obligation of contracts) on the enforceability of the escheat laws in conjunction with the validity of banking depositor contracts is somewhat unclear. Although the statute purportedly relieves financial
institutions of responsibility for abandoned property turned over to the Department, the financial institution likely must, under contract, pay a claiming beneficiary the property paid to the Department plus interest according to the contract. As noted above, the statute then permits the financial institution to seek reimbursement or credit from the Department for amounts paid. But see Anderson National Bank et al. v. Reeves, 170 S.W.2d at 354 (holding that taking away a depositor's right of action against bank upon transfer of a deposit to the Department did not create a "deprivation of property" where in lieu thereof depositor was afforded a right against the State).

B. Banking Assets Subject to Escheat.

1. **Inactive Accounts.** Any deposit payable on demand or deposit other than those payable on demand (including checking accounts, savings accounts, money market accounts, etc.) of a financial institution (including any interest thereon) will be presumed abandoned unless the owner has within seven (7) years:

   (a) negotiated in writing with the financial institution concerning the account;

   (b) been credited with interest on the account on instrument on his request;

   (c) had a transfer, disposition of interest, or other transaction noted of record in the books or records of the financial institution; or

   (d) increased or decreased the amount of the deposit.

KRS 393.060(1) and 070.

2. **Certified Checks, Bank Checks, and Certificates of Deposit.** Any sums payable on checks certified by a financial institution or instruments issued directly by a financial institution (including certificates of deposit, drafts, money orders and travelers checks) are presumed abandoned if they have been outstanding for more than seven (7) years from the date the instrument became payable, or from the date of issuance if payable on demand, or, in the case of travelers checks, if the checks have been outstanding for more than fifteen (15) years from the date of issuance unless the owner has within seven (7) years (or fifteen (15) years in the case of travelers checks) corresponded in writing with the financial institution concerning the item, or otherwise indicated in interest as evidenced by a memorandum on file with the financial institution. KRS 393.060(2).

3. **Safe Deposit Box Contents.** Any funds or other personal tangible or intangible property removed from a safe deposit box or any other safekeeping repository or agency or collateral deposit box on which the lease or rental period has expired due to nonpayment of rental charges or other reason are presumed abandoned if unclaimed by the owner for more than seven (7) years from the date of the expiration of the lease or rental period. KRS 393.060(3).

4. **Bank or Holding Company Stock Certificates and Dividends.** Any stock or other certificate of ownership or any dividend, profit, distribution, interest, payment or principal or other sum held or owing by a financial institution for or to any of its shareholders, bond holders
or other security holders who has not claimed such property, or corresponded in writing with the
financial institution concerning that property, within seven (7) years after the prescribed date for
payment or delivery of that property is generally presumed abandoned. KRS 393.064. Thus, any
holding company stock certificates deliverable to former bank shareholders in connection with a
holding company formation, any dividends returned as undeliverable, and any proceeds of the sale
of financial institution stock in connection with any merger or other acquisition transaction that
remain undelivered for a period of seven (7) years are presumed to be abandoned.

5. Property Held by Financial Institutions in Fiduciary Capacities. Generally property in Kentucky that has been devised or bequeathed to any person and is not claimed by that person or his heirs within seven (7) years of the date of death of the testator, or the owner of any property having situs in the state dies without heirs entitled to it and without disposing of it by will, the property is deemed to vest in the state. KRS 393.020. Similarly, intangible personal property and any income thereon held by a fiduciary for the benefit of another person is presumed abandoned unless the owner has, within seven (7) years after it becomes payable or distributable, increased or decreased the principal, accepted payment of principal or income, corresponded in writing concerning the property or otherwise indicated an interest as evidenced by a memorandum on file with the financial institution. KRS 393.066. Thus, financial institutions serving as executors of estates or as trustees, have an obligation to report abandoned trust or estate property to the Department and to pay that property over in accordance with applicable law.

III. ABANDONED PROPERTY NOTIFICATION REQUIREMENTS

Any financial institution holding property presumed abandoned in accordance with KRS Chapter 393 shall cause a report, in the form attached hereto as Exhibit B, to be filed with the Department on or before August 1 of each year listing any property presumed abandoned as of the immediately preceding July 1. KRS 393.110(1).

A. Information Required. The report should include the abandoned property owner's name, last known address, nature and identifying number or a description of the property, the amount of the property appearing due from appropriate records, the date when the property became payable, demandable or returnable, and the last known transaction with the owner with respect to the property. KRS 393.110(1)(a). Items of property presumed abandoned having a value of less than $100 may be reported in the aggregate. KRS 393.110(1).

B. Payment of Abandoned Property to Department. Any financial institution making a report of any property presumed abandoned shall turn over such abandoned property to the Department on or before January 1 of each year with respect to property reported the preceding August 1. KRS 393.110(3). If there occurs between the date an abandoned property report is filed and the next following January 1 any condition that has a substantial tendency to rebut the presumption of abandonment, then the financial institution shall not be required to turn the property in question over to the Department except on order of a court. Id.

C. Legal Proceedings. Any financial institution holding property presumed abandoned has the right to a judicial determination of its rights under KRS Chapter 393. Likewise, the Commonwealth of Kentucky may institute an actions to recover the property presumed abandoned, whether it has been reported or not, and may include in one petition all the property within the
jurisdiction of the court in which the action is brought. KRS 393.110(4).

D. **Department Examination Rights.** If any financial institution fails to make a full and complete report of property as required by KRS Chapter 393, the Department after giving the financial institution ten (10) days notice in writing, may examine the records and other accounts of the financial institution. 20 KAR1:050, Section 1. The examination may include (a) current, dormant and closed account records, (b) verification of contractual agreements between depositors and the financial institution regarding the deduction of services charges, account increases or decreases and the cessation of interest payments, and (c) the financial institution's procedures for reviewing dormant accounts. The Department shall have reason to believe that a financial institution has failed to comply with the reporting requirements of KRS Chapter 393 and may examine the records of the financial institution if (a) the financial institution has not submitted a report to the Department, (b) the financial institution has submitted reports to the Department in which the financial institution's report states that it has no unclaimed property, (c) the financial institution fails to report types of unclaimed property normally reported by like businesses or associations, (d) when amounts remitted from the financial institution are not comparable to reports received from like financial institutions, or (e) when information is provided from other reliable sources that a financial institution may be holding unclaimed property that has not been reported. After the completion of an examination, the Department shall provide the financial institution with a statement of its examination findings and proposed adjustments. The financial institution shall have thirty days in which to review the examination findings and proposed adjustments. No later than thirty days after the date of the statement, the financial institution shall cause to be generated an amended annual report. If the financial institution disagrees with the examination findings, the financial institution may file an official protest within the thirty (30) day period or the amount as set out in the statement will become absolute and final and be immediately due and payable. The financial institution is entitled to an administrative hearing in its protest. 20 KAR1:050, Section 1(5). If any financial institution refuses to pay or surrender property to the Department as provided in KRS 393.110, an equitable proceeding may be brought on the relation of the State Treasurer to force payment or surrender.

E. **Special Procedures for Abandoned Property and Safe Deposit Boxes.** Every financial institution maintaining safe deposit boxes or other safekeeping repositories shall report to the Department with an inventory of property in its possession which constitutes unclaimed funds. 20 KAR 1:060, Section 1. An inventory report shall be submitted for each safe deposit box or repository, signed by two officials of the financial institution who opened the box and conducted the inventory. Each report with respect to a box or repository shall include various required information concerning the owner and the contents of the box. The property of each unclaimed safe deposit box or repository shall be placed in an individual envelope, with a copy of the inventory report. The envelope shall then be sealed appropriately and signed by the financial institution and delivered to the Department.

IV. **RECENT DEVELOPMENTS IN ESCEHAT LAW AND PROPOSED LEGISLATION**

A. **Summary of Pending Litigation of the KBA.**

1. **Kentucky Bankers Association, et al. v. Treasurer,** Franklin Circuit Court, Civil Action No. 97-CI-01429 (September 23, 1997).
The KBA and two named banks, Home Federal, FSB and Kentucky Bank, filed a class action suit against the Treasurer challenging both his authority to conduct audits in the fashion he is attempting and his interpretation and application of current laws. Specifically, the lawsuit challenges:

- The Treasurer's legal authority to use outside auditors, on a contingency fee basis, for Chapter 393 examinations. KRS 393.280(1).
- The Treasurer's legal authority to require a financial institution to submit to a "desk audit". KRS 393.280(1).
- The Treasurer's interpretation of sufficient contact on automatically renewable accounts, including "rollover CDs".
- The Treasurer's policy of requiring financial institutions to reimburse owners for property already escheated to the State, with credit given on the next reporting period.
- The Treasurer's or the State's legal authority to regulate dormancy fees or other service charges, which are regulated by federal law.
- The Treasurer's practice of examining for a fifteen year period.

A temporary injunction was granted on October 2, 1997 prohibiting the Treasurer from using outside auditors in examinations and prohibiting desk audits. That order was modified on December 19, 1997 to exclude desk audits from its coverage, although that issue has not been resolved on the merits. The Treasurer has, to date, unsuccessfully sought relief from this order from both the Kentucky Court of Appeals and the Kentucky Supreme Court.

2. **Cassady and Parrish v. Hamilton, individually and in his capacity as Treasurer**, Franklin Circuit Court, Civil Action No. 98-CI-00259 (March 6, 1998).

Ballard W. Cassady and Selina O. Parrish, as citizens and taxpayers of Kentucky, brought action against John Kennedy Hamilton for his improper expenditure of escheated funds for radio ads lobbying of the passage of a particular bill, House Bill 693, in violation of KRS Chapter 393 and of Kentucky's Constitution.


Although as of the time of publication of these materials the KBA has not yet been served, it is our understanding that an action has been filed against the Treasurer, the KBA, and two Kentucky financial institutions alleging violations of KRS Chapter 393 and seeking declarative and injunctive relief, among other things, to require compliance with KRS Chapter 393 by all Kentucky financial institutions. Mr. Marcum has filed suit individually and on behalf of all owners of unclaimed property. A copy of this lawsuit is attached hereto as Exhibit C.

**B. Summary of Proposed Legislation.** At the time of publication of these materials,
March 17, 1998, there were two bills introduced in the 1998 General Assembly that would impact KRS Chapter 393.

1. **House Bill 693.** This bill is based on the most recent version of the Uniform Act with certain modifications suggested by the Treasurer's office, which were unacceptable to the holders of property potentially subject to escheat. This law has not come out of Committee in the House and, at this late stage, is not expected to move further.

2. **Senate Bill 339.** This bill makes specific, limited modifications to KRS Chapter 393 as it currently reads. See copy of bill attached hereto as Exhibit D. The changes made by the bill, as amended, are:

   (a) **Activity sufficient** to constitute contact on an account, thus avoiding the presumption of abandonment, will include:

   - Communication by the owner, in writing or otherwise, which is reflected in a contemporaneous record prepared by or on behalf of the bank holder;

   - A regularly mailed statement of account or other notification, such as a federal form 1099, unless the mailed statement has been returned to the bank as undeliverable by the United States Postal Service or other similar provider. "Regularly mailed" is described as a type of mailing sent at least annually to all owners of a similar category of account.

   (b) **Interest and gain** on escheated funds must be paid to the owner. Upon proper claim of property escheated to the state, the Treasurer will pay to the claimant all monies escheated plus any gain. For property that is held in an interest bearing account prior to escheatment, the holder will report that money as presumed abandoned but will continue to hold it in an interest bearing escrow account for an additional 10 years.

   (c) **Safe deposit boxes.** Holders of property held in safe deposit boxes will be reimbursed by the state for the cost of opening the box for escheatment and for any valid liens of the holder.

   (d) **The examination provisions** will be amended in several ways:

   - Examination period shall be limited to the period and records for establishing the accuracy of the information in the next preceding reporting period.

   - Examinations shall be performed by the Department of Financial Institutions.

   - Documents or work papers obtained or compiled during the examination are not open records and must be kept
(e) **Property finders** are restricted in their activities. Arrangements with an attorney to file a claim for property is excluded from these provisions:

- Finders cannot contract to find property until it has been escheated for more than 24 months.

- Finders must contract with owners by written agreement, with the following limitation: the fee cannot exceed 10%; the agreement must specify the property; the agreement must be signed; the agreement must itemize the value of the property after deduction of the fee.

- Owners may seek legal remedy from violations of these provisions and may recover attorney's fees.

- Finders must give consumer disclosures in ads or other written communications.
KENTUCKY ESCHEAT STATUTE
AND
ADMINISTRATIVE REGULATIONS

KENTUCKY REVISED STATUTES

CHAPTER 393

ESCHEATS

393.010. Definitions for chapter — Application of chapter.
(1) As used in this chapter, unless the context requires otherwise:
   (a) "Banking organization" means any bank, trust company, savings bank, industrial bank, land bank, safe deposit company, or a private banker engaged in business in this state;
   (b) "Business association" means any corporation, joint stock company, business trust, partnership, or any association for business purposes of two (2) or more individuals;
   (c) "Financial organization" means any savings and loan association, building and loan association, credit union, cooperative bank, or investment company, engaged in business in this state;
   (d) "Life insurance corporation" means any corporation or association transacting within this state the business of insurance on the lives of persons or insurance appertaining thereto, including, but not by way of limitation, endowments and annuities;
   (e) "Claim" means to demand payment or surrender of property from the person whose duty it is to pay the claimant, or surrender to him the property involved;
   (f) "Treasurer" means the State Treasurer;
   (g) "Department" means the Department of the Treasury;
   (h) "Person" means any individual, state or national bank, partnership, joint stock company, business, trust, association, corporation, or other form of business enterprise, including a receiver, trustee, or liquidating agent.
(2) This chapter does not apply to bonds of counties, cities, school districts, or other tax-levying subdivisions of this state or to any money, funds, or other intangible property at any time held or owing for any minerals or other raw materials capable of being used for fuel in the course of manufacturing, processing, production, or mining. The provisions of this subsection shall be effective retroactively to all such moneys, funds, or other intangible property held or owing by any person on June 1, 1960, or thereafter.
393.020. Property subject to escheat.

If any property having a situs in this state has been devised or bequeathed to any person and is not claimed by that person or by his heirs, distributees, or devisees within seven (7) years after the death of the testator, or if the owner of any property having a situs in this state dies without heirs or distributees entitled to it and without disposing of it by will, it shall vest in the state, subject to all legal and equitable demands. Any property abandoned by the owner, except a perfect title to a corporeal hereditament, shall vest in the state, subject to all legal and equitable demands. Any property that vests in the state under this section shall be liquidated, and the proceeds, less costs, fees, and expenses incidental to all legal proceedings of the liquidation shall be paid to the department.

(1606; 1994, ch. 58, § 3, effective March 10, 1994; 1994, ch. 83, § 1, effective July 15, 1994.)

393.025. Owner of abandoned property loses income or increments accruing thereafter.

When property is paid under this chapter or KRS 271B.14-400, the owner is not entitled to receive income or other increments accruing thereafter.


393.030. Disposition of property subject to escheat.

(1) The personal representative of a person, any part of whose property is not distributed by will, and who died without heirs or distributees entitled to it shall settle their accounts within one (1) year after qualifying, and pay to the department the proceeds of all personal property, first deducting the proper legal liabilities of the estate.

(2) If the whole personal property cannot be settled and the accounts closed within one year, the settlement as far as practicable, shall then be made and the proceeds paid to the department, and the residue shall be settled and paid as soon thereafter as can be properly done.

(3) The personal representative shall take possession of the real property of the decedent not disposed of by his will, and rent it out from year to year until it is otherwise legally disposed of, and pay the net proceeds to the department.

(4) The personal representative shall also make out and transmit to the department a description of the quantity, quality, and estimated value of the real property and its probable annual profits.

(1607; 1994, ch. 58, § 4, effective March 10, 1994.)

393.040. Procedure if legacy or devise is not claimed.

If any devisee or legatee, or his heir, devisee, or distributee, has failed for seven (7) years to claim his legacy or devise, the personal representative of the testator, or other person possessing it shall, after deducting the legal liabilities thereon, pay and deliver it and the net profits from it to the department.

(1608; 1994, ch. 58, § 5, effective March 10, 1994; 1994, ch. 83, § 2, effective July 15, 1994.)

393.050. Presumption of death after seven years — Disposition of property.

When a person owning any property having a situs in this state is not known to be living for seven (7) successive years, and neither he nor his heirs, devisees, or distributees can be located or proved to have been living for seven (7) successive years, he shall be presumed to have died without heirs, devisees, or distributees, and his property shall be liquidated and the proceeds, less costs incidental to the liquidation and any legal proceedings, and the liabilities which have been properly claimed and approved against it, shall be paid to the department.

(1609; 1994, ch. 58, § 6, effective March 10, 1994.)
393.060. Presumption of abandonment of certain property held by
bank or trust company.

The following property held or owing by a banking or financial organization is presumed abandoned:

(1) Any deposit (legal, beneficial, equitable, or otherwise) payable on demand in any bank or trust company in this state, together with the interest thereon, unless the owner has within seven (7) years:
   (a) Negotiated in writing with the bank or trust company concerning it;
   (b) Been credited with interest on the passbook or certificate of deposit on his request;
   (c) Had a transfer, disposition of interest, or other transaction noted of record in the books or records of the bank or trust company; or
   (d) Increased or decreased the amount of the deposit;

(2) Any sum payable on checks certified in this state or on written instruments issued in this state on which a banking or financial organization or business association is directly liable, including, by way of illustration but not of limitation, certificates of deposit, drafts, money orders, and traveler's checks, that with the exception of traveler's checks has been outstanding for more than seven (7) years from the date it was payable, or from the date of its issuance if payable on demand, or, in the case of traveler's checks that has been outstanding for more than fifteen (15) years from the date of its issuance unless the owner has within seven (7) years or within fifteen (15) years in the case of traveler's checks corresponded in writing with the banking or financial organization concerning it, or otherwise indicated an interest as evidenced by a memorandum on file with the banking or financial organization;

(3) Any funds or other personal property, tangible or intangible, removed from a safe deposit box or any other safekeeping repository or agency or collateral deposit box in this state on which the lease or rental period has expired due to nonpayment of rental charges or other reason, or any surplus amounts arising from the sale thereof pursuant to law, that have been unclaimed by the owner for more than seven (7) years from the date on which the lease or rental period expired.


393.062. Presumption of abandonment of unclaimed funds held by
life insurance corporation. — (1) "Unclaimed funds," as used in this section, means all moneys held and owing by any life insurance corporation unclaimed and unpaid for more than seven (7) years after the moneys became due and payable as established from the records of the corporation under any contract which has matured or terminated. A life insurance policy not matured by actual proof of the death of the insured is deemed to be matured and the proceeds thereof are deemed to be due and payable if such policy was in force when the insured attained the limiting age under the mortality table on which the reserve is based, unless the person appearing entitled thereto has within the preceding seven (7) years, (a) assigned, readjusted, or paid premiums on the policy, or subjected the policy to loan, or (b) corresponded in writing with the life insurance corporation concerning the policy. Moneys otherwise payable according to the records of the corporation are deemed due and payable although the policy or contract has not been surrendered as required.

(2) Unclaimed funds, as defined in this section, held and owing by a life insurance corporation shall be presumed abandoned if the last known address, according to the records of the corporation, of the person entitled to the funds is within this state. If a person other than the insured or annuitant is entitled to the funds and no address of such person is known to the corporation or if it is not definite and certain from the records of the corporation what person is entitled to the funds, it is presumed that the last known address of the person entitled to the funds is the same as the last known address of the insured or annuitant according to the records of corporation.

393.064. Presumption of abandonment of stock or dividend of business association.

Except as provided in KRS 272.291, any stock or other certificate of ownership, or any dividend, profit, distribution, interest, payment, or principal, or other sum held or owing by a business association for or to a shareholder, certificate holder, member, bondholder, or other security holder, or a participating patron of a cooperative, who has not claimed it, or corresponded in writing with the business association concerning it, within seven (7) years after the date prescribed for payment or delivery, is presumed abandoned if:

(1) It is held or owing by a business association organized under the laws of or created in this state; or

(2) It is held or owing by a business association doing business in this state, but not organized under the laws of or created in this state, and the records of the business association indicate that the last known address of the person entitled thereto is in this state.


393.066. Presumption of abandonment of intangible personal property held by fiduciary. — All intangible personal property and any income or increment thereon, held in a fiduciary capacity for the benefit of another person is presumed abandoned unless the owner has, within seven (7) years after it becomes payable or distributable, increased or decreased the principal, corresponded in writing concerning the property, or otherwise indicated an interest as evidenced by a memorandum on file with the fiduciary:

(1) If the property is held by a banking organization or a financial organization, or by a business association organized under the laws of or created in this state; or

(2) If it is held by a business association doing business in this state, or any agent or fiduciary acting for or under contract with a business association doing business in this state, but not organized under the laws of or created in this state, and the records of the business association indicate that the last known address of the person entitled thereto is in this state; or

(3) If it is held in this state by any other person. (Enact. Acts 1960, ch. 142, § 4, effective June 16, 1960.)

393.068. Presumption of abandonment of personal property held by federal government.

(1) All tangible personal property or intangible personal property, including choses in action in amounts certain, and all debts owed or entrusted funds or other property held by the federal government or any federal agency, or any officer, or appointee thereof, shall be presumed abandoned in this state if the last known address of the owner of the property is in this state and the property has remained unclaimed for five (5) years.

(2) The federal government or any federal agency thereof which pays or delivers abandoned property to the department under this section is relieved of all liability to the extent of the value of the property so paid or delivered for any claim which then exists or which thereafter may arise or be made in respect to the property.

(3) The federal government or any federal agency thereof may deduct from the amounts to be paid or delivered to the department the proportionate share of the actual and necessary costs of examining records and reporting such information.

393.070. Deposits not payable on demand — When presumed abandoned.

Any deposit (legal, beneficial, equitable, or otherwise) other than those payable on demand in any bank or trust company in this state, together with the interest thereon shall be presumed abandoned unless the owner has, within the seven (7) years immediately prior to the date reports are required by KRS 393.110:

(1) Negotiated in writing with the bank or trust company concerning it;
(2) Been credited with interest on the passbook or certificate of deposit on his request;
(3) Had a transfer, disposition of interest, or other transaction noted of record in the books or records of the bank or trust company; or
(4) Increased or decreased the amount of the deposit.

(1610: amend. 1994, ch. 83, § 5, effective July 15, 1994.)

393.080. Presumption of abandonment of security deposit or public utility refund.

The following funds held or owing are presumed abandoned:

(1) Any deposit of money, stocks, bonds, or other credits made to secure payment for services rendered or to be rendered, or to guarantee the performance of services or duties, or to protect against damage or harm, and the increments thereof, unless claimed by the person entitled thereto within seven (7) years after the occurrence of the event that would obligate the holder or depository to return it or its equivalent.

(2) Except as provided in KRS 272.291, any sum which a public utility has been ordered to refund and which was received for utility services rendered in this state, together with any interest thereon, less any lawful deductions, that has remained unclaimed by the person appearing on the records of the utility entitled thereto for more than seven (7) years after the date it became payable in accordance with the final determination or order providing for the refund.

(3) If there remains a total of one million dollars ($1,000,000) or more in unclaimed sums one (1) year after a public utility refund became payable in accordance with the final determination or order providing for the refund, excepting sums that may eventually be claimed pursuant to KRS 272.291, and less any lawful deductions, the Finance and Administration Cabinet shall enter into an agreement or agreements with the public utility that will allow the public utility to pay the unclaimed sums, minus the exceptions noted above, to the Kentucky State Treasurer immediately if the Attorney General determines by written opinion that a reasonable relationship exists between the source of and reason for the refund, and the workers' compensation liability of a bankrupt employer who purportedly was self-insured, either individually or through a self-insurance group, under KRS Chapter 342. Payment of the unclaimed sums to the Kentucky State Treasurer shall constitute a complete release of the public utility from any further responsibility for the sums so paid, and from liability to any person who may have a claim to any of such sums.

(4) The Kentucky Workers' Compensation Funding Commission shall preserve the rights of persons or ratepayers entitled to claim a refund under KRS 393.080, and may utilize any funds available to the agency for the purpose of preserving those rights.

393.082. Special expendable trust fund for unclaimed sums under KRS 393.080(3) — Administration and distribution of fund — Claims procedure.

(1) Unclaimed sums delivered to the Kentucky State Treasurer pursuant to KRS 393.080(3) shall be placed in a special expendable trust fund established by the Kentucky Workers' Compensation Funding Commission. The Kentucky Workers' Compensation Funding Commission shall establish a separate trust account with respect to each final determination or order providing for a refund that the Attorney General determines to have a reasonable relationship to the workers' compensation liability of a bankrupt employer.

(2) The commissioner of the Department of Workers' Claims shall be the administrator of the resulting trust fund established pursuant to this section. The commissioner or commissioner's designee shall be authorized to determine the value of all workers' compensation claims against the bankrupt employer and to prepare a comprehensive distribution plan. Eligible claimants may elect to participate in a comprehensive distribution plan in exchange for the release of all related claims against the Commonwealth and all of its cabinets, departments, bureaus, agencies, officers, agents, and employees, with the exception of the special fund in the Labor Cabinet. A claimant shall agree as part of a release under this section not to file any future motions to reopen the named workers' compensation claim or claims, and not to file new claims with respect to the same injury or occupational disease.

(3) A comprehensive distribution plan for unclaimed utility refunds placed in a trust account pursuant to this section shall consist of the full payment of workers' compensation income benefits for eligible claimants until the fund is exhausted, subject to the exceptions noted in KRS 393.080 and this section, and may include lump-sum settlements in addition to biweekly payment plans. An initial distribution shall be made to eligible claimants after the commissioner of the Department of Workers' Claims, or the commissioner's designee, has made an initial determination of the number of eligible claimants, the amount of income benefits due, and the amount to be retained as a reserve for pending claims. The initial distribution shall include payment of all past due income benefits, without interest, for eligible claimants.

(4) Neither the special fund nor the uninsured employers' fund shall be considered to be claimants for the purposes of this section. Medical and related benefits shall not be considered in the valuation of the claims unless the amount available in the trust fund clearly exceeds the estimated value of income benefits for all claims. If a workers' compensation surety bond, letter of credit, or other form of security for the payment of the workers' compensation liabilities of a bankrupt employer has been collected by the commissioner of the Department of Workers' Claims or the Workers' Compensation Board for distribution to claimants in a manner to be determined by court order, it may be assumed in the valuation of the claims in a comprehensive distribution plan that the security will be distributed by the court on a pro rata basis and an appropriate deduction may be taken.

(5) In preparing the valuation of claims for inclusion in a comprehensive distribution plan, the commissioner or commissioner's designee shall deduct special fund payments. Settlement of a workers' compensation claim as part of a comprehensive distribution plan under this section shall not accelerate the date on which the special fund's liability becomes due.

(6) If the bankrupt employer ceased business operations at least three (3) years prior to establishment of a trust account pursuant to this section, only claimants who file workers' compensation claims within sixty (60) days of the establishment of the trust account or before shall be eligible to receive payments from the trust fund.

(7) All claimants shall cooperate with information requests from the Department of Workers' Claims concerning prior payments of workers' compensation benefits. The commissioner of the Department of Workers' Claims or commissioner's designee may subpoena witnesses, including present or past managers and officers of the bankrupt employer,
and may conduct evidentiary hearings under oath relating to the past and present workers' compensation liabilities of the bankrupt employer or information relevant to unpaid workers' compensation benefits. Administrative subpoenas issued under the authority of the commissioner of the Department of Workers' Claims for this purpose may be enforced in the Franklin Circuit Court.

(8) The Attorney General shall provide representation of the comprehensive distribution plan as a named defendant in the event the establishment of the trust fund is challenged.

(9) The provisions of KRS 393.080(3) or this section shall not be construed to constitute an admission of the validity of any workers' compensation claims, nor shall these provisions be interpreted in a manner that would transfer or create liability on behalf of the commissioner of the Department of Workers' Claims, any agency or employee, beyond that expressly set forth in a comprehensive distribution plan.

(10) The special fund shall issue trust fund checks in the amounts and to the claimants or claimants' representatives as directed by the commissioner of the Department of Workers' Claims.

(11) The personnel and other costs of administering a trust fund established pursuant to this section shall be paid out of the investment income of the trust fund.

(12) Attorney fees shall be subject to the limitations and maximum amounts for the payment of attorney's fees established by subsection (1) of KRS 342.320, as well as the approval of the commissioner or the commissioner's designee.

(13) If a workers' compensation claimant elects not to participate in a comprehensive distribution plan proposed by the commissioner of the Department of Workers' Claims or the commissioner's designee, that claimant shall not be entitled to any portion of the utility refund for the payment of the workers' compensation benefits. A claimant shall have sixty (60) days following issuance of a comprehensive distribution plan in which to make an election to participate or not.


393.090. Presumption of abandonment of intangible personal property not otherwise covered. — Except as otherwise provided in KRS 393.010, all intangible property, not otherwise covered by this chapter, including any income or increment thereon and deducting any lawful charges, that is held or owing in this state by any person and has remained unclaimed by the owner for more than seven (7) years after it became payable or distributable is presumed abandoned. (1610: amend. Acts 1960, ch. 142, § 8; 1962, ch. 144, § 2; 1966, ch. 255, § 267.)

393.092. Effect of property owner's residence in another state. — If specific property which is subject to the provisions of KRS 393.060, 393.064, 393.066, 393.070 and 393.090 is held for or owed or distributable to an owner whose last known address is in another state by a holder who is subject to the jurisdiction of that state, the specific property is not presumed abandoned in this state and subject to this chapter if:

(1) It may be claimed as abandoned or escheated under the laws of such other state; and

(2) The laws of such other state make reciprocal provision that similar specific property is not presumed abandoned or escheatable by such other state when held for or owed or distributable to an owner whose last known address is within this state or by a holder who is subject to the jurisdiction of this state. (Enact. Acts 1960, ch. 142, § 13, effective June 16, 1960.)
393.095. Unclaimed pari-mutuel tickets from quarter horse or appaloosa racetracks. — All funds represented by unclaimed pari-mutuel winning tickets held in this state by any person, association or corporation operating a pari-mutuel or similar system of betting at quarter horse or appaloosa racetracks shall be presumed abandoned, within the meaning of KRS Chapter 393, if not claimed by the person entitled thereto within two (2) years from the time the ticket became payable. (Enact. Acts 1950, ch. 29; 1978, ch. 307, § 16, effective June 17, 1978; 1980, ch. 84, § 15, effective July 15, 1980.)

393.100. Property paid into court — When presumed abandoned — Reversion to municipality which procured payment into court. — Any property paid into any court of this state for distribution and the increments thereof, shall be presumed abandoned if not claimed within five (5) years after the date of payment into court or as soon after the five-year period, as all claims filed in connection with it, have been disallowed or settled by the court. Provided, however, That any property paid into any court of this state for distribution and the increments thereof, which may be presumed abandoned as provided in this chapter and which shall have been recovered or procured upon the relationship or through the instrumentality of any municipality of this state, shall revert to the general fund of such municipality and at any time after the five-year period has expired, after the date of the payment into the court, the municipality may by petition filed against the custodian of such funds, in the court in which said property is located, request the payment thereof to said municipality and the judge of said court shall order the custodian thereof, to pay the entire sum to said municipality. Provided, further That before entering judgment, ordering said sum so paid, the court shall require that notice be published at least once in a newspaper of general bona fide circulation in the county, stating the intention of the court to award such sum to the municipality and final judgment shall not be entered, until fifteen (15) days shall have elapsed from the date of such publication. At any time prior to the final judgment, the court may consider any bona fide claims made by claimants to said property or any part thereof. However, thereafter, any and all claimants shall be forever barred therefrom. (1610: amend. Acts 1944, ch. 50.)

393.110. Holders of abandoned property to report to department — Posting and publication of notices: exceptions — Duty to surrender property to department — Rights of action.

(1) Every person holding funds or other property, tangible or intangible, presumed abandoned under this chapter shall report to the department with respect to the property annually as of July 1. The report shall be filed in the office of the department on or before August 1 of each year for the preceding July 1. The report shall include:
(a) Except with respect to travelers' checks and money orders, the name, if known, and last known address, if any, of each person appearing from the records of the holder to be the owner of any property of value of one hundred dollars ($100) or more presumed abandoned under this chapter and in the case of unclaimed funds of life insurance corporations, the full name of the insured or annuitant and his last known address according to the records of the life insurance corporation;
(b) The nature and identifying number, if any, or description of the property and the amount appearing from the records to be due, except that items of value under one hundred dollars ($100) each may be reported in the aggregate. The holder of abandoned property shall maintain its records for a period of five (5) years from the date of its report for items reported in the aggregate. If the
owner of property reported in the aggregate makes a valid claim within five (5) years, the holder shall refund the property and deduct the amount refunded from the next report due to the department;

(c) The date when the property became payable, demandable, or returnable, and the date of the last known transaction with the owner with respect to the property if readily available; and

(d) Any other information which the department prescribes by administrative regulations necessary for the administration of this chapter. The report shall be made in duplicate; the original shall be retained by the department, and the copy shall be mailed to the sheriff of the county where the property is located or held. It shall be the duty of the sheriff to post for not less than twenty (20) consecutive days this copy on the courthouse door or the courthouse bulletin board, and also to publish the copy pursuant to KRS Chapter 424; except the sheriff shall not be required to publish any item with a fair cash value of one hundred dollars ($100) or less. The list shall be published within thirty (30) days of its receipt by the sheriff and this publication shall constitute compliance with the requirements of KRS Chapter 424. The cost of the publication shall be paid by the state. The sheriff shall immediately certify in writing to the department the dates when the list was posted and published. The list shall be posted and published as required on or before October 1 of the year when it is made, and the posting and publishing shall be constructive notice to all interested parties.

(2) Within sixty (60) days after the receipt of the report required by subsection (1) of this section, the department shall mail notice to each person having an address listed in the report who appears to be entitled to property presumed abandoned under this chapter; except the department shall not be required to mail a notice to any person whose name appears on the abandoned property list where the fair cash value of the property is one hundred dollars ($100) or less. The notice shall contain:

(a) A statement that according to a report filed with the department properties are being held to which the addressee appears entitled;

(b) The name and address of the person holding the property and any necessary information regarding changes of name and address of the holder; and

(c) A statement that, if satisfactory proof of claim is not presented by the owner to the holder by the date specified in the published notice, the property will be placed in the custody of the department to whom all further claims must be directed.

(3) Any person who has made a report of any estate or property presumed abandoned, as required by this chapter, shall, by January 1 of each year, turn over to the department all property so reported; but if the person making the report or the owner of the property shall certify to the department that any or all of the statutory conditions necessary to create a presumption of abandonment no longer exist or never did exist, or shall report the existence of any fact or circumstance which has a substantial tendency to rebut the presumption, then, the person reporting or holding the property shall not be required to turn the property over to the department except on order of court. If a person files an action in court claiming any property which has been reported under the provisions of this chapter, the person reporting or holding the property shall be under no duty while the action is pending to turn the property over to the department, but shall have the duty of notifying the department of the pendency of the action.

(4) The person reporting or holding the property or any claimant of it shall always have the right to a judicial determination of his rights under this chapter, and nothing in this chapter therein shall be construed otherwise. The Commonwealth may institute an action to recover the property presumed abandoned, whether it has been reported or not, and may include in one (1) petition all the property within the jurisdiction of the court in which the action is brought if the property of different persons is set out in separate paragraphs.

393.115. Advertising expenses. — The department shall deduct the proportionate share of the cost, in no event less than one dollar ($1.00), of the advertisement and the cost of preparing the advertisement required by KRS 393.110 from the amount of any claim allowed. (Enact. Acts 1960, ch. 142, § 11, effective June 16, 1960.)

393.120. Sale of property required to be liquidated to pay department.

(1) Tangible personal property required by this chapter to be liquidated in order to permit payment to the department shall be delivered to the master commissioner of the county in which such property is located. The master commissioner shall within a reasonable time advertise the property for sale in accordance with KRS Chapter 424 and shall sell it at public auction to the highest bidder. The master commissioner shall pay to the department the proceeds of such sale, less costs incidental to the liquidation or any legal proceedings, and any liabilities against the property which have been properly claimed and approved.

(2) For intangible personal property required by this chapter to be liquidated so as to permit payment to the department, the department shall require the agencies or holders of abandoned intangible personal property to sell or dispose of the property on a given date at the quoted market value in the case of property listed in recognized market exchanges, or, in the case of property not listed in a recognized market exchange, at a price recommended by the department or at the highest price offered at a public sale, whichever is greater. In the event that the intangible property is of a nature such that there is not a readily available market, the department may offer the property to the highest bidder at public sale at Frankfort, or in whatever city in the state affords, in its judgment, the most favorable market for the particular property involved. If a sale is required to permit payment to the department, the department may decline the highest bid and reoffer the property for sale if it considers the price offered insufficient. The sale shall be advertised by publication pursuant to KRS Chapter 424 in the county where the property was found or abandoned, and in the county where the sale is to be made. The sale shall be held at the courthouse door.


393.130. Rights and duties of persons who have transferred property to department.

Upon the payment or delivery of abandoned property to the department, the state shall assume custody and shall be responsible for the safekeeping thereof. Any person who pays or delivers abandoned property to the department under this chapter is relieved of all liability to the extent of the value of the property so paid or delivered for any claim which then exists or which thereafter may arise or be made in respect to the property. Any holder of deposits or any life insurance company who has paid moneys to the department pursuant to this chapter shall make payment to any person appearing to such holder to be entitled thereto, and upon proof of such payment and proof that the payee was entitled thereto, the department shall forthwith reimburse the holder or company. Notwithstanding the provisions of KRS 393.140, posting or advertising is not required in the event payment is made to persons entitled thereto by holders of deposits of life insurance companies in compliance with this section. The claim shall be paid without deduction for the cost of advertising or services provided in KRS 393.115.

393.140. Claim of interest in property surrendered to state.

(1) Any person claiming an interest in any property paid or surrendered to the state in accordance with KRS 393.020 to 393.050 who was not actually served with notice, and who did not appear, and whose claim was not considered during the action or at the proceedings that resulted in its payment to the state, may, within five (5) years after the judgment, file his claim to the property with the department.

(2) Any person claiming an interest in any estate or property paid or surrendered to the state in accordance with KRS 393.060 to 393.120, that was not subsequently adjudged under the procedure set out in KRS 393.230 to have been actually abandoned, or owned by a decedent who had no heir, distributee, devisee, or other person entitled under the laws of this state relating to wills, descent, and distribution to take the legal or equitable title, may file his claim to it at any time after it was paid to this state.

(3) Any claimant that is an heir or a relative to the original owner shall, within fifteen (15) days after filing any claim permitted under this section in excess of one hundred dollars ($100), publish notice of the claim pursuant to KRS Chapter 424 in the county in which the property was held before being transferred to the state. If the claim is for one hundred dollars ($100) or less, the claimant shall post at the courthouse door and three (3) other conspicuous places in that county, and shall file proof of publication or posted notice with the department. No claim shall be allowed until fifteen (15) days after proof of the notice is received by the department.


393.150. State Treasurer to determine claims.

The State Treasurer shall consider any claim or defense permitted to be filed before the department and hear evidence concerning it. If the claimant establishes his claim, the State Treasurer shall, when the time for appeal or further legal procedure has expired, authorize payment to him of a sum equal to the amount paid into the State Treasury in compliance with this chapter. The decision shall be in writing and shall state the substance of the evidence heard by the State Treasurer, if a transcript is not kept. The decision shall be a matter of public record.


393.160. Appeals from decision of State Treasurer.

Any person dissatisfied with the decision of the State Treasurer may, within sixty (60) days, appeal from it to the Franklin Circuit Court or file an action in that court to vacate the decision. In either event the proceedings shall be de novo, and no transcript of the record before the State Treasurer shall be required to be kept unless requested by the claimant. In the proceeding the State Treasurer shall be made a party defendant, and all other persons required by law to be made parties in actions in rem or quasi in rem shall be made parties. Any party adversely affected by the decision of the Franklin Circuit Court may appeal to the Court of Appeals in accordance with the Rules of Civil Procedure. Upon an appeal the state shall not be required to make a supersedeas bond. The provisions of this section relating to the decision of the State Treasurer and appeals therefrom shall also apply to a decision of the State Treasurer rendered under authority of KRS 393.110.

393.170. Property in federal custody — Determination of whether escheat has occurred. — Whenever any property escheated under this chapter by reason of actual abandonment, or death or presumption of death of the owner without leaving any person entitled to take the legal or equitable title under the laws of this state relating to wills, or descent and distribution, has been deposited with, or in the custody or under the control of, any federal court in and for any district in this state, or in the custody of any depository, clerk or other officer of such court, or has been surrendered by such court or its officers to the United States treasury, the circuit court of any county in which such federal court sits shall have jurisdiction to ascertain whether an escheat has occurred, and to enter a judgment of escheat in favor of the state. This section does not authorize a judgment to require such courts, officers, agents or depositories to pay or surrender funds to this state on a presumption of abandonment as provided in KRS 393.060 to 393.110. (1616.)

393.180. Proceedings instituted by county attorney on relation of State Treasurer.
Any legal proceeding to enforce KRS 393.020 to 393.050 and to recover any sum due the state thereunder shall be instituted, on the relation of the State Treasurer, by the county attorney of the county in which the property is located. The petition and all necessary pleadings shall be sent to the State Treasurer for his signature and approval. The petition shall be accompanied by an affidavit of the county attorney, stating the facts on which it is based. For all other pleadings, there shall be a statement by the county attorney of the reason for the particular pleading.

393.190. Assistant Attorney General to aid county attorney.
On any action filed by a county attorney under the provisions of this chapter, the assistant Attorney General provided for in KRS 15.105 shall offer assistance and suggestions to the county attorney in the preparation of the petition or any pleadings, and revise and correct them as he considers necessary, subject to the ultimate approval of the State Treasurer, when he is required to sign them.

393.200. State Treasurer may perform duties of county attorney.
If the county attorney declines to perform the duties imposed upon him by this chapter, they may be performed by the State Treasurer. When he considers it to the best interest of the state, the State Treasurer may institute any action authorized by this chapter to be brought by the county attorney, or join the county attorney in the active prosecution of the action.
393.210. Property in two or more counties. — If the property of a person coming within the purview of KRS 393.020 to 393.050 is located in two (2) or more counties, all the property may be included in one (1) action. The county attorneys of all counties in which such property is located may join in the prosecution of the proceeding. (1618: amend. Acts 1976 (Ex. Sess.), ch. 17, § 50, effective January 1, 1978.)

393.220. Disposition of tangible property during proceeding. — Pending the outcome of an action, the court may make such disposition of the land or tangible personal property involved as it considers best from the standpoints of use, rents, interest and profits. If the use of the property is given to the claimant by the court, he shall be held accountable for returns and profits arising from it if the state is successful in the proceeding. (1618.)

393.230. Proceeding to force payment or surrender of intangible property — To establish actual abandonment.
(1) If any person or the agent of any court refuses to pay or surrender intangible property to the department as provided in KRS 393.060 to 393.110, an equitable proceeding may be brought on the relation of the State Treasurer to force payment or surrender. All property subject to KRS 393.060 to 393.110 may be listed and included in a single action.
(2) If any intangible property is turned over to the department on presumption of abandonment, in accordance with KRS 393.060 to 393.120, the State Treasurer may at any subsequent time institute proceedings to establish conclusively that it was actually abandoned, or that the owner has died and there is no person entitled to it.
(1619: amend. 1994, ch. 58, § 16, effective March 10, 1994; 1994, ch. 276, § 16, effective July 15, 1994.)

393.240. Actions may be joined — Procedure for action.
(1) If any person has property coming within the purview of KRS 393.020 to 393.050, and also of KRS 393.060 to 393.110, the actions required to be brought by the county attorney and the State Treasurer may be joined, but joinder is not required, and if separate actions are brought, they shall not be considered as coming within the rule against splitting a cause of action. The county attorney is not charged with the duty of enforcing sections KRS 393.060 to 393.120, 393.150, or 393.160.
(2) The procedure for all actions under this chapter shall be filed as equity actions and follow the procedure provided by the Rules of Civil Procedure, unless otherwise provided in this chapter.
(1619: amend. 1994, ch. 58, § 17, effective March 10, 1994; 1994, ch. 276, § 17, effective July 15, 1994.)

393.250. Source of payment of expenses — County attorney to collect judgments.
(1) Any necessary expense required to be paid by the state in administering and enforcing this chapter shall be paid out of the abandoned property receipts.
(2) The county attorney shall act as agent of the department for the collection of all judgments recovered in actions prosecuted by him under this chapter. He shall promptly remit the judgment recovered to the department with the information relating thereto as the department requires.
393.260. Limitation of state’s action. — Any action brought by the state under this chapter shall be brought within fifteen (15) years from June 12, 1940 or from the time when the cause of action accrued, whichever is the later date. (1621.)

393.270. Person under disability, extension. — Any person under disability affected by this chapter shall have five (5) years after the disability is removed in which to take any action or procedure or make any defense allowed to one sui juris. (1622.)

393.280. Examination of records — Promulgation of rules — Delegation of State Treasurer’s authority.

(1) The department, through its employees, may examine all records of any person where there is reason to believe that there has been or is a failure to report property that should be reported under this chapter.

(2) The State Treasurer may promulgate any reasonable and necessary rules for the enforcement of this chapter, and govern hearings held before him. He may delegate in writing to any regular employee of the department authority to perform any of the duties imposed on him by this chapter, except the promulgation of rules.

(1622-1: amend. 1994, ch. 58, § 19, effective March 10, 1994; 1994, ch. 276, § 18, effective July 15, 1994.)

393.290. Civil action to enforce production reports or the surrender of property.

(1) The department may require the production of reports, or the surrender of property as provided in this chapter by civil action, including an action in the nature of a bill of discovery, in which case the defendant shall pay a penalty equal to ten percent (10%) of all amounts that he is ultimately required to surrender. This penalty shall not exceed five hundred dollars ($500).

(2) Any person who in good faith contests the applicability of this chapter to him may be relieved of the threat of any penalty by posting a compliance bond in an amount and of surety sufficient to the court.

(1622-1; 1994, ch. 58, § 20, effective March 10, 1994.)

393.300. Restriction on escheat of real property held by lending corporation under supervision. — No person shall institute proceedings to escheat real property the title to which was acquired by any lending corporation in satisfaction of debts previously contracted in the course of its business, or that it purchases under a judgment for any such debt in its favor, if such lending corporation is under the supervision of the department of banking and securities of this state, comptroller of currency of the United States or any other duly constituted supervising banking authority, state or federal, without first obtaining the consent of the supervising authority having supervision over that corporation. (1623-1.)

393.990. Penalties. — Any person who refuses to make any report as required by this chapter shall be fined not less than fifty ($50.00) dollars nor more than two hundred dollars ($200), or imprisoned for not less than thirty (30) days nor more than six (6) months, or both. (1622-1.)
CHAPTER 1 STATE TREASURY

20 KAR 1:010. Access to public records of State Treasury.

RELATES TO: KRS 61.870 to 61.884
STATUTORY AUTHORITY: KRS 61.876

NECESSITY, FUNCTION, AND CONFORMITY: This administrative regulation sets out definitions for this and all administrative regulations relating to KRS Chapter 393, and establishes a policy to locate owners of unclaimed property.

Section 1. The department shall make reasonable efforts to locate the owners of unclaimed property reported to the department as follows:

(1) Contracted services with established firms, credit bureaus, telephone networking companies;

(2) Intergovernmental agency agreements;

(3) Use of computerized information on telephone lists, directories, voter information, or other available data;

(4) Civic or professional meetings or gatherings; or

(5) Public media and printed material. (21 Ky.R. 681; Am. 1280; eff. 10-12-94.)

20 KAR 1:020. Unclaimed property; definitions; location of owners.

RELATES TO: KRS 393.280(2)
STATUTORY AUTHORITY: KRS 393.280

NECESSITY, FUNCTION, AND CONFORMITY: This administrative regulation sets out definitions for this and all administrative regulations relating to KRS Chapter 393, and establishes a policy to locate owners of unclaimed property.

Section 1. If the rightful owner of unclaimed property claims his property between July 1 and August 1, the holder shall not report such property because the presumption of abandonment as of July 1 no longer exists.

Section 2. If the rightful owner or legal claimant of property reported as presumed abandoned establishes his claim between August 1 and January 1, the holder shall certify by sworn statement to the department the specific items which have been returned to the rightful owner or legal claimant and, therefore, are not subject to escheat. (21 Ky.R. 682; Am. 1280; eff. 10-12-94.)

20 KAR 1:040. Unclaimed properties; claims.

RELATES TO: KRS 393.010, 393.040, 393.110, 393.140, 393.150
STATUTORY AUTHORITY: KRS 393.280

NECESSITY, FUNCTION, AND CONFORMITY: This administrative regulation relates to the claims process for unclaimed property, which owners and heirs shall follow; and the proof necessary for authorization of a claim refund.

Section 1. Claims for unclaimed property or the proceeds from the sale of unclaimed property shall be filed with the department. Upon receipt of the initial claims inquiry from a person having an interest in the property, the department shall send the required claim forms to be completed by the claimant; and request necessary documentation as proof of ownership.

(1) Documentation to prove ownership shall consist of a driver’s license or other picture identification, a document proving Social Security number; and, one (1) or more of the following:

(a) Copy of birth certificate;

(b) Copy of will;

(c) Copy of probate distribution;

(d) Copy of marriage certificate;

(e) Copy of divorce decree;

(f) Copy of documentation providing a connection with the reported address or business for the year cited as the “Date of Last Transaction” in the holder’s report.
(g) Copy of letters testamentary;
(h) Copy of guardianship or trust agreement;
   (i) Notarized affidavit executed by an individual other than the
      claimant having knowledge of, and in support of, a claim when
      requested information or documentation is not available;
(i) Signature verification cards of financial institutions;
(k) Family or church records, and personal correspondence;
(l) Newspaper articles, including marriage announcements and
    birth or obituary notices;
(m) Other documentation which may be used in support of the
    claim include an income tax return, adoption records, court records,
    CD's, state dated checks, or other public or business records.
(2) In addition to items set out above, minimum requirements
    needed to establish ownership for various types of property shall be:
   (a) Checking accounts: a check (blank or canceled) showing the
       account number for that bank, or a statement on that account which
       contains the account number;
   (b) Savings account: a copy of the passbook showing the account
       number or correspondence referencing the account number;
   (c) Safe deposit box: a copy of the safe-deposit box rental receipt
       or correspondence referencing that rental;
   (d) Wages: copies of W-2 forms, tax records or correspondence
       relating to that employment;
   (e) Stocks or dividends: copies of a stock certificate of the
       business entity reported, correspondence relating to the stock
       certificate or a statement from the broker showing purchase or sale
       of that stock;
   (f) Bearer bonds and certificates of deposit: a copy of the record
       of purchase;
   (g) Insurance: a copy of the policy, or correspondence relating to
       that policy by policy number;
   (h) Court funds: a copy of the court decree or court order for the
       estate or personal representative; the court appointed guardian; or to
       an heir for distribution to other heirs, if any. [21 Ky.R. 682; Am. 1280;
       eff. 10-12-94.]

20 KAR 1:050. Unclaimed property; examination of holder
records.

RELATES TO: KRS 393.010, 393.110, 393.160, 393.280
STATUTORY AUTHORITY: KRS 393.280
NECESSITY, FUNCTION, AND CONFORMITY: This administra-
tive regulation relates to the examination of holder records by the
department if any holder fails to make a full and complete report of
property as required by KRS Chapter 393.

Section 1. If any holder fails to make a full and complete report
of property as required by KRS Chapter 393, the department, after
23 giving notice as provided in subsection (1) of this section, may
examine the records and other accounts of the holder.
   (1) The department shall notify the holder in writing ten (10) days
   prior to an examination. However, if the department determines that
   the existence of the records may be placed in jeopardy unless action
   is taken forthwith, the department may examine all records immedi-
   32 ately without any prior notice.
   (2) The examination may include:
      (a) Records of current accounts, dormant accounts, and accounts
          that may have been closed and archived;
      (b) Verification of contractual agreements between depositors and
          the final organization regarding the deduction of service charges,
          account increases or decreases, and the cessation of interest
          payments; and
      (c) In addition to the examination of unclaimed accounts and
          contractual agreements, the examiner may review the holder's annual
          procedures for reviewing dormant accounts.
   (3) The department shall have reason to believe that a holder has
   failed to comply with the reporting requirements of KRS Chapter 393
   and may examine the records of the holder if one (1) of the following
   conditions exist:
      (a) A holder has not submitted a report to the department;
      (b) A holder has submitted reports to the department in which the
          holder's report states it has no unclaimed property;
      (c) A holder fails to report types of unclaimed property normally
          reported by like businesses or associations;
      (d) When amounts on the holder's report or amounts remitted
          from the holder are not comparable to reports received from like
          holders; and
      (e) When information is provided by other governmental agencies
          or reliable sources that a holder may be holding unclaimed property
          that has not been reported.
   (4) At the completion of an examination a statement of examina-
   tion findings and proposed adjustments shall be delivered to the
   holder. The statement shall be delivered by the department by hand
   or by certified mail. The statement shall contain sufficient information
   to make the holder aware of his reporting obligations and legal
   options.
   (5) The holder shall have thirty (30) days in which to review the
   examination findings and proposed adjustments to the findings. No
   later than thirty (30) days of the date of the statement, the holder shall
   cause to be generated an amended annual report. If the holder
   disagrees on the facts, he shall file an official written protest within
   the thirty (30) day period or the amount as set out by the statement
   will become absolute and final and be immediately due and payable.
The protest shall be filed with the department and shall set out a clear
and concise assignment of any error alleged to have been committed
by the department in its examination or its statement. The holder may
request an administrative hearing in its protest. (21 Ky.R. 684; Am.
128; eff. 10-12-94.)

20 KAR 1:060. Unclaimed property; safe deposit boxes or
other safekeeping repositories.

RELATES TO: KRS 393.010, 393.020, 393.050, 393.060,
393.062, 393.064, 393.090, 393.110, 393.120
STATUTORY AUTHORITY: KRS 393.280
NECESSITY, FUNCTION, AND CONFORMITY: This administra-
tive regulation relates to the reporting, inventory, safekeeping and
liquidation of unclaimed property from holders who maintain safe
deposit or other safekeeping repositories.

Section 1. Pursuant to KRS Chapter 393, every holder maintaining
safe deposit boxes or other safekeeping repositories located in
the Commonwealth shall report to the department with an inventory
of property in its possession which constitute unclaimed funds.
(1) An inventory report shall be submitted for each safe deposit
box or safekeeping repository. Each report shall be signed by two (2)
officials of the holding company who opened the safe deposit box or
safekeeping repository and conducted the inventory. Each report shall
include a statement containing the following information:
(a) The name, last known address, and Social Security number
of owner;
(b) The expiration date of the lease or rental agreement for such
safe deposit box or other safekeeping repository;
(c) The date of opening of such safe deposit box or other
safekeeping repository;
(d) The number or identifying description of the safe deposit box
or other safekeeping repository;
(e) A detailed list describing each item therein;
(f) The name and address of the holder reporting the property;
and
(g) The names, signatures, and official positions of the two (2)
holding company employees who opened the box and conducted the
inventory.
(2) The property of each safe deposit box or safekeeping
repository shall be placed in an individual envelope. A copy of the
holder inventory report shall be placed in the envelope. The envelope
shall be sealed and initialed on the reverse side by the two (2)
holding company employees who conducted the inventory. The name
of the owner of the box, date, and holder name shall be printed on
the reverse side of the envelope. Transparent sealing tape (of the
strong bonding type) shall be placed over the flap of the envelope. A
second copy of the holder inventory report shall be attached to the
front of the envelope.
(3) The holder shall mail a copy of the report(s) and notify the
department of pending delivery of property.
(4) The holder shall be responsible for the secured delivery of the
contents of each safe deposit box or other safekeeping repository to
the department. The department may take direct delivery from the
holder at the holder’s place of business or residence.

Section 2. Upon receipt of the contents of the safe deposit
box(es) or other safekeeping repository(ies), along with the inventory
report(s), the department shall immediately conduct an inventory of
property delivered, verify holder report(s), and secure property in the
department vault.
(1) The inventory shall be conducted by two (2) department
employees with appropriate supervision.
(2) The contents of each envelope will be separated into the
following groups:
(a) TNG - jewelry with gemstones, watches and other valuables;
(b) MNY - coins and paper money (foreign & domestic) which
have numismatic value;
(c) STK - stock certificates;
(d) BND - U.S. Savings Bonds;
(e) INS - insurance policies;
(f) CSH - Coins and paper money which do not have numismatic
value;
(g) DST - items of no value; and
(h) OTH - military discharge, birth certificate, photos, etc.
(3) Each item shall be assigned an identification or serial number.
A property tag shall be prepared for each group with an assigned
owner identification or serial number, name of owner, and Social
Security number if available. The groups of tangible property will be
placed in individually secured plastic bags. The groups of intangible
property shall placed into folders.
(4) A detailed department inventory statement shall be completed
for each safety deposit box or safekeeping repository envelope
received. Each statement shall include the following information:
(a) The name and last known address of the owner(s);
(b) The name and address of holder reporting the property;
(c) Date of delivery and holder inventory;
(d) Date of holder inventory;
(e) Number or identifying description of the safe deposit box or
safekeeping repository;
(f) Date of department inventory;
(g) A detailed list describing each item therein, separated into
groups as stated in subsection (2) of this section;
(h) The assigned holder identification or serial number;
(i) The assigned owner identification or serial number; and
(j) An official note signed by department employees, who
conducted the inventory, verifying accuracy of holder report. The
note shall be signed for approval by a supervisor.
(5) Property shall be secured in the department vault for safe-
keeping purposes. Tangible property shall be retained for a period of
three (3) years and then put to public auction, pursuant to KRS
Chapter 393, and proceeds, less costs, paid to the state. Intangible
property shall be retained for a period of one (1) year, then liquidated
and the proceeds, less costs, paid to the state. Owners of property
shall be credited for the amount received through liquidation or
auction.
(a) Coins and paper money not of numismatic value shall be
deposited for the state immediately and a copy of the pay-in voucher
placed in owner’s file;
(b) Miscellaneous papers or property of no value shall be retained
for a period of three (3) years and, then, destroyed.
(c) The Kentucky Historical Society shall be contacted for
determination of items of historical value. Papers or property
determined to have historical value shall be retained and may be
loaned to the society.
(6) The department shall maintain an accurate inventory and
essential information through entry into the computer.
(7) The department shall direct that two (2) employees be present
at all times when handling property. Security of property in the vault
shall be maintained by the following procedure:
(a) Two (2) employees shall receive written authorization from a
supervisor prior to entry to the vault; and
(b) The employees shall state in writing the purpose, property to
be handled, the time and date. (21 Ky.R. 685; Am. 1282; eff. 10-12-
94.)

20 KAR 1:070. Unclaimed property; administrative hearing,
appeals process.

RELATES TO: KRS 393.010, 393.160
STATUTORY AUTHORITY: KRS 393.280
NECESSITY, FUNCTION, AND CONFORMITY: This administra-
tive regulation sets out the appeals and administrative hearings
process when a department decision regarding unclaimed property
adversely affects a person.

Section 1. Any person adversely affected by a decision of the
department may appeal the decision and request an administrative
hearing.
(1) Upon receipt of a written request for an administrative hearing, the department shall immediately set the date, time, and place of hearing and forthwith notify the person by regular U.S. mail. The date set for the hearing shall be within thirty (30) days from the date the written request was received, unless otherwise agreed by the parties.

(2) The Treasurer shall appoint a hearing officer to conduct the hearing.

(3) The hearing officer shall make findings of fact, conclusions of law, and enter a final order. (21 Ky.R. 686; Am. 1283; eff. 10-12-94.)
# ABANDONED PROPERTY REPORT FORM

## 1996 UNCLAIMED PROPERTY REPORT FORM

### KENTUCKY TREASURY DEPARTMENT

**JOHN KENNEDY HAMILTON, STATE TREASURER**

**NOTE:** THIS FORM MUST BE COMPLETED FOR ALL UNCLAIMED PROPERTY REPORTING.

**KRS 393 PROVIDES FOR PENALTIES FOR NON-COMPLIANCE**

<table>
<thead>
<tr>
<th>Name</th>
<th>Address</th>
<th>City, State and Zip Code</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
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</tbody>
</table>

### COMPANY ASSETS | 1993 COMPANY SALES

<table>
<thead>
<tr>
<th>Number of Employees</th>
<th>State of Incorporation</th>
<th>Date of Incorporation</th>
</tr>
</thead>
<tbody>
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### FEIN # | Name and Phone of Official Responsible for Unclaimed Property

**INSTRUCTIONS:** Report by August 1 any unclaimed funds/property accounts for Kentucky owners that have not responded to the reporting concerning due diligence letters as follows: DORMANCY PERIODS - 13 years for traveler's checks, 1 year for estates without heirs, 5 years for state or federal; 7 years for all other accounts (examples: bank accounts, wages, dividends, etc.). Per KRS 393.110 these accounts must include complete owner information, i.e., complete account name(s), social security #, complete address, etc. For assistance call (502) 564-4

### TOTAL NUMBER OF SHARES (list accounts on reverse)

1. **Number of Shares**

### NUMBER OF SAFE DEPOSIT BOXES (list accounts on reverse)

2. **Number of Safe Deposit Boxes**

### TOTAL OF ACCOUNTS UNDER $100.00 (REPORTED AS AGGREGATE)

3. **Total of Accounts Under $100.00**

### TOTAL OF ACCOUNTS OVER $100.00 (list accounts on reverse)

4. **Total of Accounts Over $100.00**

### TOTAL MONEY REPORTED (line 3 plus line 4)

5. **Total Money Reported**

### DOES HOLDER CONSIDER ANY CATEGORY OR TYPE PROPERTY EXEMPT FROM KRS 393?

6. **Does Holder Consider Any Category or Type Property Exempt**

### IS HOLDER MAKING ANY DEDUCTIONS OR WITHHOLDINGS FROM PROPERTY SUBJECT TO KRS 393?

7. **Does Holder Making Any Deductions or Withholdings**

**DO NOT SUBMIT PAYMENT WITH THIS REPORT. PAYMENT IS DUE BY JANUARY 1 WITH FORM TREAS401**

If you are successor to the above holder, or its transfer agent, or if your name mailing address has changed please explain:

List any additional reports filed:

The undersigned declares under penalty of perjury, that to the best of his/her knowledge and belief, the foregoing facts & information are true & correct.

**Type or Print Name** | **Signature** | **Date**
---|---|---

**MAIL TO:** KENTUCKY TREASURY DEPT., UNCLAIMED PROPERTY BRANCH, SUITE 183 CAPITOL ANNEX, FRANKFORT, KY 40601

**K - 27**
JAMES V. MARCUM
Individually, and on Behalf of All
Unknown Owners of Abandoned Properties

v.

JOHN KENNEDY HAMILTON, as the
KENTUCKY STATE TREASURER
183 Capitol Annex, West Wing
Frankfort, KY 40601

-and-

KENTUCKY BANKERS ASSOCIATION
Suite 1000, 325 West Main Street
Louisville, KY 40202 Serve: Judy L. Blain

-and-

KENTUCKY BANK
400 Main Street
Paris, KY 40361 Serve: Buckner Woodford, Jr.

-and-

HOME FEDERAL BANK, FSB
1602 Cumberland Avenue
Middlesboro, KY 40965 Serve: (No agent of record)

DEFENDANTS

SERVE: A. B. Chandler, III
Attorney General
Commonwealth of Kentucky
1024 Capitol Center Drive
Frankfort, KY 40601

PLAINTIFFS
Plaintiff, JAMES V MARCUM, individually, and on behalf of all owners of unclaimed, and presumed abandoned, bank accounts, certificates of deposit and other properties described in Chapter 393 Kentucky Revised Statutes, for their Complaint herein state as follows:

SHORT SUMMARY OF THE CASE

When evidence is presented in this matter it will show that millions of dollars of unclaimed and “presumed abandoned” bank accounts, Certificates of Deposit and the like are being unlawfully held and retained by certain Kentucky banks and financial institutions, when by statute, KRS Chapter 393, such accounts and deposits are required to be surrendered to the State Treasury for proper disposition by the Commonwealth. If this statute is not enforced, the offending banks will privately, and unlawfully, escheat such accounts and deposits for their own use and benefit, to the detriment of the unknown owners and the citizens and taxpayers of Kentucky.

The evidence will further show that the State Treasurer has been unable, for whatever causes, to enforce this statute; and for this reason it is necessary that this Court exercise its equitable and statutory jurisdiction to declare the rights of the interested parties and to fashion a remedy that will lead to a proper enforcement of the statute and which will protect the appropriate financial interests of the banks, the unknown owners and the citizens of this Commonwealth.

NATURE OF ACTION

1. (i) This is an action for declaratory and injunctive relief concerning the fact that millions of dollars in unclaimed, and presumed abandoned, bank accounts, Certificates of Deposit and similar intangible properties (herein referred to as the “presumed abandoned properties”) are being held by certain unidentified Kentucky banks and financial institutions contrary to the provisions of Chapter 393, Kentucky Revised Statutes; and

(ii) that the Kentucky State Treasurer has failed to enforce, or has been unable to enforce, the said statute which specifically requires that all such “presumed abandoned properties” be accounted for by the defendants and surrendered to the Department of Treasury for subsequent disposition to the rightful owners, or to the Commonwealth for General Fund purposes.

PARTIES

2. PLAINTIFF, James V. Marcum, is an adult, tax-paying citizen of the Commonwealth domiciled and residing at 125 Buena Vista Drive, Ashland, KY 41101. He is an attorney at law, desirous that the laws of the Commonwealth shall be well and faithfully executed.

(i) The Plaintiff, as a taxpayer, and on behalf of the unknown owners of the “presumed abandoned properties” have standing to sue in this civil action because the State Treasurer has failed to perform the statutory duties imposed upon him by KRS Chapter 393 by not requiring the defendant banks to account for and surrender all “presumed abandoned properties” held by them.
(ii) By reason of this default in the enforcement of the statute the defendant banks have been, or will be, enabled to privately escheat these "presumed abandoned properties" to the detriment of the true, but unknown, owners of these properties and to the detriment of the General Fund of the Commonwealth which is entitled to keep and use all such "presumed abandoned properties" subject only to the claims of the rightful owners.

(iii) The Plaintiffs, and all citizens of the Commonwealth are, consequently, deprived of the use and benefit of these "presumed abandoned properties", and "are thereby appropriate parties as taxpayers to bring this action." See, Price et al v. Commonwealth et al, 945 S.W.2d 429 (Ky. App. 1996).

3. (i) DEFENDANT, John Kennedy Hamilton, is the duly elected State Treasurer, a constitutional office, authorized by KRS Chapter 41 to direct the affairs and carry out the statutory obligations imposed upon the Department of Treasury.

(ii) KRS Chapter 393 imposes upon the State Treasurer, and the Department of Treasury, the sole authority in this Commonwealth to carry out and enforce the provisions of that statute, including the direct and specific authority to examine the records of the defendant banks and to cause such defendants to surrender to the Department of Treasury all "presumed abandoned properties" held by them.

4. (i) The DEFENDANTS, Kentucky Bankers Association, Bank of Kentucky and Home Federal Bank, FSB are sued in their individual capacities and as members of a class. These defendants have heretofore described and represented themselves to this Court as being members of a class in an action concerning KRS Chapter 393.

In the case of Kentucky Bankers Association et al v. Hamilton, 97-C-01429 now pending in Division I of this Court, these defendants stated in a Verified Complaint, as follows:

"The KBA is a business and trade association, registered under Section 501(c) of the Internal Revenue Code and located in Jefferson County, Kentucky, having as its members 309 banks and thrifts located in the Commonwealth. The KBA's mission is to provide effective advocacy for the financial services industry in this state. Kentucky Bank is a state chartered bank with its principal place of business at 400 Main Street, Paris, Kentucky 40362. Home Federal, FSB, is a federal savings bank with its principal place of business at 1602 Cumberland Avenue, Middlesboro, Kentucky 40965. These Plaintiffs bring this action on behalf of themselves and all other banks and financial institutions located in Kentucky which are similarly situated. This case is proper for certification as a class action pursuant to C.R. 23 because:

a) The class consists of approximately 329 business entities, making joinder in this action of all members of the class impractical;
b) The questions of law or fact at issue are common to all members of the class;
c) The representative Plaintiffs possess claims that are typical of the claims all members of the class have against the Defendants;"
d) The representative Plaintiffs will fairly and adequately assert and protect the interests of all members of the class, have no conflicts of interest which would preclude a vigorous maintenance of this action, and have retained counsel who is experienced and knowledgeable in the areas of law and facts involved herein;

c) Prosecution of separate actions by individual members of the class in other forums would create a risk of inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the parties opposing the class and the adjudications would be dispositive of the interests of the other members not parties to these adjudications or substantially impair or impede their ability to protect their interests; and

f) Questions of law or fact common to the members of the class predominate over any questions affecting only individual members and a class action is superior to other available methods for the fair and efficient adjudication of this controversy in that certification of the class will enable the questions of fact and law involved in the Complaint to be determined in a single forum in which all parties with an interest in the subject matter will have the opportunity to be heard."

(Verified Complaint, supra, pages 2 and 3)

(ii) All of the foregoing elements are applicable to these parties as defendants in this case, and accordingly these parties should be certified as a defendant class pursuant to C.R.23.

JURISDICTION AND VENUE

5. This Court has jurisdiction over this action pursuant to KRS 23A.010 in that it is a justiciable cause of action not exclusively vested in another court and involves a claim for injunctive relief.

6. The Franklin Circuit Court is the proper venue for this action pursuant to KRS 452.405(2); KRS 452.480; and KRS 452.505(2).

STATEMENT OF ADDITIONAL FACTS

7. (i) In 1994 the Kentucky General Assembly passed House Bill 85 which transferred the responsibility for the administration and enforcement of Chapter 393 of the Kentucky Revised Statutes, relating to unclaimed and presumed abandoned properties, from the Revenue Cabinet to the Treasurer and the Department of the Treasury.

(ii) For many years, prior to such transfer, the requirements of KRS 393 were not rigidly enforced; and as a consequence, many banks and other financial institutions throughout the Commonwealth have been inattentive to the statutory requirements imposed upon them by KRS 393. Furthermore, since the maximum penalty imposed for the violation of these statutes may not exceed $500, there is little incentive for voluntary compliance with these laws.

8. (i) Large amounts of money are at issue here. Since 1994, over $20,000,000 has been added to the Treasury's Unclaimed Property Account, even under the present "honor system"
compliance programs. Studies prepared by the Treasury, based upon actual audits, indicate that an additional $10-to-$20,000,000 of unclaimed and presumed abandoned, intangible properties may not have been reported by holders.

(ii) In addition, audits by independent accountants revealed widespread abuses of the following kind:

a) Failure to report due to mistake or inadvertence;

b) Write-off or write-down of “presumed abandoned properties” by accounting journal entries to income or to some other account controlled by the bank;

c) Reducing or writing off “presumed abandoned properties” by charging dormancy or service fees not charged to other accounts.

d) Depositing pennies, or using other accounting artifices, for the purpose of showing some activity in the “presumed abandoned properties” to avoid reporting or surrendering such deposits.

e) Failure to properly count the seven-year threshold for “presumed abandoned properties” by ignoring undelivered mail or confirmation notices or other evidences of abandonment.

f) Failure to understand or recognize that the contents of safety deposit boxes are subject to the statute.

g) Rolling over certificates of deposit to avoid the statute where the owner of the deposit had no other account or personal contacts with the bank.

(iii) The attached Affidavit and Exhibits prepared by James M. Roller, C.P.A. (who performed the audits herein above referred to), fully document the nature and extent of the abuses and violations of law which are the subject of this lawsuit.

9. (i) Upon assuming office in 1996, the newly elected Treasurer, John Kennedy Hamilton, undertook a more active enforcement program, utilizing a Kentucky public accounting firm (Hisle) to perform office and field audits of a number of Kentucky banks.

(ii) When the auditing efforts of the public accounting firm had yielded almost $1,000,000 in unreported and unsurrendered accounts, the Kentucky Bankers Association, purporting to act on behalf of all its members, filed an action to enjoin the Hisle audits, and on October 2, 1997, persuaded the Court to grant a temporary restraining order which provided as follows:

“...the Kentucky State Treasurer, and...Department of Treasury...are hereby RESTRAINED AND ENJOINED from using Hisle or other individuals who are not employees of the Department of Treasury to perform abandoned property and escheat examinations and audits under KRS Chapter 393 with respect to...all other banks and financial institutions who are members of the Kentucky Bankers Association...”

10. Shortly after being restrained from using contract accountants to perform the audits necessary to ensure compliance with Chapter 393, the Treasurer made the following request to Dr. James Ramsey, Director of the Budget and head of the Governor’s Office of Policy and Management.
"In light of the judge's ruling, I am hereby asking for an amended budget request for the Treasury Department of $117,865 annually (see enclosure titled "Compensation Comparison") which would allow me to hire three individuals with a bachelors degree in accounting and pay them the average state pay for such personnel. The accounting firm with whom we had contracted this past year had assigned this number of people to Treasury's audit program and I feel confident that I, too, would require the expertise of at least three people to meet my responsibilities for enforcement and oversight of this statute."

This request was summarily denied on January 16, 1998.

11. (i) As a consequence of (a) the Restraining Order issued by the Franklin Circuit Court on October 2, 1997; and (b) the refusal of the Governor's Office to allot sufficient funds for auditing and enforcement purposes, the Treasurer and the Department of Treasury have only limited resources to assure that the reporting and surrender requirements of Chapter 393 are being followed; notwithstanding, that Treasury's study clearly shows that these statutes are being widely ignored and abused, and that millions of dollars of unclaimed and presumed abandoned properties are being held and privately escheated by banks and financial institutions in violation of KRS Chapter 393.

(ii) By reason of the foregoing events, the members of the Kentucky Bankers Association now enjoy almost complete immunity from the enforcement and audit provisions of Chapter 393.

12. (i) The Defendants, Kentucky Bankers Association and its members, have continued to resist audit efforts of the State Treasurer; and

(ii) most recently two of the officials affiliated with Kentucky Bankers Association have filed a personal retaliatory action against Mr. Hamilton, individually, because of newspaper and media ads placed by Mr. Hamilton in an effort to educate the public about the recent activities of the Kentucky Bankers Association.

13. This thinly disguised threat to Mr. Hamilton's First Amendment rights makes it abundantly clear that the jurisdiction of this Court must be invoked to quiet this contest and to determine and declare the respective rights and responsibilities of the parties in regard to Kentucky's escheat and abandoned properties statute.

WHEREFORE, in light of the extensive abuses and violations of law described in the attached affidavit of James M. Roller, C.P.A. the Plaintiffs respectfully request this Court to declare:

1. That the Defendant banks, and each of them, have affirmative duties to observe and comply with all of the provisions of KRS Chapter 393, notwithstanding that said statute has been indifferently enforced in recent years, with particular emphasis on the following sections:

a) KRS 393.110 (1), which requires:

"Every person holding funds or other property, tangible or intangible, presumed abandoned under this Chapter shall report to the department with respect to the property annually as of July 1...on or before August 1 of each year.

K - 34
b) **KRS 393.110 (3)**, which requires:

"Any person who has made a report of any estate or property presumed abandoned, as required by this Chapter, shall, by January 1 of each year, turn over to the Department all property so reported..."

(Emphasis added)

(152x697)

2. That the State Treasurer has an affirmative duty to utilize to the fullest all of the enforcement and audit provisions of KRS Chapter 393 to require compliance with this statute, in particular the following sections:

a) **KRS 393.290 (1)** which provides:

"The Department may require the production of reports, or the surrender of property as provided in this chapter by civil action, including an action in the nature of a bill of discovery, in which case the defendant shall pay a penalty equal to ten percent (10%) of all amounts that he is ultimately required to surrender. This penalty shall not exceed five hundred dollars ($500)...

b) **KRS 393.230 (1)** which provides:

"If any person...refuses to pay or surrender intangible property to the department as provided in KRS 393.06 to 393.110, an equitable proceeding may be brought on the relation of the State treasurer to force payment or surrender. All property subject...may be listed and included in a single action."

c) **KRS 393.110 (4)**

"...The Commonwealth may institute an action to recover the property presumed abandoned, whether it has been reported or not...

(Emphasis added)

For their further relief herein, the plaintiffs respectfully demand:

1. That the State Treasurer be enjoined to forthwith file against each member of the Kentucky Bankers Association the Bill of Discovery authorized by KRS 393.290 (1) in order to determine the precise amount of presumed abandoned properties (described in KRS Chapter 393), held by each of the Defendants; and that the State Treasurer be further enjoined to file the civil actions authorized by KRS 393.290 (1) and KRS 393.230 (1) against each member of the Kentucky Bankers Association who refuses to surrender and pay over to the Department of Treasury any presumed abandoned properties held by them.

2. That each member of the Kentucky Bankers Association be enjoined:

a) To examine and review their respective records related to the presumed abandoned properties described in KRS Chapter 393 for each annual period commencing...
July 1 and ending on June 30 for each calendar year commencing in 1983 and ending in 1997; and

b) Upon completion of such examination, to report and pay over to the Department of Treasury (to the extent that it has not done so) the original unadjusted values of all presumed abandoned properties held by it; and

c) To report and pay over to the Department of Treasury the exact amounts of any presumed abandoned properties which were not reported in full to the Department because of:

1) Failure to report due to mistake or inadvertence;
2) Write-off or write-down of any presumed abandoned properties by accounting journal entries to income or to some other account controlled by the bank;
3) Reducing or writing off any abandoned properties by charging dormancy or service fees not charged to other accounts.
4) Depositing pennies, or using other accounting artifices, for the purpose of showing some activity in the account to avoid reporting or surrendering such deposits.
5) Failure to properly count the seven-year threshold for presumed abandoned properties by ignoring undelivered mail or confirmation notices or evidences of abandonment.
6) Failure to understand or recognize that the contents of safety deposit boxes are subject to the statute.
7) Rolling over certificates of deposit to avoid the statute where the owner of the deposit had no other account with the bank or other personal contacts with the bank.
8) Any other reason not fully explained or divulged at the time of filing any annual report.

3. That the Plaintiffs be awarded their costs herein expended, including reasonable attorney fees, to be paid from the funds recovered on behalf of the owners of the presumed abandoned properties; and to all other relief to which they may appear entitled.

James V. Marcum
P. O. Box 2315
Ashland, KY 41105
(606) 329-5075

Roger L. Massengale
249 Court Street
P. O. Drawer 1278
Paintsville, KY 41240-5278
(606) 789-2433

COUNSEL FOR PLAINTIFFS
The undersigned, James M. Roller, a certified public accountant, licensed to practice in the Commonwealth of Kentucky and a partner in the accounting firm of Hisle & Company after first being duly sworn, states as follows:

1. Hisle & Company, with offices located at 277 E. High Street, Lexington, Kentucky 40507, responded to a Request for Proposal for Personal Services ("RFP") issued by the Kentucky Department of Treasury.

2. The purpose of the RFP was to assist the unclaimed property section of the Kentucky Department of Treasury in (1) staff training and development, (2) unclaimed property holder education, owner identification and notification and (3) compliance auditing.

3. The unclaimed property section was moved from the Kentucky Revenue Cabinet to the Kentucky Department of Treasury in 1994 as a result of legislation adopted by the Kentucky General Assembly. At the time the Treasury Department took over the program, the dormancy period of unclaimed property was generally reduced to 7 years.
AN ACT relating to unclaimed property.

Amend KRS 393.060 to establish when property held by a bank or financial organization is presumed abandoned; create a new section of KRS Chapter 393 to provide that if property, other than money, delivered to the state, the owner is entitled to any income or gain realized or accruing on the property at or before liquidation or conversion of the property into money; amend KRS 393.280 to examination of relevant records of a person where it is believed that is a failure to report property during the preceding reporting period; documents and working papers obtained in the course of conducting the examination are not public records; amend KRS 393.130 to permit the holder of property who has paid money to the department to pay the person who appears to be the entitled holder and the department must reimburse the holder without imposing a fee; provide that property removed from a safe deposit box or other safekeeping depository is received by the department subject to the holder's right to be reimbursed for the cost of opening the box and to any valid lien or contract providing for the holder to be reimbursed for unpaid or other charges; create a new section of KRS Chapter 393 to provide that an agreement by an owner to locate or recover property presumed abandoned is void if entered into during the period beginning on the date the property was presumed abandoned until 24 months after the date the property is paid or delivered to the department; provide conditions under which such agreement is enforceable; repeal KRS 393.025, Owner of abandoned property loses income or increments accruing thereafter, and KRS 393.070, Deposits not payable on demand--When presumed abandoned.
SB 339 - AMENDMENTS

SFA (1, D. Karem) - Clarify that Treasury examination documents are not open records; move the new section to provide that if property, other than money, is delivered to the state, the owner is entitled to any income or gain realized or accruing on the property at or before liquidation or conversion of the property into money to a new subsection of KRS 393.130; delete the new requirement that the Treasurer pay 8 percent interest or any lesser rate that the property earned while in the possession of the holder; amend KRS 393.130 to provide that an interest-bearing account presumed abandoned shall be held in the name of the state, but that a proper holder of the account may withdraw the property plus any accrued interest.

SFA (2, D. Karem) - Amend existing provisions to provide that the Department of Financial Institutions may examine relevant records of banking organizations and financial institutions if there is reason to believe that there has been a failure to report abandoned property.

HFA (1, M. Long) - WITHDRAWN

HFA (2, M. Long) - Amend KRS 393.110 to require reports to be filed by November 1 and property to be turned over to treasury by November 1; require holder of abandoned property to send notice to the apparent owner; amend KRS 393.140 to delete provisions relating to posting by claimants that are heirs or relatives; create a new section of KRS Chapter 393 to allow treasury to auction property after 3 years.

HFA (3, M. Long) - Amend KRS 393.110 to require reports to be filed by November 1 and property to be turned over to treasury by November 1; require holder of abandoned property to send notice to the apparent owner except property valued at less than $100; amend KRS 393.140 to delete provisions relating to posting by claimants that are heirs or relatives; create a new section of KRS Chapter 393 to allow treasury to auction property after 3 years.

HFA (4, C. Hoffman) - Amend to decrease from twenty-four (24) months to twelve (12) months the time period regarding an agreement for location and delivery of unclaimed property, to remove fee and compensation limitations from an agreement to locate or deliver unclaimed property, and to remove requirement that an agreement to locate or deliver unclaimed property state the value of the property before and after the fee or other compensation has been deducted.

Feb 23-introduced in Senate
Feb 24-to State and Local Government (S)
Mar 5-reported favorably, 1st reading, to Calendar; floor amendment (1) filed
Mar 6-2nd reading, to Rules
Mar 12-floor amendment (2) filed; posted for passage in the Regular Orders of the Day for March 13, 1998
Mar 13-3rd reading, passed 37-0 with floor amendments (1) and (2)
Mar 16-received in House
Mar 17-to Banking and Insurance (H); posted in committee
Mar 19-reported favorably, 1st reading, to Calendar; floor amendment (1) filed
Mar 20-2nd reading, to Rules; floor amendment (2) filed; floor amendment (1) withdrawn
Mar 23-floor amendment (3) and (4) filed
Mar 26-3rd reading, passed 97-1 with floor amendment (3)
Mar 27-received in Senate
Mar 31-posted for passage for concurrence in House amendment on March 31, 1998; Senate concurred in House floor amendment (3); passed 34-0

includes all legislative and executive action through March 31, 1998
Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 393.060 is amended to read as follows:

The following property held or owing by a banking or financial organization is presumed abandoned:

(1) Any deposit (legal, beneficial, equitable, or otherwise), whether payable on demand or a time deposit, including a deposit that is automatically renewable, in any bank or trust company in this state, together with the interest thereon and less any deductions permissible under state or federal law including but not limited to dormancy fees and service charges, unless the owner has within seven (7) years or within seven (7) years of the first date of maturity, in the instance of a time deposit:

(a) Communicated[Negotiated] in writing or by other means, reflected in a contemporaneous record prepared by or on behalf of the bank or trust company, with the bank or trust company concerning it;

(b) Been credited with interest[ on the passbook or certificate of deposit] on his request or by his action;

(c) Had a transfer, disposition of interest, or other transaction noted of record in the books or records of the bank or trust company;[or]

(d) Increased or decreased the amount of the deposit; or
(c) *Has not received a regularly mailed statement of account or other notification or communication, mailed by the bank or trust company. Mailings shall be considered not received if returned to the bank or trust company marked undeliverable by the United States Postal Service or other provider of delivery services. A mailing shall be considered regularly mailed if it is of the type sent to all owners of a certain category of deposit and is mailed no less than annually;*

(2) *Any sum payable on checks certified in this state or on written instruments issued in this state on which a banking or financial organization or business association is directly liable, including, by way of illustration but not of limitation, certificates of deposit, drafts, money orders, and traveler's checks, that with the exception of traveler's checks has been outstanding for more than seven (7) years from the date it was payable, or from the date of its issuance if payable on demand, or, in the case of traveler's checks that has been outstanding for more than fifteen (15) years from the date of its issuance unless the owner has within seven (7) years or within fifteen (15) years in the case of traveler's checks corresponded in writing with the banking or financial organization concerning it, or otherwise indicated an interest as evidenced by a memorandum on file with the banking or financial organization;*

(3) *Any funds or other personal property, tangible or intangible, removed from a safe deposit box or any other safekeeping repository or agency or collateral deposit box in this state on which the lease or rental period has expired due to nonpayment of rental charges or other*
reason, or any surplus amounts arising from the sale thereof pursuant to law, that have been unclaimed by the owner for more than seven (7) years from the date on which the lease or rental period expired.

Section 2. KRS 393.280 is amended to read as follows:

(1) The department, through its employees, may at reasonable times and upon reasonable notice examine all relevant records of any person except any banking organization or financial organization where there is reason to believe that there has been or is a failure to report property that should be reported under this chapter during the preceding reporting period. Records shall be considered relevant to the examination of the preceding reporting period if they document the period necessary, for that type of property, to establish presumed abandonment.

(2) The Department of Financial Institutions may at reasonable times and upon reasonable notice examine all relevant records of any banking organization or financial organization if there is reason to believe that there has been or is a failure to report property that should be reported under this chapter during the preceding reporting period.
(3) Documents and working papers obtained or compiled by the department or the Department of Financial Institutions in the course of conducting an examination are confidential and are not open records under KRS 61.870 to 61.884.

(4) The State Treasurer may promulgate any reasonable and necessary rules for the enforcement of this chapter, and govern hearings held before him. He may delegate in writing to any regular employee of the department authority to perform any of the duties imposed on him by this chapter, except the promulgation of rules.

Section 3. KRS 393.130 is amended to read as follows:

(1) Upon the payment or delivery of abandoned property to the department, the state shall assume custody and shall be responsible for the safekeeping thereof. Any person who pays or delivers abandoned property to the department under this chapter is relieved of all liability to the extent of the value of the property so paid or delivered for any claim which then exists or which thereafter may arise or be made in respect to the property.

(2) Any holder of property who has paid moneys to the department pursuant to this chapter may make payment to any person appearing to such holder to be entitled thereto, and upon proof of such payment and proof that the payee
was entitled thereto, the department shall forthwith reimburse the holder or company
without imposing a fee or other charge. The department may accept a holder’s affidavit
as sufficient proof of the holder’s right to recover money under this section.

(3) Notwithstanding the provisions of KRS 393.140, posting or advertising is not required in
the event payment is made to persons entitled thereto by holders of deposits of life insurance
companies in compliance with this section. The claim shall be paid without deduction for the
cost of advertising or services provided in KRS 393.115.

(4) Upon payment or delivery of property presumed abandoned, other than money, by a
holder to the department in accordance with this chapter, any person appearing entitled
thereto shall receive from the department, in addition to proceeds from the liquidation or
conversion of the property, any income or gain realized or accruing to the property at or
before the liquidation or conversion of the same.

(5) Property that is held in an interest-bearing demand, savings, or time deposit shall, from
the time that it is presumed abandoned in accordance with this chapter, be placed by the
holder in an interest-bearing account made assignable to the department. The
department, through its employees, may examine the records relevant to the
establishment and maintenance of an interest bearing account in accordance with KRS
393.280. Upon demand and proper proof by a person appearing entitled to payment of property or portions of property so deposited, the holder may withdraw the property and any accrued interest for payment to the person entitled thereto. Property so deposited and not claimed by a person appearing properly entitled to receipt shall be paid, with accrued interest, to the department ten (10) years after it is presumed abandoned or upon establishment of actual abandonment, whichever occurs first.

(6) Property removed from a safe deposit box or other safekeeping depository is received by the department subject to the holder’s right to be reimbursed for the cost of opening and to any valid lien or contract providing for the holder to be reimbursed for unpaid or other charges. The department shall reimburse the holder out of the proceeds remaining after deducting the expense incurred by the department in selling the property.

SECTION 4. A NEW SECTION OF KRS CHAPTER 393 IS CREATED TO READ AS FOLLOWS:

(1) An agreement by an owner, the primary purpose of which is to locate, deliver, recover, or assist in the recovery of property that is presumed abandoned, is void and unenforceable if it was entered into during the period commencing on the date that the property was presumed abandoned and extending to a time that is twenty-four (24)
months after the date that the property is paid or delivered to the department. This subsection shall not apply to an owner's agreement with an attorney to file a claim as to identified property or contest the administrator's denial of a claim.

(2) An agreement by an owner, the primary purpose of which is to locate, deliver, recover, or assist in the recovery of property and that is not in violation of subsection (1) of this section, is enforceable only if:

(a) The agreement is in writing;

(b) The agreement provides that the fee or compensation agreed upon is an amount not more than ten percent (10%) of the value of the property collected;

(c) The agreement clearly sets forth the nature of the property and the services to be rendered;

(d) The agreement is signed by the apparent owner; and

(e) The agreement states the value of the property before and after the fee or other compensation has been deducted.

(3) An agreement covered by this section that provides for compensation that is unconscionable is unenforceable except by the owner. An owner who has agreed to pay
compensation that is unconscionable, or the administrator on behalf of the owner, may maintain an action to reduce the compensation to a conscionable amount. The court may award reasonable attorney's fees to an owner who prevails in the action.

(4) This section does not preclude an owner from asserting that an agreement covered by this section is invalid on grounds other than unconscionable compensation.

(5) An advertisement, a written communication, or an agreement concerning the location, delivery, recover, or assistance in the recovery of property reported under this chapter shall contain a provision stating that, by law, any contract provision requiring the payment of a fee for finding property that has been held by the administrator for less than twenty-four (24) months is void and not enforceable, and that fees are limited to an amount not more than ten percent (10%) of the value of the property collected.

Section 5. KRS 393.092 is amended to read as follows:

If specific property which is subject to the provisions of KRS 393.060, 393.064, 393.066,[393.070] and 393.090 is held for or owed or distributable to an owner whose last known address is in another state by a holder who is subject to the jurisdiction of that state, the specific property is not presumed abandoned in this state and subject to this chapter if:

(1) It may be claimed as abandoned or escheated under the laws of such other state; and
(2) The laws of such other state make reciprocal provision that similar specific property is not presumed abandoned or escheatable by such other state when held for or owed or distributable to an owner whose last known address is within this state by a holder who is subject to the jurisdiction of this state.

Section 6. The following KRS sections are repealed:

393.025 Owner of abandoned property loses income or increments accruing thereafter.

393.070 Deposits not payable on demand -- When presumed abandoned.
RECENT BANK AND
BANK HOLDING COMPANY DEVELOPMENTS

Walter R. Byrne, Jr.
Stites & Harbison
Lexington, Kentucky

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SECTION L
RECENT BANK AND BANK HOLDING COMPANY DEVELOPMENTS

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SECTION L
RECENT BANK AND BANK
HOLDING COMPANY DEVELOPMENTS

by

Walter R. Byrne, Jr.
Stites & Harbison
Lexington, Kentucky

I. OVERVIEW. The purpose of this outline is to provide a brief overview of certain recent developments involving banks and bank holding companies, and is not intended to provide a complete discussion or analysis on any of the specific topics. My comments are limited to: (1) branching and main office relocations in Kentucky; (2) Federal Reserve changes in bank regulation dealing with the change in bank control of insured depository institutions; (3) practical stock redemption issues with respect to bank holding companies; and (4) a quick review of several federal application changes.

II. BRANCHING AND MAIN OFFICE RELOCATIONS IN KENTUCKY.

A. Existing Kentucky Branching Laws: Kentucky bank branching statutes are presently governed by KRS 287.180 (dealing with banking business where done - branch and agency banks); KRS 287.915 (dealing with branching by acquisitions); and KRS 287.920 (dealing with interstate branching).

B. Proposed Legislative Changes to Branching Statute (HB 491): At this time, the Senate has received and sent to committee HB 491 for consideration (see Exhibit "A" attached hereto) which proposes to permit branching where the principal office or an existing branch is located and in up to four counties contiguous to the county in which the principal office is located.

C. Principal Office Relocations for Banks: The Office of the Comptroller ("OCC") presently permits a national bank to relocate its main office up to 30 miles pursuant to the provisions of 12 U.S.C. § 30 and retain its existing branches including the location of the former main office. The Commissioner of the Department of Financial Institutions has issued Parity Letter 96-1 (see Exhibit "B" attached hereto) which permits and presently deals with principal office relocations for state chartered banks in Kentucky.

D. Resurrection of Former Main Office Charter: KRS 287.915(2)(d) permits a holding company to resurrect a banking charter that has been surrendered after a banking combination pursuant to KRS 287.915 with the approval of the commissioner.
E. **Federal Thrift Branching Rights:** Many bank holding companies have formed or acquired thrifts to take advantage of a federal thrift's favorable branching rights which allows both interstate and intrastate branch banking. Thrifts are permitted to be merged into commercial banks with the approval of the regulators and are permitted to retain their branches.

F. **ATM's of National Banks:** On April 1, 1997, the OCC issued OCC Interpretative Letter No. 772 (March 6, 1998) permitting national banks to set up ATMs free of geographic restrictions.

III. **FEDERAL RESERVE'S CHANGE IN BANK CONTROL REPORTING ISSUES.**

A. **12 U.S.C. 1817(j) and Regulation Y:** 12 U.S.C. 1817(j) deals with change in control of insured depository institutions and Regulation Y (12 CFR Part 225.41, et seq.) deals with change in control for bank holding companies.

B. **Revised Interagency Forms:** The OCC, FDIC, Federal Reserve and OTS on January 30, 1997 made available common interagency corporate forms for change in control for all financial institutions (see Exhibit "C" attached hereto for joint release) on the internet at http://www.fdic.gov or fax-on-demand at 202/906-5660.

C. **Recent Federal Reserve Regulatory Changes:** In April 1997, the Federal Reserve amended Regulation Y and among other changes made the following changes dealing with bank control act filings:

- Eliminate the current requirement that a person that has already received Federal Reserve Board approval under the Change in Bank Control Act obtain additional approvals to acquire additional shares of the same bank or bank holding company;

- Add definitions of the term *acting in concert* and *immediate family*, which are discussed below, and establish presumptions to resolve questions about when a group is *acting in concert*;

- Allow after-the-fact filings when a CIBC Act filing requirement is triggered by the action of an unrelated third party;
 Permit public notice of CIBC Act filings to be published 30 days in advance of filing notice with the System.

The new definition of "immediate family" is as follows:

(3) Immediate family includes a person's father, mother, stepfather, stepmother, brother, sister, stepbrother, stepsister, son, daughter, stepson, stepdaughter, grandparent, grandson, granddaughter, father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law, daughter-in-law, the spouse of any of the foregoing, and the person's spouse.

The new definition of "acting in concert" is as follows:

(2) Acting in concert includes knowing participation in a joint activity or parallel action towards a common goal of acquiring control of a state member bank or bank holding company whether or not pursuant to an express agreement.

IV. PRACTICAL ASPECTS OF BANK HOLDING COMPANIES PLANNING TO REDEEM STOCK. After considering the usual securities and Kentucky corporate issues associated with a corporate redemption of shares by a bank holding company organized in Kentucky (which this outline does not review), any bank holding company must also consider whether: (1) a prior federal reserve notice of the redemption is required; (2) a change of control notice filing is triggered for any of its principal shareholders; and (3) whether the transaction would likely affect the ability of the corporation to undertake an acquisition transaction for the next two years and account for the transaction as a "pooling of interest" from an accounting perspective, as opposed to "purchase" accounting pursuant to Accounting Principles Board Opinion No. 16 ("APB 16").

A. Federal Reserve Notice.

1. In Regulation Y, 12 CFR 224.4(b) (a copy of which is attached hereto as Exhibit "D") requires prior written notice to the Federal Reserve before purchasing or redeeming equity securities "if the gross consideration for the purchase or redemption, when aggregated with the net consideration paid by the company for all such purchases or redemptions during the preceding 12 months, is equal to 10 percent or more of the company's consolidated net worth. "Net consideration" is defined as the gross consideration paid by the holding company for all of its
equity securities purchased or redeemed during such 12 month period minus the gross consideration received for all its equity securities sold during the period.

2. There is an Exception from notice for well-capitalized and well-managed bank holding companies. A bank holding company is not required to obtain prior Federal Reserve approval for the redemption or purchase of its equity securities under this section provided:

   (i) Both before and immediately after the redemption, the bank holding company is well-capitalized;

   (ii) The bank holding company is well-managed; and

   (iii) The bank holding company is not the subject of any unresolved supervisory issues.

B. **Effect on Accounting Treatment for Future Acquisitions:** A bank holding company should make a determination that as a result of the ownership of the bank holding company immediately after the redemption whether any shareholder(s) or group of shareholders, deemed acting in concert, are required to make a notice filing pursuant to 12 U.S.C. 1817(j), and Regulation Y at 12 CFR Part 225.41 et seq. If a notice of change in control is required by a shareholder as a result of the redemption, the notice in many instances must precede the bank holding company redemption, unless the shareholder does not have advance knowledge of the redemption and provides the written notice within 90 calendar days of the redemption.

C. **Change in Control Issues:** Any bank holding company considering a corporate redemption should review the impact of the redemption transaction with their accountants to determine any adverse effect for the redemption on the ability of the corporation to undertake an acquisition transaction that would qualify as a "pooling of interest." [See APB-16 for accounting for business combinations.]

V. **FEDERAL APPLICATION CHANGES.** Several significant federal application changes should be reviewed and noted.

A. Revisions to Federal Reserve Regulation Y are found at 12 CFR Part 225, Federal Register, Vol. 61, No. 174, September 6, 1996. Included at this cite are the Federal Reserve summary of the changes.

C. The Board of Governors of the Federal Reserve System has also provided Streamlined Section 3 Procedures for Well-Capitalized and Well-Managed Banking Organizations, SR-97-12 (APP) Attached as Exhibit "G" to this outline is a copy of SR-97-12 (APP). It can be found at CCH's Federal Banking Law Reports of May 16, 1997, paragraph 59-311-B.

D. The Office of Thrift Supervision has revised 12 CFR Part 516 dealing with Application Processing Guidelines and Procedures. This can be found at CCH's Federal Banking Law Reports of April 18, 1997, paragraphs 19-051 through 19-053.

E. The Office of the Comptroller of the Currency's has issued a final rule and summary of a national bank's corporation activities and transaction regulations dealing with corporate applications and notices. This notice can be found at CCH's Federal Banking Law Reports of December 6, 1996 paragraph 90-449.
GENERAL ASSEMBLY
COMMONWEALTH OF KENTUCKY

1998 REGULAR SESSION

HOUSE BILL 491

AN ACT relating to bank branches.
Amend KRS 287.180 to permit banks to establish branches in contiguous counties; limit to four the number of contiguous counties in which branches may be established.

HB 491 - AMENDMENTS

HFA (1, C. Geveden) - Amend to decrease the number of branches from four (4) to two (2); amend to require that a banking establishment must be located in a county that has a city of the first or second class, or a banking establishment must be located in a county that has an urban-county-government, in order for the banking establishment to establish a branch in contiguous counties; and amend to allow reciprocity to a banking establishment located in those contiguous counties.

HFA (2, C. Geveden) - Amend to decrease the number of branches from four (4) to two (2).

HFA (3, S. Riggs) - Amend to require that a banking establishment must be located in a county that has a city of the first or second class, or a banking establishment must be located in a county that has an urban-county-government, in order for the banking establishment to establish a branch in contiguous counties; and amend to allow reciprocity to a banking establishment located in those contiguous counties.

HFA (4, C. Walton) - Amend to require that a banking establishment must be located in a county that has a city of the first, second or third class, or a banking establishment must be located in a county that has an urban-county-government, in order for the banking establishment to establish a branch in contiguous counties; and amend to allow reciprocity to a banking establishment located in those contiguous counties.

HFA (5, C. Walton) - Amend to require that a banking establishment must be located in a county that has a city of the first, second, or third class, or a banking establishment must be located in a county that has an urban-county-government, in order for the banking establishment to establish a branch in contiguous counties; and amend to allow reciprocity to a banking establishment located in those contiguous counties.

Feb 3-introduced in House
Feb 4-to Banking and Insurance (H)
Feb 9-posted in committee
Feb 19-reported favorably, 1st reading, to Calendar
Feb 20-2nd reading, to Rules
Feb 25-floor amendments (1) and (2) filed
Feb 27-3rd reading, floor amendment (1) rejected; defeated 48-48
Mar 2-floor amendments (3) (4) and (5) filed; reconsidered, placed in the Orders of the Day
Mar 4-floor amendment (5) adopted; floor amendment (5) reconsidered and rejected; passed 52-44
Mar 5-received in Senate
Mar 6-to Banking and Insurance (S)
AN ACT relating to bank branches.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 287.180 is amended to read as follows:

(1) Banks authorized under the laws of this state may, except as provided in subsections (2) or (3) of this section, exercise, only at their principal office, powers necessary to carry on the business of banking by discounting and negotiating notes, drafts, bills of exchange and other evidences of debt, and by purchasing bonds, receiving deposits and allowing interest on these items, buying and selling exchange, coin, and bullion, and lending money on personal or real security.

(2) (a) Any corporation presently or after July 13, 1990, engaged in the business of banking, and meeting the requirements of this subsection, may apply to the commissioner for permission to establish, within any county in which its principal office or an existing branch is located, a branch at which all of the powers conferred in subsection (1) of this section may be exercised:

1. Within any county in which its principal office or an existing branch is located; and

2. Within any county contiguous to the county in which its principal office is located, but a branch may not be established in more than four (4) contiguous counties.

(b) Before the commissioner shall approve or disapprove any application made under this subsection he shall ascertain and determine that the public convenience and advantage will be served and promoted and that there is reasonable probability of the successful operation of the branch based upon the financial and managerial impact of the branch on the bank establishing the branch.

(c) The following conditions shall apply to applications for branches:

L - 8
The permission to open a branch shall lapse one (1) year after the commissioner has rendered a final order as defined in KRS 13B.010, unless it shall have been opened and business actually begun in good faith. If, for reasons beyond the control of the applicant, the branch is not opened within this time period, permission to open the branch may, with the approval of the commissioner, be extended for any period of time he deems to be necessary; and

An application to establish a branch office shall be approved or disapproved by the commissioner based upon the facts existing at the date of filing of the application, except for the financial condition of the bank proposing to establish a branch office, which condition shall be subject to review until an order ruling on the application is made.

Any corporation which on January 1, 1966, was engaged in operating an agency or branch bank may continue to retain and operate the agency or branch bank under the general banking laws, and the requirements set forth in this section in respect to capital shall not apply to any existing agency or branch bank but only as to those agencies or branch banks which may be established in the future pursuant to the terms of this section.

The provisions of this section shall not be construed to prohibit the merger of banks in the same county and the operation by the merged corporation of the banks, nor to prohibit the sale of any bank to, and the purchase by, any other bank in the same county and the operation of the bank by the purchasing bank as a branch, provided the commissioner shall determine that the public convenience and necessity will be served by the operation, and provided further that, at the time of the merger or purchase, each of the banks involved shall have been in operation for a period of five (5) years or more. The bank which does not survive the merger shall surrender its charter.
(5) Any national banking association or any state bank member of the Federal Reserve system whose principal office is located in this state may do all things and perform all acts which state banks are permitted to do or perform under this section, subject to the conditions and restrictions provided for banks as to exercise of these powers.

(6) When a branch or agency bank has once been established any operation of the branch or agency bank shall not be discontinued, and the branch or agency bank shall not be closed until after ninety (90) days' notice in writing to the commissioner. In the discretion of the commissioner the branch or agency bank proposing to discontinue operation may be required to give notice of the date when its operation will cease.
MEMORANDUM

To: All Kentucky State Chartered Banks

From: Larry D. Lander
Commissioner

Date: June 24, 1996

RE: Parity Letter 96-1
Principal Office Relocations

Enclosed is a copy of Parity Letter 96-1 relating to the relocation of a Kentucky state chartered bank's principal office. As stated, the effective date of Parity Letter 96-1 is June 24, 1996.

If you should have any questions, please feel free to contact me at (502) 573-3390.
HISTORICAL PERSPECTIVE


At the time that Parity Letter 92-3 was issued, the Office of the Comptroller of the Currency, based on its interpretation of 12 U.S.C. 30 and its rulings concerning intrastate relocations, permitted national banks to relocate principal offices up to thirty miles, and required that, if such move occurred across county lines, the relocated bank's initial principal office be closed and further branching in the former county forfeited.

Parity Letter 92-3 permitted state-chartered banks, the relocation of which is governed by KRS 287.185, on a vote of the shareholders owning two-thirds of the stock of such and upon the approval of the Commissioner, to relocate a principal office within a thirty miles radius of the city, town, or village in which the principal office was originally located, close its original principal office, and retain as branches any existing branches in the original principal office county.

Since August 24, 1993, the Department has received three applications from state-chartered banks to relocate principal offices as permitted under Parity Letter 92-3. Of the three applications, two were approved. In addition, several state-chartered banks have expressed an interest in applying to relocate principal offices as permitted under Parity Letter 92-3.

The Department found that competitive inequalities arose after the issuance of Parity Letter 92-3 and after certain actions on the part of the Office of the Comptroller of the Currency, namely the approval of three applications which permitted certain Kentucky located national banks to relocate principal offices across county and state lines and retain former branches, under 12 U.S.C. 30, establish branches at the locations of former principal offices, under 12 U.S.C. 36(c), and establish additional branches in the Kentucky counties where said bank could have established branches prior to the relocation, under 12 U.S.C. 36(c).

On November 20, 1995, then acting Commissioner Edward J. Holmes, issued notice, and request for comment, regarding the possible implementation of Amended Parity Letter 92-3, which was drafted to alleviate concerns that further inequalities had arisen since the issuance of Parity Letter 92-3, due in part to the Comptroller's rulings noted above.

Proposed Amended Parity Letter 92-3 restated the original findings of Parity Letter 92-3 but further proposed that a relocated state-chartered bank be permitted to establish a branch office at the location of its former principal office and additional branches in its county of origin, as if it had not moved.

Action on the proposed Amended Parity Letter 92-3 was delayed until a new commissioner was appointed by Governor Paul E. Patton during January, 1996. Immediately after his appointment, Commissioner Larry D. Landers initiated an internal evaluation of the current status of banking law and regulation in Kentucky, to determine what effects rulings issued by the Office of the Comptroller of the Currency, and recently enacted legislation would have on the need for Amended Parity Letter 92-3. Particular attention was paid to the intent of KRS 287.020 under which
the Commissioner is given parity power (Section 3) but also under which certain limitations may be imposed in regard to the establishment of branches (Section 4).

During the 1996 session of the General Assembly, several amendments to KRS 287 were contained in House Bill 607, which the Governor signed on April 10, 1996. In particular, an amendment was made to KRS 287.180 which would allow any banking corporation, meeting the requisite requirements, to apply to the Commissioner for permission to locate a branch in any county in which the principal office of said bank, or an existing branch of same, is located.

On May 8, 1996, the Commissioner issued a memorandum to all Kentucky state-chartered banks regarding the continued evaluation by the Department of Amended Parity Letter 92-3 particularly given the enactment of HB 607.

Hereinafter stated are the conclusions of the Commissioner and a statement of policy of the Department, effective this date.

EFFECT OF LEGISLATION

HB 607

The major purpose of HB 607 was to amend KRS 287 to conform to the federal Riegle-Neal Act.

The Department endorsed bill, HB 607, contained amendments to KRS 287.180 relating to branch banks. These amendments allow a state-chartered bank to apply for permission to establish a branch in any county in which its principal office or a branch is located. Prior to these amendments, KRS 287.180 was silent about branching in any county other than the county where the bank’s principal office was located, though 287.915(2)(a) does allow a “combined bank” to branch in multiple counties.

In light of the amendments to KRS 287.180, certain restrictions set out in Parity Letter 92-3 are no longer applicable. State-chartered banks are no longer at a competitive disadvantage in regards to branching, only in regards to principal office relocations.

Now, after a state-chartered bank has relocated its principal office, state law clearly delineates the bank’s branching rights in all counties where it is located. When a bank relocates to another county, assuming it has at least one branch in addition to its principal office, it may apply for permission to establish other branches in the original county. It may apply for a branch at the location of the original principal office location, which must have been closed. It may also apply for a branch simultaneously with the closure of the principal office required.

Multiple Relocations

Concern has been expressed to the Department that some banks may attempt to use authority granted by the Commissioner, under his parity powers, to effectuate multiple relocations over a short period of time. It is submitted that this is a valid concern.

The Office of the Comptroller of the Currency has stated that it will not approve subsequent principal office relocations until several years have passed. The Department likewise will only approve multiple relocations of a bank’s principal office under certain conditions.

One of the primary responsibilities of the Department is to ensure that any banking activity which transpires in Kentucky promotes the public convenience and advantage. The General Assembly has set five (5) years as the period of time that a newly chartered bank must be in existence before it may be acquired, KRS 287.900. Subsequent relocations, too soon after initial relocations, would not serve the public convenience and advantage. The Department shall therefore, from this date, require a relocated bank to remain in the county of its new principal office location for a period of not less than five (5) years before it shall be permitted to make a subsequent application for a relocation of its principal office to another county.

Newly Chartered Banks

A state-chartered bank, chartered after May 31, 1996, shall be in existence for a period of not less than five (5) years prior to submitting an application for a subsequent relocation of its principal office to another county. Contained in the application made by any state-chartered bank are provisions that set forth ways in which it will benefit its community. The five (5) years will permit the Department to determine whether a new bank has met its commitments under its original application prior to permitting it to relocate its principal office.

ACTION TAKEN

The Commissioner issued a notice of FINDINGS OF PERMISSIBLE ACTIVITIES, SERVICES, OR PRODUCTS, regarding proposed Parity Letter 96-1, on May 31, 1996, and invited comment. Said comment period closed on June 21, 1996, with all comments related thereto having been addressed to:

Larry D. Landers
Commissioner
Dept of Financial Institutions
477 Versailles Road
Frankfort, Kentucky 40601
(502) 573-3390

PARITY STATEMENT

Parity Letter 92-3 is nullified and consideration of Amended Parity Letter 92-3 is terminated, its need having been negated by the enactment of HB 607.

From the effective date set forth herein, the Department will permit state-chartered banks to:
(1) file an application to relocate a principal office to a site in another county which is within thirty (30) miles of the city, town, or village of the existing principal office.

(2) to file an application for a branch in any county where it has a principal office or an existing branch.

Said applications shall be permitted of those state-chartered banks in existence on or before May 31, 1996. Any state-chartered bank, not in existence on or before May 31, 1996, shall have been in existence in the location of its originally established charter for a minimum of five (5) years prior to the filing of the application to relocate its principal office to another county.

Further, no state-chartered bank, which has been permitted to relocate its principal office to another county, will be permitted to make an application to the Department to relocate its principal office to another county prior to the passage of five (5) years from the date of the previous relocation.

The Commissioner, on May 31, 1996, issued notice of this proposed parity letter, Parity Letter 96-1, and solicited public comment thereon. The comment period ended in keeping with the appropriate rules and regulations governing such. All responses received supported the issuance of Parity Letter 96-1. However, some respondents did request clarification of certain issues raised thereby.

In response to such, the Department hereby gives notice of the following guidelines as such shall relate to Parity Letter 96-1 and transactions anticipated to arise as a result of the issuance thereof:

a) Criteria that the Commissioner will use to determine whether to approve a bank's request for a principal office relocation to another county is contained in KRS 287.185. Prerequisites to the approval of a principal office relocation shall be the determination that the public convenience and advantage will be served and promoted by such relocation, and that there is reasonable probability of the successful operation of the principal office in the new location.

b) Parity Letter 96-1 applies only to requests for principal office relocations to a new county. Relocations within an existing county of a bank's operations continue to be controlled by KRS 287.185.

c) A bank desirous of relocating its principal office within a thirty mile radius and into another county must, in addition to its principal office, have at least one branch office to avail itself of certain of the permissible activities allowed under Parity Letter 96-1. In order to branch further in the original county, such bank must have at least one branch existing at the time of the relocation of its principal office to a new county. Any bank consisting only of a principal office, and having no branches would forfeit all branching rights in the original county if it relocated its principal office to a new county.

FINDING OF PERMISSIBLE ACTIVITIES, SERVICES, OR PRODUCTS

The Commissioner of Financial Institutions issues this Finding of Permissible Activities, Services, or Products pursuant to KRS 287.020(3). Competitive inequality exists between some state-chartered and national banks as a result of the difference in policies and rules governing relocation of a bank's principal office.

The relocation of a state-chartered bank's principal office is governed by KRS 287.185 and the relocation of a national bank's principal office is governed by 12 U.S.C. §30(b). The Office of the Comptroller of the Currency has interpreted 12 U.S.C. §30(b) to permit national banks to relocate principal offices across county lines while requiring that the original principal office be closed. Premised on this interpretation, the Comptroller of the Currency has approved numerous transactions involving principal office relocations across county lines.

On and after the effective date of this Finding, a state bank may, through a resolution of its board of directors, adopt the provisions of 12 U.S.C. §30(b), and upon a vote of the shareholders owning two-thirds of the stock of a bank, and upon approval of the Commissioner, a state-chartered bank may relocate its principal office to a location in another county which is within thirty (30) miles of the city, town, village in which the principal office was originally located. The principal office in the original county must close. A bank chartered after May 31, 1996 must have been in existence at least five (5) years before it may apply to again relocate its principal office to another county. A bank which has relocated its principal office to another county must wait at least five years before it may apply to again relocate its principal office to another county.

Parity Letter 92-3 is nullified and subjects raised therein shall now be controlled by Parity Letter 96-1.

Larry D. Landers, Commissioner
June 24, 1996
FOR IMMEDIATE RELEASE
January 30, 1997

Interagency Corporate Forms Available

The four federal banking agencies have adopted three interagency corporate forms that replace and streamline forms that had previously been different for each agency.

Under Section 304 of the Riegle Community Development and Regulatory Improvement Act of 1994, the agencies have developed forms that promote consistency and uniformity in a manner that reduces federal regulatory burden on the banking industry. These are the first uniform corporate forms adopted and issued by the agencies.

The forms adopted by the agencies are:

- Interagency Notice of Change in Control: Generally, this notice is used by persons who wish to acquire control of a depository institution;

- Interagency Notice of Change in Director and Senior Executive Officer: This notice is used to notify the appropriate regulatory agency when required prior to the employment of a new director or senior executive officer; and,

- Interagency Biographical and Financial Report: This report is filed in conjunction with the Interagency Notice of Change in Control and the Interagency Notice of Change in Director and Senior Executive Officer. It is also used by organizers of a new financial institution and for other related purposes.

The revised forms will be available from each of the federal banking agencies. On the Internet, they will be available at http://www.occ.treas.gov and at http://www.fdic.gov. In addition, they will be available from the fax-on-demand system at (202) 906-5660 or (202) 479-0141.

The regulatory agencies are continuing to review other corporate forms in their efforts to achieve uniformity and to simplify or eliminate duplicative or outmoded policies or procedures which unnecessarily burden financial institutions.
Federal Reserve Notice

**Regulation Y:**
Requiring Prior Written Notice To the Federal Reserve
Before Purchasing or Redeeming Equity Securities

§ 225.4 Corporate practices.
(a) **Bank holding company policy and operations.** (1) A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner.

(2) Whenever the Board believes an activity of a bank holding company or control of a nonbank subsidiary (other than a nonbank subsidiary of a bank) constitutes a serious risk to the financial safety, soundness, or stability of a subsidiary bank of the bank holding company and is inconsistent with sound banking principles or the purposes of the BHC Act or the Financial Institutions Supervisory Act of 1966, as amended (12 U.S.C. 1818(b) et seq.), the Board may require the bank holding company to terminate the activity or to terminate control of the subsidiary, as provided in section 5(e) of the BHC Act.

(b) **Purchase or redemption by bank holding company of its own securities**—(1) **Filing notice.** Except as provided in paragraph (b)(6) of this section, a bank holding company shall give the Board prior written notice before purchasing or redeeming its equity securities if the gross consideration for the purchase or redemption, when aggregated with the net consideration paid by the company for all such purchases or redemptions during the preceding 12 months, is equal to 10 percent or more of the company's consolidated net worth. For the purposes of this section, "net consideration" is the gross consideration paid by the company for all of its equity securities purchased or redeemed during the period minus the gross consideration received for all of its equity securities sold during the period.

(2) **Contents of notice.** Any notice under this section shall be filed with the appropriate Reserve Bank and shall contain the following information:

(i) The purpose of the transaction, a description of the securities to be purchased or redeemed, the total number of each class outstanding, the gross consideration to be paid, and the terms and sources of funding for the transaction;

(ii) A description of all equity securities redeemed within the preceding 12 months, the net consideration paid, and the terms of any debt incurred in connection with those transactions; and

(iii)(A) If the bank holding company has consolidated assets of $150 million or more,
consolidated pro forma risk-based capital and leverage ratio calculations for the bank holding company as of the most recent quarter, and, if the redemption is to be debt funded, a parent-only pro forma balance sheet as of the most recent quarter; or

(B) If the bank holding company has consolidated assets of less than $150 million, a pro forma parent-only balance sheet as of the most recent quarter, and, if the redemption is to be debt funded, one-year income statement and cash flow projections.

(3) Acting on notice. Within 15 calendar days of receipt of a notice under this section, the appropriate Reserve Bank shall either approve the transaction proposed in the notice or refer the notice to the Board for decision. If the notice is referred to the Board for decision, the Board shall act on the notice within 30 calendar days after the Reserve Bank receives the notice.

(4) Factors considered in acting on notice. (i) The Board may disapprove a proposed purchase or redemption if it finds that the proposal would constitute an unsafe or unsound practice, or would violate any law, regulation, Board order, directive, or any condition imposed by, or written agreement with, the Board.

(ii) In determining whether a proposal constitutes an unsafe or unsound practice, the Board shall consider whether the bank holding company’s financial condition, after giving effect to the proposed purchase or redemption, meets the financial standards applied by the Board under section 3 of the BHC Act, including the Board’s Capital Adequacy Guidelines (Appendix A of this part) and the Board’s Policy Statement for Small Bank Holding Companies (Appendix C of this part).

(5) Disapproval and hearing. (i) The Board shall notify the bank holding company in writing of the reasons for a decision to disapprove any proposed purchase or redemption. Within 10 calendar days of receipt of a notice of disapproval by the Board, the bank holding company may submit a written request for a hearing.

(ii) The Board shall order a hearing within 10 calendar days of receipt of the request if it finds that material facts are in dispute, or if it otherwise appears appropriate. Any hearing conducted under this paragraph shall be held in accordance with the Board’s Rules of Practice for Formal Hearings (12 CFR part 263).

(iii) At the conclusion of the hearing, the Board shall by order approve or disapprove the proposed purchase or redemption on the basis of the record of the hearing.

(6) Exception for well-capitalized bank holding companies. A bank holding company is not required to obtain prior Board approval for the redemption or purchase of its equity securities under this section provided:

(i) Both before and immediately after the redemption, the bank holding company is well-capitalized;

(ii) The bank holding company is well-managed; and

(iii) The bank holding company is not the subject of any unresolved supervisory issues.
FRANCHISE TAX UPDATE

S CORPORATION FORM FOR BANKS

Thomas J. Luber
Wyatt, Tarrant & Combs
Louisville, Kentucky

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SECTION M
HOUSE BILL NO. 419

AN ACT relating to revenue and taxation and declaring an emergency.

Amend KRS 136.500 to change the Internal Revenue Code and National Bank Act reference date from December 31, 1995, to December 31, 1997; add definition for Kentucky obligations; amend KRS 136.515 to provide that savings and loan associations that combine with a bank are allowed a credit on their bank franchise tax return for tax paid as a savings and loan association during the year of combination; amend KRS 141.010 to exclude the distributive share of a shareholder's income from a S corporation subject to the bank franchise tax or the capital stock tax; provide that the amendment contained in Section 3 of the Act applies for taxable years beginning after December 31, 1996, and the amendments contained in Sections 1 and 2 of the Act apply for taxable years beginning after December 31, 1997; EMERGENCY.

HB 419 - AMENDMENTS

HCA (1, M. Long) - Retain original provisions of the bill; provide that distributive shares of a shareholder's net income from an S corporation related to a qualified subchapter S subsidiary are to be excluded from adjusted gross income.

Jan 26-introduced in House
Jan 27-to Appropriations and Revenue (H)
Feb 12-posted in committee
Feb 17-reported favorably, 1st reading, to Calendar with Committee Amendment (1)
Feb 18-2nd reading, to Rules
Feb 23-3rd reading, passed 86-1 with Committee Amendment (1)
Feb 24-received in Senate
Feb 25-to Appropriations and Revenue (S)
Mar 24-reported favorably, 1st reading, to Consent Calendar
Mar 25-2nd reading, to Rules; posted for passage in the Consent Orders of the Day for March 26, 1998

Mar 26-3rd reading, passed 36-0; received in House; enrolled, signed by each presiding officer
Mar 27-delivered to Governor

includes all legislative and executive action through March 31, 1998
AN ACT relating to revenue and taxation and declaring an emergency.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 136.500 is amended to read as follows:

As used in KRS 136.500 to 136.575, unless the context requires otherwise:

1. "Billing address" means the location indicated in the books and records of the financial institution, on the first day of the taxable year or the date in the taxable year when the customer relationship began, as the address where any notice, statement, or bill relating to a customer's account is mailed;

2. "Borrower located in this state" means a borrower, other than a credit card holder, that is engaged in a trade or business that maintains its commercial domicile in this state or a borrower that is not engaged in a trade or business;

3. "Credit card holder located in this state" means a credit card holder whose billing address is in this state;

4. "Cabinet" means the Revenue Cabinet;

5. "Commercial domicile" means:

   a. The location from which the trade or business is principally managed and directed; or

   b. The state of the United States or the District of Columbia from which the financial institution's trade or business in the United States is principally managed and directed, if a financial institution is organized under the laws of a foreign country, the Commonwealth of Puerto Rico, or any territory or possession of the United States.

It shall be presumed, subject to rebuttal, that the location from which the financial institution's trade or business is principally managed and directed is the state of the United States or the District of Columbia to which the greatest number of employees are regularly connected or out of which they are working, irrespective of
where the services of the employees are performed, as of the last day of the taxable year;

(6) "Compensation" means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services that are included in the employee's gross income under the Internal Revenue Code. In the case of employees not subject to the Internal Revenue Code, the determination of whether the payments would constitute gross income to the employees under the Internal Revenue Code shall be made as though the employees were subject to the Internal Revenue Code;

(7) "Credit card" means credit, travel, or entertainment card;

(8) "Credit card issuer's reimbursement fee" means the fee a financial institution receives from a merchant's bank because one of the persons to whom the financial institution has issued a credit card has charged merchandise or services to the credit card;

(9) "Employee" means, with respect to a particular financial institution, "employee" as defined in Section 3121(d) of the Internal Revenue Code;

(10) "Financial institution" means:

(a) A national bank organized as a body corporate and existing or in the process of organizing as a national bank association pursuant to the provisions of the National Bank Act, 12 U.S.C. sec. 21 et seq., in effect on December 31, 1997, exclusive of any amendments made subsequent to that date, or a national bank organized after December 31, 1995, that meets the requirements of the National Bank Act in effect on December 31, 1995;

(b) Any bank or trust company incorporated or organized under the laws of any state, except a banker's bank organized under KRS 287.135;

(c) Any corporation organized under the provisions of 12 U.S.C. secs. 611 to 631, in effect on December 31, 1997, exclusive of any amendments made
subsequent to that date, or any corporation organized after December 31, 1997, that meets the requirements of 12 U.S.C. secs. 611 to 631, in effect on December 31, 1997; or

(d) Any agency or branch of a foreign depository as defined in 12 U.S.C. sec. 3101, in effect on December 31, 1997, exclusive of any amendments made subsequent to that date, or any agency or branch of a foreign depository established after December 31, 1997, that meets the requirements of 12 U.S.C. sec. 3101 in effect on December 31, 1997;

(11) "Gross rents" means the actual sum of money or other consideration payable for the use or possession of property.

(a) "Gross rents" includes, but is not limited to:

1. Any amount payable for the use or possession of real property or tangible property, whether designated as a fixed sum of money or as a percentage of receipts, profits, or otherwise;

2. Any amount payable as additional rent or in lieu of rent, such as interest, taxes, insurance, repairs, or any other amount required to be paid by the terms of a lease or other arrangement; and

3. A proportionate part of the cost of any improvement to real property made by or on behalf of the financial institution which reverts to the owner or lessor upon termination of a lease or other arrangement. The amount to be included in gross rents is the amount of amortization or depreciation allowed in computing the taxable income base for the taxable year. However, where a building is erected on leased land by or on behalf of the financial institution, the value of the land is determined by multiplying the gross rent by eight (8) and the value of the building is determined in the same manner as if owned by the financial institution;

(b) The following are not included in the term "gross rents":

M - 4
1. Reasonable amounts payable as separate charges for water and electric service furnished by the lessor;

2. Reasonable amounts payable as service charges for janitorial services furnished by the lessor;

3. Reasonable amounts payable for storage, if these amounts are payable for space not designated and not under the control of the financial institution; and

4. That portion of any rental payment which is applicable to the space subleased from the financial institution and not used by it;

(12) "Internal Revenue Code" means the Internal Revenue Code, Title 26 U.S.C., in effect on December 31, 1997, exclusive of any amendments made subsequent to that date;

(13) "Loan" means any extension of credit resulting from direct negotiations between the financial institution and its customer, and the purchase, in whole or in part, of the extension of credit from another. Loans include participations, syndications, and leases treated as loans for federal income tax purposes. Loans shall not include properties treated as loans under Section 595 of the Internal Revenue Code, futures or forward contracts, options, notional principal contracts such as swaps, credit card receivables, including purchased credit card relationships, noninterest-bearing balances due from depository institutions, cash items in the process of collection, federal funds sold, securities purchased under agreements to resell, assets held in a trading account, securities, interests in a real estate mortgage investment company, or other mortgage-backed or asset-backed security, and other similar items;

(14) "Loan secured by real property" means a loan or other obligation for which fifty percent (50%) or more of the aggregate value of the collateral used to secure the loan or other obligation, when valued at fair market value as of the time the original loan or obligation was incurred, was real property;
(15) "Merchant discount" means the fee or negotiated discount charged to a merchant by the financial institution for the privilege of participating in a program where a credit card is accepted in payment for merchandise or services sold to the card holder;

(16) "Person" means an individual, estate, trust, partnership, corporation, limited liability company, or any other business entity;

(17) "Principal base of operations" means:

(a) With respect to transportation property, the place from which the property is regularly directed or controlled; and

(b) With respect to an employee:

1. The place the employee regularly starts work and to which the employee customarily returns in order to receive instructions from his or her employer; or

2. If the place referred to in subparagraph 1. of this paragraph does not exist, the place the employee regularly communicates with customers or other persons; or

3. If the place referred to in subparagraph 2. of this paragraph does not exist, the place the employee regularly performs any other functions necessary to the exercise of the employee's trade or profession at some other point or points;

(18) "Real property owned" and "tangible personal property owned" mean real and tangible personal property, respectively, on which the financial institution may claim depreciation for federal income tax purposes, or property to which the financial institution holds legal title and on which no other person may claim depreciation for federal income tax purposes or could claim depreciation if subject to federal income tax. Real and tangible personal property do not include coin, currency, or property acquired in lieu of or pursuant to a foreclosure;
(19) "Regular place of business" means an office at which the financial institution carries on its business in a regular and systematic manner and which is continuously maintained, occupied, and used by employees of the financial institution;

(20) "State" means a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, or any foreign country;

(21) "Syndication" means an extension of credit in which two (2) or more persons fund and each person is at risk only up to a specified percentage of the total extension of credit or up to a specified dollar amount;

(22) "Taxable year" means calendar year 1996 and every calendar year thereafter;

(23) "Transportation property" means vehicles and vessels capable of moving under their own power, such as aircraft, trains, water vessels, and motor vehicles, as well as any equipment or containers attached to the property, such as rolling stock, barges, or trailers;

(24) "United States obligations" means all obligations of the United States exempt from taxation under 31 U.S.C. sec. 3124(a) or exempt under the United States Constitution or any federal statute, including the obligations of any instrumentality or agency of the United States that are exempt from state or local taxation under the United States Constitution or any statute of the United States; and

(25) "Kentucky obligations" means all obligations of the Commonwealth of Kentucky, its counties, municipalities, taxing districts, and school districts, exempt from taxation under the Kentucky Revised Statutes and the Constitution of Kentucky.

Section 2. KRS 136.515 is amended to read as follows:

(1) Net capital shall be determined by adding the value determined under subsection (2) of this section for the current taxable and preceding four (4) calendar years and dividing the resulting sum by five (5). If a financial institution has not been in
existence for a period of five (5) calendar years, net capital shall be determined by adding together the values determined under subsection (2) of this section for the number of calendar years the financial institution has been in existence and dividing the resulting sum by the number of years the financial institution has been in existence. For purposes of this section, a partial year shall be treated as a full year.

(2) (a) The value of net capital for each year for purposes of subsection (1) of this section shall be determined by:

1. Adding together the book value of:
   a. Capital stock paid in;
   b. Surplus;
   c. Undivided profits and capital reserves;
   d. Net unrealized holding gains or losses on available for sale securities; and
   e. Cumulative foreign currency translation adjustments; and

2. Deducting from the total determined under subparagraph 1. of this subsection an amount equal to the same percentage of the total as the book value of United States obligations and Kentucky obligations bears to the book value of the total assets of the financial institution.

(b) For purposes of this subsection, net capital shall include equity related to investment in subsidiaries.

(c) For purposes of this subsection, except as provided in paragraphs (d) and (e) of this subsection, the foregoing book values and deductions for United States obligations and Kentucky obligations for each year shall be determined by the reports of condition for each quarter filed in accordance with the requirements of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or
other applicable regulatory authority. Book values shall be calculated by averaging the quarterly book values as determined by the reports of condition.

(d) For any year in which a financial institution does not file four (4) quarterly reports of condition, book values and deductions for United States obligations and Kentucky obligations shall be determined by adding together the respective book values and deductions for United States obligations and Kentucky obligations as determined by each quarterly report of condition filed for the year and the respective book values and deductions for United States obligations and Kentucky obligations determined in accordance with generally accepted accounting principles as of the end of each of the remaining quarters and dividing the resulting sums by four (4) the number of the reports of condition filed.

(e) For any calendar year in which a financial institution is not in existence for four (4) quarters, other than by combination with another financial institution, the book value for that year shall be determined by adding together the book values and deductions for United States obligations and Kentucky obligations for each quarter in which the financial institution was in existence and dividing the sums by four (4) the total number of quarters that the financial institution was in existence that calendar year.

(f) In the case of a financial institution which does not file reports of condition, book values shall be determined in accordance with generally accepted accounting principles.

(3) For purposes of this section:

(a) A change in identity, form, or place of organization of one (1) financial institution shall be treated as if a single financial institution had been in existence prior to as well as after the change;
(b) The combination of two (2) or more financial institutions into one (1) shall be treated as if the constituent financial institutions had been a single financial institution in existence prior to as well as after the combination, and the book values and deductions for United States obligations and Kentucky obligations from the reports of condition of the constituent institutions shall be combined. A combination shall include any acquisition required to be accounted for by the surviving financial institution under the pooling of interest method in accordance with generally-accepted accounting principles or a statutory merger or consolidation; and

(c) 1. The combination of one (1) or more financial institutions and one (1) or more savings and loan associations taxable under KRS 136.300 into a single financial institution shall be treated for the taxable year in which the combination occurred as if the single financial institution had been in existence prior to as well as after the combination, and the book values and deductions for United States obligations and Kentucky obligations from the reports of condition of the financial institution and the reports to the federal regulatory agency which are the equivalent of reports of condition for a savings and loan association shall be combined.

2. The conversion of a savings and loan association taxable under KRS 136.300 into a financial institution shall be treated for the taxable year in which the conversion occurred as if the savings and loan association had been a financial institution prior to as well as after the conversion, and the book values and deductions for United States obligations and Kentucky obligations from the reports to the federal regulatory agency which are the equivalent of reports of condition for a savings and loan association shall be used.
3. The savings and loan association shall not be relieved of the responsibilities of filing and paying tax under KRS 136.300 for taxable years prior to the year of any combination or conversion.

4. Notwithstanding any other provision of KRS 136.500 to 136.575, the financial institution resulting from a combination with or conversion of a saving and loan association shall receive a credit on the bank franchise tax return equal to the amount of tax paid under KRS 136.300 for the assessment date occurring within the taxable year during which the combination or conversion takes place for bank franchise tax purposes.

Section 3. KRS 141.010 is amended to read as follows:

As used in this chapter, unless the context requires otherwise:

(1) "Secretary" means the secretary of revenue;

(2) "Cabinet" means the Revenue Cabinet;

(3) "Internal Revenue Code" means the Internal Revenue Code in effect on December 31, 1995, exclusive of any amendments made subsequent to that date, other than amendments that extend provisions in effect on December 31, 1995, that would otherwise terminate, and as modified by KRS 141.0101;

(4) "Dependent" means those persons defined as dependents in the Internal Revenue Code;

(5) "Fiduciary" means "fiduciary" as defined in Section 7701(a)(6) of the Internal Revenue Code;

(6) "Fiscal year" means "fiscal year" as defined in Section 7701(a)(24) of the Internal Revenue Code;

(7) "Individual" means a natural person;

(8) For taxable years beginning on or after January 1, 1974, "federal income tax" means the amount of federal income tax actually paid or accrued for the taxable year on
taxable income as defined in Section 63 of the Internal Revenue Code, and taxed under the provisions of this chapter, minus any federal tax credits actually utilized by the taxpayer;

(9) "Gross income" in the case of taxpayers other than corporations means "gross income" as defined in Section 61 of the Internal Revenue Code;

(10) "Adjusted gross income" in the case of taxpayers other than corporations means gross income as defined in subsection (9) of this section minus the deductions allowed individuals by Section 62 of the Internal Revenue Code and as modified by KRS 141.0101 and adjusted as follows, except that deductions shall be limited to amounts allocable to income subject to taxation under the provisions of this chapter, and except that nothing in this chapter shall be construed to permit the same item to be deducted more than once:

(a) Exclude income that is exempt from state taxation by the Kentucky Constitution and the Constitution and statutory laws of the United States and Kentucky;

(b) Exclude income from supplemental annuities provided by the Railroad Retirement Act of 1937 as amended and which are subject to federal income tax by Public Law 89-699;

(c) Include interest income derived from obligations of sister states and political subdivisions thereof;

(d) Exclude employee pension contributions picked up as provided for in KRS 6.505, 16.545, 21.360, 61.560, 65.155, 67A.320, 67A.510, 78.610, and 161.540 upon a ruling by the Internal Revenue Service or the federal courts that these contributions shall not be included as gross income until such time as the contributions are distributed or made available to the employee;

(e) Exclude Social Security and railroad retirement benefits subject to federal income tax;
(f) Include, for taxable years ending before January 1, 1991, all overpayments of federal income tax refunded or credited for taxable years;

(g) Deduct, for taxable years ending before January 1, 1991, federal income tax paid for taxable years ending before January 1, 1990;

(h) Exclude any money received because of a settlement or judgment in a lawsuit brought against a manufacturer or distributor of "Agent Orange" for damages resulting from exposure to Agent Orange by a member or veteran of the armed forces of the United States or any dependent of such person who served in Vietnam;

(i) 1. Exclude the applicable amount of total distributions from pension plans, annuity contracts, profit-sharing plans, retirement plans, or employee savings plans.

2. The "applicable amount" shall be:
   a. Twenty-five percent (25%), but not more than six thousand two hundred and fifty dollars ($6,250), for taxable years beginning after December 31, 1994, and before January 1, 1996;
   b. Fifty percent (50%), but not more than twelve thousand five hundred dollars ($12,500), for taxable years beginning after December 31, 1995, and before January 1, 1997;
   c. Seventy-five percent (75%), but not more than eighteen thousand seven hundred fifty dollars ($18,750), for taxable years beginning after December 31, 1996, and before January 1, 1998; and
   d. One hundred percent (100%), but not more than thirty-five thousand dollars ($35,000), for taxable years beginning after December 31, 1997.

3. As used in this paragraph:
a. "Distributions" includes but is not limited to any lump-sum distribution from pension or profit-sharing plans qualifying for the income tax averaging provisions of Section 402 of the Internal Revenue Code; any distribution from an individual retirement account as defined in Section 408 of the Internal Revenue Code; and any disability pension distribution;

b. "Annuity contract" has the same meaning as set forth in Section 1035 of the Internal Revenue Code; and

c. "Pension plans, profit-sharing plans, retirement plans, or employee savings plans" means any trust or other entity created or organized under a written retirement plan and forming part of a stock bonus, pension, or profit-sharing plan of a public or private employer for the exclusive benefit of employees or their beneficiaries and includes plans qualified or unqualified under Section 401 of the Internal Revenue Code and individual retirement accounts as defined in Section 408 of the Internal Revenue Code; and

(j) 1. a. Exclude the distributive share of a shareholder's net income from an S corporation subject to the franchise tax imposed under KRS 136.505 or the capital stock tax imposed under KRS 136.300; and

   b. Exclude the portion of the distributive share of a shareholder's net income from an S corporation related to a qualified subchapter S subsidiary subject to the franchise tax imposed under KRS 136.505 or the capital stock tax imposed under KRS 136.300.

2. The shareholder's basis of stock held in a S corporation where the S corporation or its qualified subchapter S subsidiary is subject to the
franchise tax imposed under KRS 136.505 or the capital stock tax imposed under KRS 136.300 shall be the same as the basis for federal income tax purposes.

(11) "Net income" in the case of taxpayers other than corporations means adjusted gross income as defined in subsection (10) of this section, minus the standard deduction allowed by KRS 141.081, or, at the option of the taxpayer, minus the deduction allowed by KRS 141.0202 and minus all the deductions allowed individuals by Chapter 1 of the Internal Revenue Code as modified by KRS 141.0101 except those listed below, except that deductions shall be limited to amounts allocable to income subject to taxation under the provisions of this chapter and that nothing in this chapter shall be construed to permit the same item to be deducted more than once:

(a) Any deduction allowed by the Internal Revenue Code for state taxes measured by gross or net income, except that such taxes paid to foreign countries may be deducted;

(b) Any deduction allowed by the Internal Revenue Code for amounts allowable under KRS 140.090(1)(h) in calculating the value of the distributive shares of the estate of a decedent, unless there is filed with the income return a statement that such deduction has not been claimed under KRS 140.090(1)(h);

(c) The deduction for personal exemptions allowed under Section 151 of the Internal Revenue Code and any other deductions in lieu thereof; and

(d) Any deduction for amounts paid to any club, organization, or establishment which has been determined by the courts or an agency established by the General Assembly and charged with enforcing the civil rights laws of the Commonwealth, not to afford full and equal membership and full and equal enjoyment of its goods, services, facilities, privileges, advantages, or accommodations to any person because of race, color, religion, national origin, or sex, except nothing shall be construed to deny a deduction for
amounts paid to any religious or denominational club, group, or establishment or any organization operated solely for charitable or educational purposes which restricts membership to persons of the same religion or denomination in order to promote the religious principles for which it is established and maintained;

(12) "Gross income," in the case of corporations, means "gross income" as defined in Section 61 of the Internal Revenue Code and as modified by KRS 141.0101 and adjusted as follows:

(a) Exclude income that is exempt from state taxation by the Kentucky Constitution and the Constitution and statutory laws of the United States;
(b) Exclude all dividend income received after December 31, 1969;
(c) Include interest income derived from obligations of sister states and political subdivisions thereof;
(d) Exclude fifty percent (50%) of gross income derived from any disposal of coal covered by Section 631(c) of the Internal Revenue Code if the corporation does not claim any deduction for percentage depletion, or for expenditures attributable to the making and administering of the contract under which such disposition occurs or to the preservation of the economic interests retained under such contract;
(e) Include in the gross income of lessors income tax payments made by lessees to lessors, under the provisions of Section 110 of the Internal Revenue Code, and exclude such payments from the gross income of lessees;
(f) Include the amount calculated under KRS 141.205;
(g) Ignore the provisions of Section 281 of the Internal Revenue Code in computing gross income; and
(h) Exclude income from "safe harbor leases" (Section 168(f)(8) of the Internal Revenue Code);
(13) "Net income," in the case of corporations, means "gross income" as defined in subsection (12) of this section minus the deduction allowed by KRS 141.0202 and minus all the deductions from gross income allowed corporations by Chapter 1 of the Internal Revenue Code and as modified by KRS 141.0101, except the following:

(a) Any deduction for a state tax which is computed, in whole or in part, by reference to gross or net income and which is paid or accrued to any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, or to any foreign country or political subdivision thereof;

(b) The deductions contained in Sections 243, 244, 245, and 247 of the Internal Revenue Code;

(c) The provisions of Section 281 of the Internal Revenue Code shall be ignored in computing net income;

(d) Any deduction directly or indirectly allocable to income which is either exempt from taxation or otherwise not taxed under the provisions of this chapter, and nothing in this chapter shall be construed to permit the same item to be deducted more than once;

(e) Exclude expenses related to "safe harbor leases" (Section 168(f)(8) of the Internal Revenue Code); and

(f) Any deduction for amounts paid to any club, organization, or establishment which has been determined by the courts or an agency established by the General Assembly and charged with enforcing the civil rights laws of the Commonwealth, not to afford full and equal membership and full and equal enjoyment of its goods, services, facilities, privileges, advantages, or accommodations to any person because of race, color, religion, national origin, or sex, except nothing shall be construed to deny a deduction for
amounts paid to any religious or denominational club, group, or establishment
or any organization operated solely for charitable or educational purposes
which restricts membership to persons of the same religion or denomination in
order to promote the religious principles for which it is established and
maintained;

(14) (a) "Taxable net income," in the case of corporations having property or payroll
only in this state, means "net income" as defined in subsection (13) of this
section;

(b) "Taxable net income," in the case of corporations having property or payroll
both within and without this state means "net income" as defined in
subsection (13) of this section and as allocated and apportioned under KRS
141.120;

(c) "Property" means either real property or tangible personal property which is
either owned or leased. "Payroll" means compensation paid to one (1) or more
individuals, as described in KRS 141.120(8)(b). Property and payroll are
deemed to be entirely within this state if all other states are prohibited by
Public Law 86-272, as it existed on December 31, 1975, from enforcing
income tax jurisdiction; and

(d) "Taxable net income" in the case of homeowners' associations as defined in
Section 528(c) of the Internal Revenue Code, means "taxable income" as
defined in Section 528(d) of the Internal Revenue Code. Notwithstanding the
provisions of subsection (3) of this section, the Internal Revenue Code
sections referred to in this paragraph shall be those code sections in effect for
the applicable tax year;

(15) "Person" means "person" as defined in Section 7701(a)(1) of the Internal Revenue
Code;
(16) "Taxable year" means the calendar year or fiscal year ending during such calendar year, upon the basis of which net income is computed, and in the case of a return made for a fractional part of a year under the provisions of this chapter or under regulations prescribed by the secretary, "taxable year" means the period for which such return is made;

(17) "Resident" means an individual domiciled within this state or an individual who is not domiciled in this state, but maintains a place of abode in this state and spends in the aggregate more than one hundred eighty-three (183) days of the taxable year in this state;

(18) "Nonresident" means any individual not a resident of this state;

(19) "Employer" means "employer" as defined in Section 3401(d) of the Internal Revenue Code;

(20) "Employee" means "employee" as defined in Section 3401(c) of the Internal Revenue Code;

(21) "Number of withholding exemptions claimed" means the number of withholding exemptions claimed in a withholding exemption certificate in effect under KRS 141.325, except that if no such certificate is in effect, the number of withholding exemptions claimed shall be considered to be zero;

(22) "Wages" means "wages" as defined in Section 3401(a) of the Internal Revenue Code and includes other income subject to withholding as provided in Section 3401(f) and Section 3402(k), (o), (p), (q), and (s) of the Internal Revenue Code;

(23) "Payroll period" means "payroll period" as defined in Section 3401(b) of the Internal Revenue Code;

(24) "Corporations" means "corporations" as defined in Section 7701(a)(3) of the Internal Revenue Code;

(25) "S corporations" means "S corporations" as defined in Section 1361(a) of the Internal Revenue Code. Stockholders of a corporation qualifying as an "S
corporation" under this chapter may elect to treat such qualification as an initial qualification under Subchapter S of the Internal Revenue Code Sections.

Section 4. The amendment contained in Section 3 of this Act shall apply retroactively to taxable years beginning after December 31, 1996. The amendments contained in Sections 1 and 2 of this Act shall be effective for taxable years beginning after December 31, 1997.

Section 5. Whereas income tax returns are due before the normal effective date of this Act, an emergency is declared to exist, and this Act takes effect upon its passage and approval by the Governor or upon its otherwise becoming a law.
ROLE OF THE THRIFT AND THRIFT CHARTER

Caryn F. Price
Wyatt, Tarrant & Combs
Louisville, Kentucky
## ROLE OF THE THRIFT AND THRIFT CHARTER

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SECTION M
ROLE OF THE THRIFT AND THRIFT CHARTER

1. Introduction

In 1997, the Office of Thrift Supervision approved 26 applications to charter federal savings banks. As of December 31, 1997, 28 federal thrift charter applications were pending with the OTS. Applicants with pending holding company applications or companies that have had such applications approved include insurance companies, credit card companies, securities firms, sub-prime mortgage lenders and other commercial enterprises. The Office of Thrift Supervision continues to approve federal thrift charter applications and companies continue to consider and apply for new uses for thrift charters.

Examples of recent applications:

Insurance companies:

Allstate Corporation application to become a savings and loan holding company filed January 26, 1998

Equitable Companies to form a federally chartered savings bank, filed December 17, 1997

Hartford Financial Services Group, Inc. application for permission to become a savings and loan holding company filed December 23, 1997

John Hancock Mutual Life Insurance Company application to form a de novo institution filed January 16, 1998

Nationwide Insurance Company application to organize a federal savings bank, filed November 25, 1997

State Farm Mutual Automobile Insurance Company application for acquisition of a savings association, filed July 1, 1997

Travelers Bank & Trust, fsb, application for trust powers and for acquisition of a savings association, filed May 11, 1997

Teachers Insurance and Annuity Association of America application to form a de novo federal savings bank, filed December 10, 1997
Securities firms:

AG Edwards application to organize a federal savings bank filed September 10, 1997.

Dean Witter, Discover & Co. application for permission to organize a federal savings bank approved August 9, 1996

Merrill Lynch & Co. application for permission to organize a federal savings bank filed October 28, 1997

Paine Webber Group, Inc. application to organize a federal savings bank, filed December 31, 1997

Credit card companies:

General Electric Capital Consumer Card Company application to convert to a federal stock savings bank, filed December 23, 1997

Sub-prime mortgage lenders:

Transamerica application to establish and acquire a de novo federal savings bank, filed July 22, 1997

First Alliance Corp., a California consumer finance company, application to acquire a federal savings bank to offer credit cards secured by equity in cardholders’ homes, filed June 1997

Other commercial firms:

Archer-Daniels Midland Company application for conversion of a state chartered commercial bank to become a federal savings bank filed September 17, 1997

Excel Communications application for permission to organize a federal savings bank, filed May 20, 1997

Hillenbrand Industries application for approval to organize a federal savings bank filed November 17, 1997

Ukrop’s Supermarkets, Inc., a Richmond, Virginia supermarket chain, application to open supermarket branches of a de novo federal savings bank formed in a joint venture with a bank holding company approved October 23, 1997
2. Reasons for New Charters

A. Repeal of thrift bad debt provisions. The Small Business Job Protection Act of 1996 repealed the thrift bad debt provisions of the tax code. Under prior law, a thrift had to qualify as a "domestic building and loan association" to avoid bad debt recapture. This required that at least 75% of the thrift's income be derived from interest on "qualifying loans".

B. Loosening of thrift operating restrictions.

[1] The Regulatory Relief Act of 1996 expanded the definition of "qualified thrift investments" which are counted for purposes of the "qualified thrift lender" test ("QTL test"). Under the QTL test, thrifts must hold "qualified thrift investments" equal to at least 65% of their "portfolio assets".

[a] consumer loans now count as qualified thrift investments in an amount up to 20% of portfolio assets.

[b] small business loans (and loans to farms that qualify as small businesses), credit card loans and education loans now qualify without restriction.

[2] Amendments to Section 5 of the Home Owners' Loan Act provided thrifts substantial additional lending flexibility.

[a] clarified that thrifts are authorized to engage in credit card lending without investment restriction.

[b] permitted education loans to be made without investment restriction (previously education loans were limited to 5% of total assets).

[c] authorized other consumer loans in an amount up to 35% of total assets with credit card loans and education loans not counting against the cap.

[d] increased the authority of thrifts to engage in consumer and small business lending by providing that thrifts can hold commercial loans not secured by real estate in an aggregate amount of up to 20% of total assets, provided that commercial loans in excess of 10% of assets are loans to small businesses.
C. Diminutions in Deposit Rate Disparity. The underfunding of SAIF and the premium disparity between SAIF and BIF were generally remedied by the one time special assessment imposed on SAIF members in 1996. Companies acquiring or forming SAIF member thrifts in 1997 and beyond have no liability for the special assessment.

D. Holding Company Powers. Any company owning a single federal savings bank which is in compliance with the QTL test is not subject to many of the activity and investment restriction imposed on bank holding companies. Thrifts can affiliate with holding companies engaged in any line of business including insurance sales and underwriting, securities brokerage and underwriting, real estate brokerage and development and other commercial enterprises.

E. Service Corporation Powers. Federal thrift service corporations are authorized to engage in any activity the Office of Thrift Supervision deems reasonably related to the business of thrifts. For example, thrift service corporations can engage in real estate development, provided appropriate capital reserves are established. Thrift service corporations can sell insurance without being subject to the town of 5,000 limitation applicable to banks (but subject to state laws prohibiting insurance sales by depository institutions).

F. Federal Preemption. The Home Owners' Loan Act contains broad preemption provisions. Federal thrifts are not subject to state laws that attempt to regulate their deposit and lending operations. Thus, thrifts may offer uniform services to customers on a nationwide basis.

G. Single Regulator. Federal thrifts and their holding companies are both regulated by the Office of Thrift Supervision. The Office of Thrift Supervision is seen as a flexible and competent regulator.

H. Branching Rights. Federal thrifts may establish and operate branches outside of the restrictions of The Reigle Neal Act and may establish de novo interstate branches. Effective June 1, 1997, national banks may branch interstate via merger acquisitions but not in states that opt out of The Reigle Neal Act. In addition, national banks are still subject to state restrictions on intrastate branching and interstate de novo branching.

I. Trust Powers. Because of OTS preemption, a thrift can offer trust services on a nationwide basis.
3. The Future of the Thrift Charter

The prospects for further thrift expansion are uncertain. On March 10, 1998, the leadership of the U.S. House of Representatives announced a compromise on the financial services modernization bill (H.R. 10). Among other things, H.R. 10:

* would allow banks, securities and insurance firms to affiliate under an umbrella financial services holding company

* would allow a financial services holding company to earn only 5% of its revenues from affiliates in non-financial businesses

* would consolidate the Office of Thrift Supervision with the Office of the Comptroller of the Currency and merge the SAIF and BIF insurance funds

* would preserve the thrift charter and provide that 10% of thrift assets have to be held in home mortgages; thrifts and their holding companies would continue under current regulations until January 1, 2000

* would eliminate charters for unitary thrift holding companies

* would provide for regulation by the Federal Reserve over remaining grandfathered unitary thrift holding companies

* would grandfather existing thrifts but provide that they could earn only 15% of their revenue from nonfinancial businesses
Popular FOIAs

Popular FOIAs are documents previously disclosed pursuant to a FOIA request for which the agency believes there may be a broad interest. Copies of the public portions of the listed record sets are available for your inspection and copying in the Public Reading Room.

Applications

- AG Edwards application to organize a federal savings bank. Filed 9/10/97. 275 pages.
- Aid Association for Lutherans & AAL Holdings, Inc., permission to organize a federal savings bank and application for trust powers. Filed 12/30/97. 152 pages.
- Allstate Corporation application to become a savings and loan holding company by acquiring Allstate Federal Savings Bank. Filed 1/26/98. 810 pages.
- American General Corporation to convert American General Finance Center to a federal savings bank, American General Financial Center, FSB. Filed 1/26/98. 1,827 pages.
- Archer-Daniels Midland Company's application for conversion of Hickory Point Bank & Trust, state-chartered commercial bank, to become a federal savings bank, Hickory Point Bank & Trust, FSB. Filed 9/18/97. 504 pages.
- Dean Witter, Discover & Co. application for permission to organize a federal savings bank and for acquisition of one savings association by a company other than a savings and loan holding company. Approved 8/9/96; Orders #96-78, #97-79. 557 pages.
- Equitable Companies, Inc. to form a federally chartered savings bank, Frontier Trust Company, FSB. Filed 12/17/98. 1,200 pages.
- Excel Communications application for permission to organization a federal savings bank and for acquisition of one savings association by a company other than a savings and loan holding company. Filed 5/20/97. 750 pages.
- First Savings Bancshares, MHC, to convert holding company from mutual to stock form. Filed 12/22/97. 325 pages.
• Hartford Financial Services Group, Inc. application for permission to become a savings and loan holding company, The Hartford Bank, FSB. Filed 12/23/97. 980 pages.
• Hillenbrand Industries Inc. and Forethought Services Inc. application for approval to organize a federal savings bank. Filed 11/18/97. 440 pages.
• John Hancock Mutual Life Insurance Company application to form a de novo institution, John Hancock Bank & Trust, FSB. Filed 1/16/98. 259 pages.
• Key West BancGroup, Inc. application to organize a federal savings bank, Key West Bank. Filed 10/28/97. 370 pages.
• Merrill Lynch & Co. application for permission to organize a federal savings bank. Approved 5/20/97; Order #97-50 400 pages.
• Nationwide Insurance Company application to organize a federal savings bank, Nationwide Trust Company, FSB. Filed 11/25/97. 350 pages.
• Paine Webber Group, Inc. and Paine Webber Thrift Holdings, Inc. application to organize a federal savings bank, Paine Webber FSB. Filed 12/31/97. 698 pages.
• Principal Mutual Life Insurance Company application for acquisition of one savings association by a company other than a savings and loan holding company. Filed 12/23/96. 270 pages.
• Relistar Financial Corporation application for ownership of holding company and application for trust powers for savings bank, Relistar Bank and Trust, FSB. Filed 1/22/98. 1000 pages.
• Security First Network Bank application to provide certain financial services through Internet. Approved 5/8/95; Order #95-88. 250 pages.
• State Farm Mutual Automobile Insurance Company application for acquisition of one savings association by a company other than a savings and loan holding company. Filed 7/1/97. 811 pages.
• Sun America, Inc. application for conversion of Resources Trust Company into a federal association with trust powers. Filed 12/24/97. 1,744 pages.
• Teachers Insurance and Annuity Association of America application to form a de novo federal savings bank, TIAA-CREF Trust Company, FSB. Filed 12/10/97. 1,155 pages.
• Transamerica application to establish and acquire a de novo federal savings bank. Filed 7/22/97. 1,100 pages.
• Travelers Bank & Trust, fsb, application for trust powers and for acquisition of one savings association by a company other than a savings and loan holding company. Filed 5/11/97. 2,061 pages.

Enforcement Actions:

Holding Companies in the Thrift Industry

Background Paper

April 1997
INDEX

Executive Summary

I. Introduction

II. Background/Historical Perspective

III. Range of Activities

IV. Restrictions on Interactions

V. Advantages to Thrifts

VI. Supervision of Thrift Holding Companies

VII. Current Holding Company Ownership of Thrifts

VIII. OTS Experience with Large Commercial Firms Owning Thrifts

IX. Examples of Large Commercial Firms Owning Thrifts

X. Examples of Small Commercial Firms Owning Thrifts

XI. Non-Banking Activities of Thrift Holding Companies
Executive Summary

As discussions evolve on the relationship between banking and commerce, it may be helpful to consider the experience of thrift holding companies which, unlike bank holding companies, have historically been given broad powers.

The range of permissible activities of thrift holding companies is governed by the Savings and Loan Holding Company Act of 1967. Under this act, holding companies that own a single thrift are generally permitted to engage in any activities that do not threaten the safety and soundness of their subsidiary thrift.

Today, the Office of Thrift Supervision regulates over 1300 thrifts; 651 of those thrifts are controlled by holding companies. These 651 thrifts hold $632 billion in assets, representing 82% of all thrift assets.

The roster of thrift holding companies includes many small holding companies engaged exclusively in activities closely related to owning and managing a subsidiary thrift. It also includes multi-billion dollar companies engaged in diverse financial, commercial and industrial activities. In between are numerous medium-size companies that engage in a few select diversified activities.

Regardless of the scope of their activities, all thrift holding companies must comply with a variety of strict statutory and regulatory requirements and restrictions. They must also undergo regular examinations by the Office of Thrift Supervision. These safeguards are intended to address the concerns that motivated passage of the Bank Holding Company Act and the Glass-Steagall Act.

In the attached paper, the Office of Thrift Supervision attempts to share its experience as the regulator of thrift holding companies. The paper:

- provides some historical context to the evolution of thrift holding company powers;
- identifies the major statutory, regulatory and supervisory controls over thrift holding companies;
- describes the various forms of thrift holding companies and their authorized activities;
- quantifies the extent of holding company involvement in the thrift industry; and
- offers some representative examples of diverse thrift holding companies.

The Office of Thrift Supervision, as the primary federal regulator of the thrift industry, remains mindful of the problems that plagued the industry during the 1980s. There certainly have been occasions when thrift holding companies have violated laws or regulations or otherwise engaged in unsafe and unsound practices that required enforcement action. We have not, however, detected any systemic problems that arise from the scope of permissible activities of thrift holding companies and their affiliates.
I. Introduction

- The thrift industry regulated by the Office of Thrift Supervision ("OTS") is comprised of over 1300 institutions with assets of $769 billion.
  - 536 are mutual institutions, which have neither stockholders nor holding companies.
  - 800 are stock institutions.
    - The vast majority of the thrift industry's assets is held by stock institutions, which control $689 billion or 90% of the industry's assets.
- Within the universe of stock institutions, 651 thrifts are controlled by holding companies.
- Thrift holding companies may be either stock or mutual, may control a single thrift (a unitary thrift holding company) or several thrifts (a multiple thrift holding company).
- The range of permissible activities for a thrift holding company generally depends on the number of thrifts that the company controls and the company's form of ownership.
  - Generally, stock holding companies controlling only one thrift (unitary thrift holding companies) are permitted to engage in a much broader range of activities than mutual thrift holding companies or those controlling multiple thrifts.
- All thrift holding companies are governed by the same restrictions on interactions between the thrift and its holding company.
  - Restrictions are designed to protect the thrift from being exploited by its holding company or its holding company affiliates.

II. Background/Historical Perspective

- Affiliations with Securities Firms
  - 1933-Glass-Steagall Act-imposed stringent restrictions on affiliations (and other relationships) between banks and securities or investment banking firms.
    - Most of those restrictions were not applicable to thrifts.
- Bank Holding Companies
o 1956-Bank Holding Company Act-restricted the scope of permissible activities of multiple bank holding companies and their subsidiaries to those that are "closely related" to banking.

o 1970-Bank Holding Company Act Amendments-extended to unitary bank holding companies the same activities restrictions that are imposed on multiple bank holding companies.

• Thrift Holding Companies

o 1959-Spence Act-halted the growth of multiple thrift holding companies until Congress had the opportunity to determine whether additional regulation was needed.
  ■ Imposed moratorium on further acquisitions of thrifts by existing thrift holding companies.
  ■ Prohibited newly-formed thrift holding companies from acquiring more than one thrift.

o 1967-Savings and Loan Holding Company Act Amendments-terminated moratorium on creation/expansion of multiple thrift holding companies.
  ■ Prohibited multiple thrift holding companies from engaging in commercial and industrial enterprises, as well as certain financial activities such as underwriting insurance or securities.
  ■ Continued to permit unitary thrift holding companies to engage in any activities that were not detrimental to the safety and soundness of the thrift.

o 1987-Competitive Equality Banking Act-permitted mutual thrifts to create mutual holding companies and sell minority interest in newly created stock thrifts.
  ■ Added specific requirement that thrift subsidiaries of unitary thrift holding companies must meet the Qualified Thrift Lender test for such companies to retain their broad powers.

III. Range of Activities

• The Savings and Loan Holding Company Act stipulates the permissible range of activities for thrift holding companies, generally depending on the number of thrifts they control.
• In order to be a qualified thrift lender (QTL), a thrift must maintain a specific amount of assets in defined qualified thrift investments, primarily housing and consumer related. Provided that its thrift meets the QTL test, a unitary thrift holding company (one that controls only one thrift) may engage in any commercial or industrial activity as long as the activity does not:

  o threaten the safety and soundness of its subsidiary thrift; or
  o enable the thrift to evade applicable laws and regulations.

• A multiple thrift holding company (one that controls more than one thrift), or a mutual thrift holding company, may generally engage in those activities authorized for bank holding companies by the Bank Holding Company Act. Limited additional activities are permitted, the most significant being:

  o real estate acquisition, development, management, sale and rental; and
  o for multiple thrift holding companies, insurance agency without geographic restriction.

• A bank holding company (one that controls both a bank(s) and a thrift(s)) may engage only in those activities authorized for bank holding companies by the Bank Holding Company Act.
BASIC TYPES OF HOLDING COMPANIES OWNING THRIFTS

<table>
<thead>
<tr>
<th>Unitary Thrift Holding Company</th>
<th>Multiple Thrift Holding Company</th>
<th>Bank Holding Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Holding Company</td>
<td>Holding Company</td>
<td>Holding Company</td>
</tr>
<tr>
<td>Controls</td>
<td>Controls</td>
<td>Controls</td>
</tr>
<tr>
<td>Thrift</td>
<td>Thrift</td>
<td>Thrift</td>
</tr>
<tr>
<td></td>
<td>Thrift</td>
<td>Bank</td>
</tr>
</tbody>
</table>

IV. Restrictions on Interactions

- All thrift holding companies and their subsidiary thrifts must comply with strict statutory and regulatory restrictions on the scope and manner of their interactions. These restrictions, which are designed to protect the thrift from being exploited by the holding company or its affiliates, include:

  o Except for existing bank holding companies, companies must obtain OTS approval before acquiring a thrift.

  o Thrifts are generally prohibited from:

    - Purchasing securities issued or being underwritten by its holding company or affiliates;
    - Making loans to affiliates engaged in activities that are impermissible for bank holding companies;
Requiring that a customer that obtains a loan or other service from the thrift must also obtain some other service from the holding company or other affiliate (subject to certain narrow exceptions); and

Agreeing, stating or suggesting that the thrift is in any way responsible for the obligations of its holding company or affiliates.

- Certain transactions with affiliates:
  - Are limited to 10 percent of the thrift’s capital with any one affiliate;
  - Are limited to 20 percent of the thrift’s capital with all affiliates in the aggregate; and
  - Must be conducted on arm’s length terms.

- Thrifts are required to notify the OTS in advance of paying any dividend to their holding companies. Thrifts that fail to maintain adequate capital are prohibited from making such payments. Dividend restrictions may be placed on other thrifts for safety and soundness reasons.

V. Advantages to Thrifts

- Affiliations between thrifts and companies engaged in financial, commercial and industrial activities have had three primary benefits:
  - Financial advantages - thrift holding companies that engage in diverse lines of business often have substantially greater financial resources than non-diversified companies:
    - Enhanced access to capital markets.
    - Diversification of liquidity sources.
    - Lowered costs of borrowing.
  - Managerial advantages - thrift holding companies can contribute business and managerial talent and expertise to the thrift:
    - Particularly true when thrift holding companies have significant experience in a broad array of financial services activities.
    - Promotes operating efficiencies through economies of scale.
VI. Supervision of Thrift Holding Companies

- Thrift holding companies (controlling only thrifts) are regulated by the Office of Thrift Supervision.

- Bank holding companies (controlling both banks and thrifts) are now regulated by the Federal Reserve Board ("FRB"). (Prior to October 1996, they were jointly regulated by OTS and the FRB).

- Thrift holding companies must undergo regular OTS examinations, which are usually concurrent with the examination of their subsidiary thrift.

  - OTS examinations of holding companies focus on:

    - Transactions between the thrift, its holding company, and the company's other affiliates;

    - Funds flowing from the thrift to its holding company and affiliates (e.g. dividends and tax payments);

    - The quality of holding company management and the extent of management's participation in and oversight of thrift decisions; and

    - The present or potential financial impact or other risks, if any, of the holding company's and its affiliates' operations on the thrift.

- The complexity of the holding company's corporate structure, and the level of its interaction with the thrift, dictate the scope of OTS examinations.

- Thrift holding companies are also required to submit periodic reports on their activities to the OTS.

- Certain activities of multiple thrift holding companies require prior notification to, or approval by, the OTS.

- Unitary thrift holding companies are not required to obtain OTS approval to undertake new non-banking activities.

VII. Current Holding Company Ownership of Thrifts
• As of December 31, 1996, there were 875 holding companies that owned 651 OTS-regulated thrifts, or 49 percent of all OTS-regulated thrifts.
  
  o The number of holding companies exceeds the number of thrifts owned by holding companies because a thrift may be owned by several companies. For example, thrifts may be owned by family trusts where separate trusts, and hence, holding companies, are formed for each member of the family.

  o The chart on Page 11 illustrates the basic ownership structures for thrift holding companies.

• Thrifts owned by holding companies held aggregate assets of approximately $632 billion as of December 31, 1996 - 82 percent of total industry assets.

  o Within this universe, there are:
    
    ■ 515 thrifts, with $467 billion in assets, controlled by unitary thrift holding companies;
    
    ■ 39 thrifts, with $94 billion in assets, controlled by multiple thrift holding companies;
    
    ■ 97 thrifts, with $71 billion in assets, controlled by bank holding companies.

• The involvement of holding companies in the thrift industry is a dynamic process, as companies move into and out of the industry regularly.

  o As the data below indicate, a substantial number of holding companies enter or leave the thrift industry each year:

        | Entries | Exits |
        |---------|-------|
        | 1996    | 168   |
        | 1995    | 201   |
        | 1994    | 192   |

  o As illustrated, the total number of holding companies entering or leaving the thrift industry in 1996 accounted for over 38% of the total number of holding companies at the end of the year.

  o Thus, the characteristics of today's holding companies, the activities in which they engage, and the statistics presented in this paper, are subject to change over time.
BASIC THRIFT HOLDING COMPANY STRUCTURES

<table>
<thead>
<tr>
<th>Single Parent / Single Tier</th>
<th>Multi-Parents / Single Tier</th>
</tr>
</thead>
<tbody>
<tr>
<td>Holding Company</td>
<td>Holding Company A</td>
</tr>
<tr>
<td>Controls</td>
<td>Holding Company B</td>
</tr>
<tr>
<td>Thrift</td>
<td>Controls</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Multi-Parents / Multi-Tiers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Holding Company A</td>
</tr>
<tr>
<td>Controls</td>
</tr>
<tr>
<td>Holding Company B</td>
</tr>
<tr>
<td>Controls</td>
</tr>
<tr>
<td>Holding Company C</td>
</tr>
<tr>
<td>Controls</td>
</tr>
<tr>
<td>Thrift</td>
</tr>
</tbody>
</table>

TABLE 1

Holding Companies Owning OTS Regulated Thrifts
(Dollars in Billions)
<table>
<thead>
<tr>
<th>Holding Company Type</th>
<th>Number</th>
<th>%</th>
<th>Number of Thrifts Owned</th>
<th>Thrift Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>OTS-Regulated HCs:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unitary</td>
<td>704</td>
<td>80%</td>
<td>515</td>
<td>$467</td>
</tr>
<tr>
<td>Multiple</td>
<td>40</td>
<td>5</td>
<td>39</td>
<td>94</td>
</tr>
<tr>
<td></td>
<td>744</td>
<td>85%</td>
<td>554</td>
<td>$561</td>
</tr>
<tr>
<td><strong>Bank HCs Owning a Thrift</strong></td>
<td>131</td>
<td>15%</td>
<td>97</td>
<td>$ 71</td>
</tr>
<tr>
<td><strong>Total HCs &amp; Thrifts in HCs</strong></td>
<td>875</td>
<td>100%</td>
<td>651</td>
<td>$632</td>
</tr>
<tr>
<td><strong>Independent Thrifts</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>685</td>
<td></td>
<td></td>
<td>$137</td>
</tr>
<tr>
<td><strong>Total Thrifts</strong></td>
<td>1,336</td>
<td></td>
<td></td>
<td>$769</td>
</tr>
</tbody>
</table>

VIII. OTS Experience with Large Commercial Firms Owning Thrifts

- Most large commercial firms purchased thrifts in the early 1980s, or the late 1980s/early 1990s.
  - During those periods, many thrifts were suffering losses. Some thrifts may have been purchased by commercial firms in order to capture the thrifts' net operating loss carryforwards or other tax credits.
  - Some thrifts may have been purchased by large commercial firms because thrifts were "cheap". Commercial firms were able to enter the thrift industry inexpensively since high interest rates, asset quality problems, and losses, depressed some thrifts' stock.
    - Some commercial firms purchased failed thrifts from the FSLIC.
- More recent thrift purchases by commercial firms have involved healthy thrifts.
  - It appears these thrifts were purchased because they offer some "synergy" between the thrifts' customers and the customers of the commercial firm. Examples include offering the firm's financial products to the thrift's customers; or allowing thrift customers to conduct financial transactions through the firm's existing distribution systems, such as grocery stores.
- Most large commercial firms held their thrifts for a period of between two and five years.
- The majority of large commercial firms purchased smaller thrifts - few had over $1 billion in assets.
• Nearly all thrifts owned by large commercial firms either shrank in asset size or remained approximately the same size.
  o A notable exception is Temple-Inland, Inc. which has purchased several thrifts over the past ten years. Total assets of thrifts held by Temple-Inland, Inc. have increased from $92 million in 1987, to $9 billion as of the end of 1996.

IX. Examples of Large Commercial Firms Owning Thrifts

• Over the past ten years, several very large commercial firms have owned OTS-regulated thrifts. Examples of such firms that previously owned thrifts are:
  o Ford Motor Company - the second largest auto manufacturer in the U.S. Also engages in vehicle leasing and rental, and manufacturing electronic equipment.
  o Sears Roebuck and Company - the world's second largest retailer. Operates full-line department and specialty stores.
  o ITT Corporation - one of the world's leading hotel, gaming, entertainment and information services companies.
  o Weyerhaeuser Company - the world's largest private owner of softwood timber, producing wood products (lumber, plywood, particle board) and paper products (pulp, newsprint, containers).

• Examples of large commercial firms that currently own thrifts are:
  o Temple Inland, Inc. - has major interests in paper, packaging, building products, and financial services. Owns and leases 1.9 million acres of timberland in TX, LA, AL and GA. Financial services include thrift activities, mortgage banking, real estate development, and insurance.
  o Pulte Corporation - One of the nation's largest builders of single-family homes and developers of residential subdivisions. Operates in 24 states and 39 markets nationwide. Also engages in thrift ownership and mortgage banking.
  o Dean Witter, Discover & Company - a diversified financial services firm with two main businesses: credit services (Discover card), and securities (Dean Witter brokerage). Recently announced a merger with Morgan Stanley which would create the largest securities firm in the world.

X. Examples of Small Commercial Firms Owning Thrifts
• Most thrift holding companies are smaller, less well-known firms.

• Some examples include:
  o Hy-Vee, Inc - an integrated food company with over 200 food, drug and convenience stores located in seven states.
  o Club Corporation International - operates country clubs, athletic clubs, resorts and golf facilities.
  o Ohio Savings Financial Corporation - owns an equity interest in an automobile rental company.

XI. Non-Banking Activities of Thrift Holding Companies

• In total, about 29 percent of OTS-regulated thrift assets are held by thrifts in holding companies with some non-banking related activities.

• 39 thrifts, with assets of $94 billion, are controlled by multiple thrift holding companies. In addition to activities permitted under the Bank Holding Company Act, these companies may engage in specified activities, including:
  o Acquisition, development, management, sale and rental of real estate.
    ■ 2 multiple thrift holding companies are actively engaged in one or more of the real estate-related activities described above. The 4 thrifts in these multiple thrift holding companies hold $24 billion in assets - about 3 percent of total industry assets.

• There are 515 thrifts, with assets of $467 billion, controlled by unitary thrift holding companies. These companies may engage in unrestricted non-banking, commercial or industrial activities.
  o Currently, there are approximately 102 unitary thrift holding companies, owning 73 thrifts, that actively engage in non-banking activities.
    ■ The 73 thrifts in these unitary thrift holding companies hold approximately $196 billion in assets - about 26 percent of the total industry.
    ■ The major types of non-banking activities that these unitary thrift holding companies currently pursue include:
      ■ Real estate development, investment and management activities (51 holding companies);
      ■ Insurance sales and underwriting (27 holding companies).
Most other non-banking activities are consumer oriented but there are a few exceptions (e.g., manufacturing, wholesale goods, energy and exploration.)

### TABLE 2

**Thrift Holding Companies With Non-Banking Related Activities**

*(Dollars in Billions)*

<table>
<thead>
<tr>
<th>Holding Company Type</th>
<th>Number</th>
<th>Number of Thrifts Owned</th>
<th>Thrift Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unitary</td>
<td>102</td>
<td>73</td>
<td>$196</td>
</tr>
<tr>
<td>Multiple</td>
<td>2</td>
<td>4</td>
<td>24</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>104</strong></td>
<td><strong>77</strong></td>
<td><strong>$220</strong></td>
</tr>
</tbody>
</table>

1 Includes three thrifts that are not regulated by the OTS; their holding companies are regulated by the OTS.
Non-Banking Activities of Unitary Thrift Holding Companies

<table>
<thead>
<tr>
<th>Activity</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate Development/Investment/Management/Sales</td>
<td>51</td>
</tr>
<tr>
<td>Insurance Sales &amp; Underwriting/Life/Proactively/Property</td>
<td>27</td>
</tr>
<tr>
<td>Equity and Fixed Income Investment</td>
<td>12</td>
</tr>
<tr>
<td>Broker/Dealer</td>
<td>6</td>
</tr>
<tr>
<td>Hotel Owner/Operator</td>
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There are 102 unitary thrift holding companies included in the above count. The same holding company may be counted for more than one activity.

Prepared by:

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N. W.
Washington, DC 20552

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ROLE AND RESPONSIBILITY
OF BANK DIRECTORS

R. James Straus
Brown, Todd & Heyburn PLLC
Louisville, Kentucky

SECTION 0
# ROLE AND RESPONSIBILITY OF BANK DIRECTORS

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### SECTION 0
ROLE AND RESPONSIBILITY OF BANK DIRECTORS

R. JAMES STRAUS
BROWN, TODD & HEYBURN PLLC
LOUISVILLE, KENTUCKY
PHONE: (502) 589-5400

I. INTRODUCTION

The responsibilities of bank directors include both the responsibilities of directors generally and the special responsibility of directors of federally insured financial institutions. The responsibilities of directors derive from legal articulation of director duties and from the fundamental principles of sound corporate governance. Lawyers who serve as bank directors must cope with difficult tensions between their role as directors and as lawyers.

II. CORPORATE DUTIES AND STANDARDS

A. General Standards for Directors - The Kentucky Business Corporation Act, Chapter 271B of the Kentucky Revised Statutes, is patterned after the American Bar Association’s Revised Model Business Corporation Act (1984). The MBCA was developed in an environment of increasing attempts to pin liability for corporate actions on directors. The MBCA is very attentive to standards for director conduct and director liability.

(a) KRS 271.8-300, expressing duties of loyalty and care and a business judgment rule, provides:

(1) A director shall discharge his duties as a director, including his duties as a member of a committee:

   (a) In good faith;

   (b) On an informed basis; and

   (c) In a manner he honestly believes to be in the best interests of the corporation.

(2) A director shall be considered to discharge his duties on an informed basis if he makes, with the care an ordinarily prudent
person in a like position would exercise under similar circumstances, inquiry into the business and affairs of the corporation, or into a particular action to be taken or decision to be made.

(3) In discharging his duties, a director shall be entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(a) One (1) or more officers or employees of the corporation whom the director honestly believes to be reliable and competent in the matters presented;

(b) Legal counsel, public accountants, or other persons as to matters the director honestly believes are within the person's professional or expert competence; or

(c) A committee of the board of directors of which he is not a member, if the director honestly believes the committee merits confidence.

(4) A director shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (3) of this section unwarranted.

(b) KRS 271B.8-300 goes on to provide with respect to the standards for discharge by directors of their duties as follows:

(5) In addition to any other limitation on a director's liability for monetary damages contained in any provision of the corporation's articles of incorporation adopted in accordance with subsection (2)(d) of KRS 271B.2-020, any action taken as a director or any failure to take any action as a director, shall not be the basis for monetary damages or injunctive relief unless:

(a) The director has breached or failed to perform the duties of the director's office in compliance with this section; and

(b) In the case of an action for monetary damages, the breach or failure to perform constitutes willful misconduct or wanton or reckless disregard for the best interests of the corporation and its shareholders.
(6) A person bringing an action for monetary damages under this section shall have the burden of proving by clear and convincing evidence the provisions of subsection (5)(a) and (b) of this section, and the burden of proving that the breach or failure to perform was the legal cause of damages suffered by the corporation.

B. **Financial Institutions**

(a) In 1986, the Kentucky General Assembly adopted a statutory standard conduct for state bank directors. KRS 287.065(3) requires that "each director exercise such ordinary care and diligence as necessary and reasonable to administer the affairs of the bank in a safe and sound manner." This standard is consistent with Kentucky case law. *Scott's Executor's v. Young*, 21 S.W. 2d 994 (Ky. 1929) holds that all that the law requires is that directors "exercise ordinary care in the selection of the officers and the agents of the bank, and the management and supervision of its affairs."

(b) There is no Kentucky or federal definition of "safety and soundness" in the bank context, although the existence of unsafe and unsound banking practices serves as a trigger for Federal formal enforcement proceedings available against bank directors, See e.g., the Financial Institution Supervisory Act of 1966 and the provisions of 12 USC 1818(b). The term "unsafe and unsound banking practices" is generic such as widely used terms like "negligence" or "good faith." See Schooner, *Fiduciary Duties' Demanding Cousin*: Bank Director Liability For Unsafe Or Unsound Banking Practices, 63 Geo. Wash. L. Rev. 175 (1995).

C. **FIRREA**: In 1989, as part of the Financial Institution's Reform, Recovery and Enforcement Act, Congress for the first time addressed the liability of directors of financial institutions for breach of fiduciary duty. FIRREA provides in part:

A director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action by, on behalf of, or at the request or direction of [the FDIC] which action is prosecuted wholly or partially for the benefit of the Corporation:

(1) acting as conservator or receiver of such institution,

(2) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed by such receiver or conservator, or
(3) acting based upon a suit, claim, or cause of action purchased from, assigned by or otherwise conveyed in whole or in part by an insured depository institution or its affiliate in connection with assistance provided under section 1823 of this title,

for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined under applicable State law. Nothing in this paragraph shall impair or affect any right of [the FDIC] under other applicable law.


FIRREA refers to actions based on "gross negligence." It took eight years for the United States Supreme Court to resolve a dispute of authority over whether FIRREA's reference to "gross negligence" immunized directors from state laws which impose liability for conduct that is less offensive than gross negligence such as simple negligence. The Supreme Court held that state law rather than federal law sets the standard of care for officers and directors of both state and federally chartered savings and loans, except to the extent that federal law preempts any state law that attempts to insulate directors by establishing a more forgiving standard of care than gross negligence. Atherton v. FDIC, 136 L.Ed. 2d 656, (1997).

D. Counseling. Lawyers are frequently asked to advise a board of directors about its duties and the duties of its members, especially when the board is in the process of establishing a strategic direction for the corporation, or when the board is considering an offer to purchase the corporation. Attached as Exhibit A is a sample format for a handout to a board of directors to assist in a discussion led by counsel about director responsibilities.

III. GUIDELINES FOR FINANCIAL INSTITUTION DIRECTORS.

A financial institution's board of directors is ultimately responsible for the institution's affairs. A board should be strong, independent and informed, and its members must be prepared to put the institution's interests before their own interests.

Both the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation have published guidelines for bank directors. A copy of the FDIC's Pocket Guide for Directors, as reprinted in November 1997, is attached as Exhibit B. The OCC's substantially lengthier publication, The Director's Book: The Role of a National Director is referred to on page 10 of the FDIC's Pocket Guide. In the word's of the FDIC's Pocket Guide, a board of directors should:
* select and retain competent management;

* establish, with management, the institution's long- and short-term business objectives, and adopt operating policies to achieve these objectives in a legal and sound manner;

* monitor operations to ensure that they are controlled adequately and are in compliance with laws and policies;

* oversee the institution's business performance; and

* ensure that the institution helps to meet its community's credit needs.

An individual director, in the OCC's words, must:

* be aware of the bank's operating environment;

* be diligent in performing the job;

* exercise independent judgment; and

* be loyal to the bank's interest.

OCC Director's Book, Page 47.

IV. LAWYERS AS DIRECTORS

Lawyers who serve as directors of a financial institution, especially lawyers who both serve as directors and provide substantial legal services to the financial institution, face serious dilemmas. Directors are expected to discharge their duties with care and loyalty. Lawyers are expected to discharge their representations with competence, as zealous advocates uncompromised by conflicting interests, within a scope designated by the client and as jealous guardian's of the client's confidences.

A. Lawyers must deal with a very real tension between a lawyer's need to avoid and ethically to deal with conflicts of interest in the multiple constituents and interests competing within a financial institution, including the interests of shareholders, directors, various officers, and the federal agencies which regulate the financial institution. See Kentucky Supreme Court's Rule 3.130(1.13) concerning the organization or corporation as the client.

B. Federal regulators work hard to establish a heightened standard of conduct for lawyers representing financial institutions. For instance, FIRREA includes legal
counsel within a definition of "institution-affiliated party," which directly targets directors, attorneys and other insiders for draconian enforcement measures and civil money penalties initiated by federal regulatory agencies. See 12 USC §1813(u)(4).

The FDIC, on February 10, 1998, issued a special release setting forth guidelines for financial institution directors regarding legal advice. The Guidance suggests that bank directors have a higher standard of fiduciary duty then directors of ordinary corporations, and suggests that lawyers representing financial institutions must take on the role of policemen when it comes to insider indiscretions. The Guidance states in part:

Banking is a heavily regulated industry, and it has long been recognized that bank officers and directors have higher standards of fiduciary duty than the officers and directors of ordinary corporations. Likewise, the safe and sound operation of insured depository institutions requires that lawyers provide advice and corporate counseling that is both accurate and complete, and that financial institution directors fully consider such advice and counseling prior to exercising approval authority regarding non-routine transactions.

If it appears that the managers of an insured depository institution are breaching their fiduciary duties, it is the responsibility of the lawyer to take appropriate steps to advise the offending officials as to their duties. When the likely result is substantial injury to the organization, the lawyers also have the obligation to take steps to prevent the offending conduct, if necessary by proceeding up the corporate ladder up to and including informing the board of directors of the institution. These communications must also be effective. It is not sufficient to expect or allow the offending officials or their subordinates to properly communicate to institution decisionmakers. This is particularly true when insider conflicts have necessitated the creation of a special committee of the board to act as decisionmaker.

A copy of the Guidance is attached as Exhibit C.

C. The changing expectations for lawyer directors and lawyers providing legal services for financial institutions is dramatically evident from the following two examples:

(a) On November 16, 1930, the National Bank of Kentucky of Louisville failed. It was then the largest bank south of the Ohio River with assets of just less than
$53,000,000. The National Bank's collapse was part of the BancoKentucky Company scandal, and led to litigation by the receiver of The National Bank against the Bank's directors, among others. After years of appeals, the proceeding resulted in a determination of substantial director liability. These directors included a number of prominent attorneys. The following dialogue is from the final arguments heard before Judge Austin Tuttle in the Western District of Kentucky at Louisville on October 17, 1933 prior to Judge Austin Tuttle's opinion which is reported as Anderson v. Akers, 7 F.Supp. 924 (W.D.Ky. 1934). The court and counsel for the receiver, Mr. Lock are discussing the failure by Mr. Crawford, a lawyer and a director, to discover massive funds illegally invested by the Bank in Kentucky Wagon Manufacturing Company.

Mr. Lock: . . . He was a lawyer and presumably he would want to know what the National Banking Act provided with reference to his duty . . . .

The Court: I thought we had decided that a man's ability didn't have anything to do with it, that whether he had great ability as a lawyer or a farmer didn't affect the way he had to conduct himself.

Mr. Lock: That is true. But what I am saying, though I use the term lawyer, as applicable to any director of ordinary care, prudence and diligence. The minimum exertion required by ordinary care, prudence and diligence of a director when he comes on the Board is first to find out the condition of the bank when he comes in, and how authority is divided among the officers and how the business is being conducted and what is the condition of the bank and what affairs or problems it has . . . . But no inquiry was made

(b) On August 22, 1990, Judge Stanley Sporkin of the United States District Court for the District of Columbia, towards the end of a lengthy opinion rebuffing an effort by Lincoln Savings and Loan Association and American Continental Corporation of Charles Keating fame to rest control of the institutions back from the Office of Thrift Supervision, said:

There are other unanswered questions presented by this case. Keating testified that he was so bent on doing the "right thing" that he surrounded himself with literally scores of accountants and lawyers to make sure all the transactions were legal. The questions that must be asked are:
Where were those professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated?

Why didn’t any of them speak up or disassociate themselves from the transactions?

Where also were the outside accountants and attorneys when these transactions were effectuated?

What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in the case.


D. Lawyer-Directors may have limited recourse to the business judgment rule in circumstances where their presumed expertise leads to a presumption that they should know better. Lawyers who are asked to serve as directors of their financial institution clients should carefully consider with their clients the heightened and complicated responsibilities resulting from a combination of the two roles.
SAMPLE GUIDE FOR LEADING DISCUSSIONS

CONCERNING DIRECTOR RESPONSIBILITIES

GENERAL DUTIES OF THE BOARD OF DIRECTORS

The Directors have a fiduciary duty to act in the best interest of the corporation and its shareholders.

- **Duty of Loyalty** - requires one to act in good faith without conflicts of interest, or if there is a conflict of interest, then the transaction must be fair to the corporation.

- **Duty of Care** - requires one to act as a reasonable and prudent person would act in a similar situation.

- **General Standard** - duties must be discharged in good faith, on an informed basis, and in a manner which you honestly believe to be in the best interests of the corporation.

- **Reliance on Experts** - in acquiring information upon which to base judgments, a director may rely on the corporation’s officers, legal counsel, accountants and other persons as to matters you honestly believe are within the person’s professional or expert competence.

PROTECTION FOR EXERCISE OF DUTIES

- **Business Judgment Rule** - Directors are protected if they exercise their judgment in good faith on an informed basis.

- **Statutory Limits on Liability** - A director will not be liable for monetary damages unless the director breaches the duties stated above and such breach constituted willful misconduct or wanton or reckless disregard for the best interests of the corporation and its shareholders.

- **Limits on Liability in Articles of Incorporation** - A Director will not be liable for monetary damages unless the director breaches the duties stated above and (1) such breach constituted willful misconduct or wanton or reckless disregard for the best interests of the corporation and its shareholders; (2) the director’s personal financial interest is in conflict with the financial interest of the corporation or its shareholders; (3) the director derives an improper personal benefit; (4) the act or omission is known by
the director to be illegal; or (5) the act results in an unlawful distribution to shareholders.

DUTIES IN RESPONDING TO A PROPOSED TAKEOVER

- **Multiple Factors** - Unless the directors have determined to break up the company, director considerations include long and short term shareholder value (of each party), the qualities of the parties and its impact on employees, customers and communities.

- **Defensive Measures** - A defensive measures adopted unilaterally by the board of directors must be reasonable in relationship to the anticipated threat posed.

- **Articles Amendments** - When recommending defensive measures to be adopted through an amendment to the articles, the directors must act in good faith and on an informed basis, and shareholder approval must be obtained through the prescribed statutory procedure, based on full and fair disclosure.
Change in the financial marketplace has created a more competitive and challenging environment for all financial institutions. As a consequence of this change, the role of the financial institution board member has grown in importance and complexity.

This Pocket Guide has been developed by the Federal Deposit Insurance Corporation to provide directors of financial institutions with accessible and practical guidance in meeting their duties and responsibilities in a changing environment. These guidelines have been endorsed by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

We hope this Pocket Guide will help to make the director’s job one that can be approached with clarity, assurance and effectiveness. If you are helped in meeting these goals, then the larger goal of maintaining confidence in the safety and soundness of our financial system will also be advanced.

Sincerely,

Andrew C. Hove, Jr.
Chairman, Federal Deposit Insurance Corporation
Eugene A. Ludwig
Joseph H. Neely
Ellen S. Seidman

Federal Deposit Insurance Corporation
Washington, D.C.
Reprinted November 1997
General Guidelines

A financial institution’s board of directors oversees the conduct of the institution’s business. The board of directors should:

- select and retain competent management;
- establish, with management, the institution’s long- and short-term business objectives, and adopt operating policies to achieve these objectives in a legal and sound manner;
- monitor operations to ensure that they are controlled adequately and are in compliance with laws and policies;
- oversee the institution’s business performance; and
- ensure that the institution helps to meet its community’s credit needs.

These responsibilities are governed by a complex framework of federal and state law and regulation. These guidelines do not modify the legal framework in any way and are not intended to cover every conceivable situation that may confront an insured institution.
Rather, they are intended only to offer general assistance to directors in meeting their responsibilities. Underlying these guidelines is the assumption that directors are making an honest effort to deal fairly with their institutions, to comply with all applicable laws and regulations, and to follow sound practices.

**Maintain Independence**

The first step both the board and individual directors should take is to establish and maintain the board's independence. Effective corporate governance requires a high level of cooperation between an institution's board and its management. Nevertheless, a director's duty to oversee the conduct of the institution's business necessitates that each director exercise independent judgment in evaluating management's actions and competence. Critical evaluation of issues before the board is essential. Directors who routinely approve management decisions without exercising their own informed judgment are not adequately serving their institutions, their stockholders, or their communities.
Ensure Qualified Management

The board of directors is responsible for ensuring that day-to-day operations of the institution are in the hands of qualified management. If the board becomes dissatisfied with the performance of the chief executive officer or senior management, it should address the matter directly. If hiring a new chief executive officer is necessary, the board should act quickly to find a qualified replacement. Ability, integrity, and experience are the most important qualifications for a chief executive officer.

Supervise Management

Supervision is the broadest of the board’s duties and the most difficult to describe, as its scope varies according to the circumstances of each case. Consequently, the following suggestions should be viewed as general.

Establish Policies. The board of directors should ensure that all significant activities are covered by clearly communicated written poli-
cies that can be readily understood by all employees. All policies should be monitored to ensure that they conform with changes in laws and regulations, economic conditions, and the institution's circumstances. Specific policies should cover at a minimum:

- loans, including internal loan review procedures
- investments
- asset-liability/funds management
- profit planning and budget
- capital planning
- internal controls
- compliance activities
- audit program
- conflicts of interest
- code of ethics

These policies should be formulated to further the institution's business plan in a manner consistent with safe and sound practices. They should contain procedures, including a system
of internal controls, designed to foster sound practices, to comply with laws and regulations, and to protect the institution against external crimes and internal fraud and abuse.

Monitor implementation. The board’s policies should establish mechanisms for providing the board the information needed to monitor the institution’s operations. In most cases, these mechanisms will include management reports to the board. These reports should be carefully framed to present information in a form meaningful to the board. The appropriate level of detail and frequency of individual reports will vary with the circumstances of each institution. Reports generally will include information such as the following:

- the income and expenses of the institution
- capital outlays and adequacy
- loans and investments made
- past due and negotiated loans and investments
- problem loans, their present status and workout programs
- allowance for possible loan loss
• concentrations of credit
• losses and recoveries on sales, collections, or other dispositions of assets
• funding activities and the management of interest rate risk
• performance in all of the above areas compared to past performance as well as to peer groups’ performance
• all insider transactions that benefit, directly or indirectly, controlling shareholders, directors, officers, employees, or their related interests
• activities undertaken to ensure compliance with applicable laws (including, among others, lending limits, consumer requirements, and the Bank Secrecy Act) and any significant compliance problems
• any extraordinary development likely to impact the integrity, safety, or profitability of the institution

Reports should be provided far enough in advance of board meetings to allow for meaningful review. Management should be asked to respond to any questions raised by the reports.
Experience has shown that certain aspects of lending are responsible for a great number of the problems experienced by troubled institutions. The importance of policies and reports that reflect on loan documentation, performance, and review cannot be overstated.

*Provide for independent reviews.* The board also should establish a mechanism for independent third party review and testing of compliance with board policies and procedures, applicable laws and regulations, and accuracy of information provided by management. This might be accomplished by an internal auditor reporting directly to the board, or by an examining committee of the board itself. In addition, a comprehensive annual audit by a CPA is desirable. It is highly recommended that such an audit include a review of asset quality. The board should review the auditors' findings with management and should monitor management's efforts to resolve any identified problems.

In order to discharge its general oversight responsibilities, the board or its audit committee should have direct responsibility for hiring, firing, and evaluating the institution's auditors,
and should have access to the institution's regular corporate counsel and staff as required. In some situations, outside directors may wish to consider employing independent counsel, accountants or other experts, at the institution's expense, to advise them on special problems arising in the exercise of their oversight function. Such situations might include the need to develop appropriate responses to problems in important areas of the institution's performance or operations.

*Heed supervisory reports.* Board members should personally review any reports of examination or other supervisory activity, and any other correspondence from the institution's supervisors. Any findings and recommendations should be reviewed carefully. Progress in addressing problems should be tracked. Directors should discuss issues of concern with the examiners.

---

**Avoid Preferential Transactions**

Avoid all preferential transactions involving insiders or their related interests. Financial
transactions with insiders must be beyond reproach. They must be in full compliance with laws and regulations concerning such transactions, and be judged according to the same objective criteria used in transactions with ordinary customers. The basis for such decisions must be fully documented. Directors and officers who permit preferential treatment of insiders breach their responsibilities, can expose themselves to serious civil and criminal liability, and may expose their institution to a greater than ordinary risk of loss.


A more detailed discussion of a director's role and responsibilities is available in the Office of the Comptroller of the Currency's book, *The Director's Book: The Role of a National Bank Director*, which is available for $10.00 from OCC, P.O. Box 70004, Chicago, Illinois 60673-0004.
TO: CHIEF EXECUTIVE OFFICER

SUBJECT: Guidance for Financial Institution Directors Regarding Legal Advice

The Federal Deposit Insurance Corporation (FDIC) has developed the attached guidance for financial institution directors receiving legal advice.

The guidance is intended to ensure that officers and directors of financial institutions recognize that attorneys providing advice and corporate counseling represent, and owe their duty of loyalty to, the financial institution, not officers and directors who in some cases may also be the control owners of the institution. In order to facilitate the exercise of independent approval authority, the board of directors, or any special committee thereof, should assure effective communication of legal advice and counsel prior to action by the board or committee.

Please ensure that all members of your board of directors receive a copy. If you have any questions, please contact your FDIC Division of Supervision Regional Office.

William F. Kroener, III
General Counsel

Nicholas J. Ketcha, Jr.
Director
Division of Supervision

Attachment

Distribution: FDIC-Supervised Banks (Commercial and Savings)
GUIDANCE FOR FINANCIAL INSTITUTION DIRECTORS REGARDING LEGAL ADVICE

Results of a recent inquiry by the FDIC emphasize the need to publicize the important roles and responsibilities of bank management and independent contractor professionals providing services to insured depository institutions.

The FDIC recently concluded an inquiry of a law firm respecting its representation of an insured depository institution. As bank counsel, the law firm and its attorneys owed important fiduciary obligations to the institution, including the duty to exercise the utmost loyalty and fidelity to the bank's interests.

An FDIC examination disclosed that the law firm conceived and drafted documents to implement a complex series of transactions between the bank and an entity controlled by the bank's Chairman and other insiders. These transactions might well have resulted in the transfer, over time, of certain bank properties to the descendants of the bank's Chairman. Despite the fact that the interests of the bank and the interests of certain senior bank officers and directors were different and in apparent conflict regarding the creation of the entity and its transactions with the bank, the law firm relied on the interested insiders or their subordinates to communicate to the bank's board of directors. Though the bank, at the suggestion of the law firm, had established a special committee of disinterested outside directors to consider and approve the transactions, the attorneys had no direct contact with that committee. Under the circumstances presented, the law firm attorneys failed to fulfill their obligation to effectively communicate all pertinent facts and legal advice to the special committee members. Similarly, it appears that the members of the special committee failed to fulfill their duty to ensure that they were fully informed of all pertinent facts prior to approving the proposed transaction.

Federal banking agency examiners are vested with the power and responsibility for making thorough examinations of depository institutions. Examiners conduct periodic examinations of depository institutions and rely on a sampling of books and records in determining compliance with safe and sound banking practices as well as applicable laws and regulations. In order to fulfill their duties, examiners must be able to rely on the completeness and accuracy of financial institution books and records.

The documents and bank records regarding the creation of the entity, all of which were prepared by the law firm, uniformly indicated that the entity had been created to benefit the bank, and that the creation of the entity and its transactions with the bank had been considered and approved by the special committee of
disinterested outside directors. Routine review of this
documentation by FDIC examiners during a series of examinations
of the bank raised no red flags or areas of regulatory concern.
Indeed, it was not until a substantial period of time after the
transactions that a bank employee informed FDIC examiners about
the true nature of the arrangement. Even with the assistance
provided by the employee, uncovering all of the details took
significant time, effort and analysis.

The FDIC believes that the situation described above
apparently resulted in part from the failure of the lawyers
involved to identify their client - the bank - and to keep its
interests paramount. The duties owed by lawyers in their
representation of insured depository institutions run to the
institution, not to the individuals who comprise management of
the institution. These principles are of particular concern to
the FDIC as many of the institutions that we supervise are
managed by the control owners of the institution.

Banking is a heavily regulated industry, and it has long
been recognized that bank officers and directors have higher
standards of fiduciary duty than the officers and directors of
ordinary corporations. Likewise, the safe and sound operation of
insured depository institutions requires that lawyers provide
advice and corporate counseling that is both accurate and
complete, and that financial institution directors fully consider
such advice and counseling prior to exercising approval authority
regarding non-routine transactions.

If it appears that the managers of an insured depository
institution are breaching their fiduciary duties, it is the
responsibility of the lawyer to take appropriate steps to advise
the offending officials as to their duties. When the likely
result is substantial injury to the organization, the lawyers
also have the obligation to take steps to prevent the offending
conduct, if necessary by proceeding up the corporate ladder up to
and including informing the board of directors of the
institution. These communications must also be effective. It is
not sufficient to expect or allow the offending officials or
their subordinates to properly communicate to institution
decisionmakers. This is particularly true when insider conflicts
have necessitated the creation of a special committee of the
board to act as decisionmaker.

In sum, the FDIC expects all attorneys representing insured
depository institutions to exercise the utmost loyalty and
fidelity to the institution's interests. When the interests of
the institution and any of its insiders differ and may be
adverse, attorneys representing the institution must make full
disclosure of all pertinent facts to and obtain the knowing
consent and approval of institution decisionmakers who are
independent from the senior officers with adverse interests.
Moreover, when an insured depository institution has occasion to establish a special committee to exercise independent approval authority for the institution regarding a matter, attorneys representing the institution have the responsibility to make sure that effective communication of pertinent facts and legal advice is made to such committee.