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21st Annual Conference on Legal Issues For Financial Institutions

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21st Annual Conference On
LEGAL ISSUES
FOR
FINANCIAL INSTITUTIONS

April 2001
21st Annual
Conference On

LEGAL ISSUES
FOR
FINANCIAL
INSTITUTIONS

April 2001

Presented by the
OFFICE OF CONTINUING LEGAL EDUCATION
UNIVERSITY OF KENTUCKY COLLEGE OF LAW

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21st ANNUAL CONFERENCE ON LEGAL ISSUES FOR FINANCIAL INSTITUTIONS

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SECTION A
KENTUCKY GENERAL ASSEMBLY UPDATE  
New Kentucky Legislative Enactments

I. Introduction. The materials included in this summary were accumulated as of April 4, 2001 and based upon bills introduced in the Kentucky 2001 General Session. The bills summarized here include issues of particular importance to financial institutions doing business in Kentucky. Detailed information will be provided to financial institutions next month in a booklet produced by the Kentucky Bankers Association entitled 2001 Session in Summary. Most of the bills summarized are included with these materials. Bills not included may be obtained through the LRC Website at www.lrc.state.ky.us/ or by contacting Debra Stamper at 502-582-2453.

II. First Annual Session—2001 marked the first annual session of the Kentucky General Assembly. Prior to 2001, Kentucky’s legislature met only on even numbered years for 60 business days. A measure was passed during the 2000 Regular Session which allowed Kentuckians to vote on annual sessions, which would maintain the existing calendar during even numbered years and include a short, 30-day session in odd numbered years. That passed during the November 2000 vote. This first annual session was difficult in that the rules were not clearly established until just before the session began. It was also difficult to pass any significant bills, if they raised discussion or controversy, because of the limited time available for consideration and the political split in the legislative houses. In summary, very little passed out of the General Assembly this year. It is significant, therefore, that several bills passed out which are of interest to the banking industry.

III. Branching/De Novo Acquisition/FHLB Letters of Credit (SB 22—signed by the Governor March 5). During the 2000 Session two bills were passed with conflicting language. This bill clarifies the confusion that resulted.

Branching—State banks now have the express authority to branch without regard to geographic limitations. Prior to the 2000 session state banks were limited to single county branching or by acquisition. After the 2000 session state banks began branching across county lines, by means of parity as other institutions within Kentucky and in other states have the authority to branch across county lines. KRS 287.180.

De Novo Acquisition—The five year existence rule (prior to acquisition of a majority of shares) is now removed. Prior to the 2000 session acquisition of a bank in Kentucky could only be obtained after the bank had been in existence for five years. During the 2000 session all references to that five-year requirement were removed, except that contained in 287.900 (2). That section is now removed.

FHLB Letters of Credit—During the 1998 and 2000 sessions, several changes were made to expand the allowable categories of collateral on public deposits made to an institution in excess of the FDIC coverage limits. One category added were Federal Home Loan Bank Letters of Credit, which are widely used by institutions in Kentucky. For some reason, certain agencies have refused to recognize these LOC’s as acceptable collateral.
Therefore, a new section (5) to KRS 41.240 has been added to require the acceptance of these LOC's as collateral.

IV. Actions relating to Securities (SB 134—signed by the Governor March 20). Specifies that the three-year statute of limitations on securities actions arising under KRS 292.480 runs from when the occurrence was discovered or should have been discovered.

V. Mortgage Loan Companies (HB 102—signed by the Governor March 15). KRS Chapter 294 deals with the regulatory structure of mortgage loan companies and brokers. Among the changes included in this bill are:

- KRS 294.020. Increases the exemption list (those entities exempt from the chapter) to include any entity that is regularly examined by the primary financial institution regulators or which is wholly owned by an exempted entity.
- KRS 294.020. Requires a disclosure to be signed by borrower and maintained by lender, in the form included in the statute, in each instance where a natural person is making a loan with his own funds without intent to resell. This shall not apply if the natural person lender is making less than 5 mortgage loans a year.
- KRS 294.030. Provides that exempt lenders (who are required to file an exemption, but fail to file) or natural person lenders (who are required to comply with disclosure requirements, but do not) operating in violation of these requirements will lose the right to collect or retain any interest or charges on the loan contract.
- KRS 294.220. Prohibits mortgage companies or brokers operating under the Chapter to charge for an initial payoff or payment history per calendar quarter.

VI. Trusts and Estates (HB 113—signed by the Governor March 15). Deletes the annual fiduciary settlement publication requirement on accounts that are not more than $2500 and are set up to limit access except by order of the court.

VII. Security Interest Issues (HB 133—signed by the Governor March 15).

Manufactured homes—The title lien on a manufactured home shall remain effective for 30 years or until discharged (increased from 14 years). KRS 186A.190.

Debtor name change—The substantial changes made to Article 9 of the UCC during the 200 session, included a requirement that an amendment be filed to reflect a debtor name change, in order to continue the security interest. This change requires the amendment only upon written notice by the debtor to the secured party of the name change. KRS 355.9-507

VIII. Safe Deposit Boxes (HB 148). This bill places into law a procedure that many financial institutions are already following as a result in a change of policy implemented by the Kentucky Revenue Cabinet in 1999. During that year the Revenue Cabinet notified financial institutions that it would discontinue the practice of sending an agent to inventory a safe deposit box upon the death of an owner. That was often the only safe method available for a bank to allow family

Debra Stamper
Kentucky Bankers Association
members access to a safe deposit box for the purpose of determining if a will was in the box. This bill adds a new section to KRS Chapter 286, which requires a financial institution to allow certain "interested persons," upon proper proof of death and the safe deposit box key, access to the box for the sole purpose of determining if a will or burial instructions are in the box. The access and search must be done in the presence of an employee of the financial institution. If the sought after documents are found, the employee will give the original to the interested party and place a copy back in the box.
SB 22 (BR 215) - T. Buford

AN ACT relating to banks.
Amend KRS 287.180 to permit a bank to establish a branch within any state, the
District of Columbia, or a territory of the United States.

SB 22 - AMENDMENTS

SCS - Retain the original provisions; amend KRS 287.900 to delete restriction on
acquisition of greater than fifty percent of the voting securities of a bank if the bank was
chartered after July 13, 1984 and was in existence less than five years at the time of
acquisition.

SFA (1, T. Buford) - Retain provisions of original; require the State Treasurer to
accept letters of credit issued by federal home loan banks as collateral.

HFA (1, J. Stacy) - Prohibit a bank located in a county of 29,000 or fewer persons
from opening a branch in another county; prohibit banks from establishing a branch in a
county of 29,000 or fewer persons.

HFA (2, J. Stacy) - Amend KRS 287.102 to provide that banking activity does not
include branch banking or the establishment of branch banks.

Jan 2-introduced in Senate
Jan 5-to Banking and Insurance (S)
Feb 15-reported favorably, 1st reading, to Consent Calendar with Committee
Substitute
Feb 16-2nd reading, to Rules
Feb 19-posted for passage in the Consent Orders of the Day for Tuesday, February
20, 2001; taken from the Consent Orders of the Day, placed in the Regular Orders of
the Day; floor amendment (1) filed to Committee Substitute
Feb 20-3rd reading, passed 37-0 with Committee Substitute, floor amendment (1)
Feb 21-received in House
Feb 22-to Banking and Insurance (H)
Feb 23-posted in committee
Feb 28-reported favorably, 1st reading, to Calendar
Mar 1-2nd reading, to Rules
Mar 5-posted for passage in the Regular Orders of the Day for Tuesday, March 6,
2001
Mar 6-floor amendments (1) and (2) filed
Mar 7-3rd reading, passed 95-4; received in Senate
Mar 8-enrolled, signed by each presiding officer, delivered to Governor
Mar 15-signed by Governor (Acts ch. 112)
AN ACT relating to banks.

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 bank may establish within any state, the District of Columbia, or a territory of the United States a branch in a county in which its principal office or an existing branch is located and may exercise all of the powers conferred in subsection (1) of this section at the branch. A bank, except for a bank that the commissioner may designate by the promulgation of administrative regulations, shall apply to the commissioner for permission to establish a branch. Before the commissioner shall approve or disapprove any application made under this subsection the commissioner 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. The following conditions shall apply to applications for branches:

(a) 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 the commissioner deems to
be necessary; and

(b) 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.

(3) 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 in accordance with the terms of this section.

(4) 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. 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.

Section 2. KRS 287.900 is amended to read as follows:

(1) For purposes of this section and KRS 287.905:

(a) "Bank" means any institution organized under this chapter, the banking laws of another state, or the National Bank Act, as amended, to do a banking business;

(b) "Bank holding company," "company," and "control" have the meanings accorded them in the Federal Bank Holding Company Act of 1956, as amended (12 U.S.C. secs. 1841 et seq.). "Control" may be acquired by acquisition of voting securities, by purchase of assets, by merger or consolidation, by contract, or otherwise;

(c) "Individual" means a natural person, partnership, association, business trust, voting trust, or similar organization. "Individual" does not include a corporation; and

(d) "Deposit" has the meaning accorded it in the Federal Deposit Insurance Act, as amended, and regulations promulgated thereunder; excluded, however, from deposits are all interbank deposits and all deposits in foreign branches and international banking facilities, as shown in the reports made by all federally insured depository institutions to their respective supervisory authorities.

(2) Any individual, or any bank holding company having its principal place of business in this state, may acquire control of one (1) or more banks or bank holding companies wherever located, except that no individual, who on July 13, 1984, controls a bank or bank holding company wherever located, and no bank holding company wherever located, may acquire, directly or indirectly, control of greater than fifty percent (50%) of the voting securities of a bank having its principal place
of business in this state if the bank was chartered after July 13, 1984, and if, at the time of the acquisition, the bank has been in existence less than five (5) years. The provisions of this subsection shall not prohibit the organization of a one (1) bank holding company for the purpose of acquiring control of a bank even if the bank was chartered after July 13, 1984, and has been in existence less than five (5) years at the time of the acquisition.

(3)] No individual or bank holding company wherever located may acquire control of any bank or bank holding company if, upon the acquisition, the individual or bank holding company would control banks 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 June 30 quarterly report made by the institutions to their respective supervisory authorities which are available at the time of the acquisition.

(3)[(4)] The limitations set forth in this section or any other provision of this chapter or any administrative regulation promulgated thereunder, as now in effect or amended after July 13, 1984, shall not apply to the acquisition of a bank if, in his or her discretion, the commissioner, if the bank is organized under the laws of this state, or the comptroller of the currency, if the bank is a national bank, determines that an emergency exists and the acquisition is appropriate in order to prevent the probable failure of the bank which is closed or is in danger of closing.

(4)[(5)] The provisions of this section shall not be construed to prohibit or restrict the merger or consolidation of banks or bank holding companies having their principal places of business in the same county and the operation by the merged or consolidated corporation of the banks, nor to prohibit the sale of any bank or bank holding company to, and the purchase thereof by, any other bank or bank holding company with its principal place of business in the same county and the operation of the bank as a branch so long as the provisions of KRS 287.180(4) have been
satisfied.

Section 3. 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 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 KRS 66.480(1)(c);

(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.

(5) The State Treasurer shall accept letters of credit issued by federal home loan banks as collateral under this section.
SB 134 (BR 1234) - R. Stivers

AN ACT relating to securities.
Amend KRS 292.480 to define the limitations period as three (3) years after the date the occurrence was discovered, or in the exercise of reasonable care should have been discovered, and to be applied retroactively to any actions accruing from the date of January 1, 1990.

SB 134 - AMENDMENTS

HCS - Move reasonable discovery language after language of the occurrence of the act, omission, or transaction constituting the violation of the chapter.
HFA (1, G. Lindsay) - Delete previous Section 2 and insert a new Section 2 in lieu thereof which expresses legislative intent and provides that the Act shall be retroactively applied to any actions, other than those given res judicata effect by a court of competent jurisdiction, which in the exercise of reasonable care should have been discovered as having accrued in the ten years immediately preceding the effective date of the Act.
AN ACT relating to securities.

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

Section 1. KRS 292.480 is amended to read as follows:

(1) Any person, who offers or sells a security in violation of this chapter or of any rules or orders promulgated hereunder or offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made in the light of the circumstances under which they are made not misleading (the buyer not knowing of the untruth or omission) and who does not sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of the untruth or omission is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at the legal rate from the date of payment costs and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security. Damages are the amount that would be recoverable upon a tender less:

(a) The value of the security when the buyer is disposed of it; and
(b) Interest at the legal rate per annum from the date of disposition.

(2) Any person who purchases a security in violation of this chapter or of any administrative regulations or orders promulgated under this chapter or who purchases a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made in light of the circumstances under which they are made not misleading, the seller not knowing of the untruth or omission, and who does not sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of the untruth or omission is liable to the person selling the security to him, who may sue either at law or in equity for:
(a) A return of the security, together with any income received by the purchaser on the security, costs, and reasonable attorney's fees, upon a tender of the full amount of the consideration received for the security; or

(b) If the purchaser no longer owns the security, the difference between the fair value of the security at the date of the transaction and the consideration received for the security, together with interest on the difference at the legal rate compounded annually from the date of the transaction, and costs and reasonable attorney's fees.

(3) For purposes of paragraph (b) of subsection (2) of this section, when the purchaser no longer owns the security, if a seller seeking relief under paragraph (b) of subsection (2) of this section offers and presents admissible evidence of the highest intermediate value of the subject security as of some specific date occurring within a reasonable period of time after the date of the sale of the security but no later than the date an action under paragraph (b) of subsection (2) of this section is filed, or of the total consideration received by the purchaser in a subsequent sale of that security, it shall be presumed until rebutted by a preponderance of evidence to the contrary that the value or sale price, as applicable, is the fair value of the security at the date of the transaction as those terms are used in paragraph (b) of subsection (2) of this section to measure damages. For purposes of subsections (1) and (2) of this section and all other provisions of this chapter, statements and omissions may be either oral or written.

(4) Every person who directly or indirectly controls a seller or purchaser liable under subsection (1) or (2) of this section, every partner, officer, or director (or person occupying a similar status or performing similar functions) or employee of a seller or purchaser who materially aids in the sale or purchase, and every broker-dealer or agent who materially aids in the sale or purchase is also liable jointly and severally with and to the same extent as the seller or purchaser, unless the nonseller or
nonpurchaser who is so liable sustains the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist. There is contribution as in cases of contract among the several persons so liable.

(5) Any tender specified in this section may be made at any time before entry of judgment. Every cause of action under this statute survives the death of any person who might have been a plaintiff or defendant. No person may sue under this section more than three (3) years after the date the occurrence of the act, omission, or transaction constituting a violation of this chapter was discovered, or in the exercise of reasonable care should have been discovered. No person may sue under this section:

(a) If the buyer received a written offer, before suit and at a time when he owned the security, to refund the consideration paid together with interest at the legal rate from the date of payment, less the amount of any income received on the security, and he failed to accept the offer within thirty (30) days of its receipt;

(b) If the buyer received an offer before suit and at a time when he did not own the security, unless he rejected the offer in writing within thirty (30) days of its receipt; or

(c) If paragraph (b) of subsection (2) of this section applies, and if the seller received a written offer before suit equal to the difference between the greater of the highest intermediate value of the security or the consideration received by the purchaser upon disposal of the security and the consideration received by the seller for the security, together with interest on the difference at the legal rate from the date of the transaction; or if paragraph (a) of subsection (2) of this section applies, and if the seller received a written offer to return the security together with any income received by the purchaser on the security; and in either case he failed to accept the offer within thirty (30) days of its receipt;
receipt.

(6) No person who has made or engaged in the performance of any contract in violation of any provision of this chapter or any rule or order hereunder, or who has acquired any purported right under any contract with knowledge of the facts by reason of which its making or performance was in violation, may base any suit on the contract. Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this chapter or any rule or order hereunder is void.

(7) The rights and remedies provided by this section are in addition to any other rights or remedies that may exist at law or in equity.

Section 2. In the past ten years an inordinately high number of the citizens of the Commonwealth have invested the hard earned proceeds of their work in securities, individually and through employer sponsored plans, and as the number of investments in the securities market have so increased so too have the instances of fraud in that market. Even though the number of participants in the securities market has increased, a commensurate increase in the knowledge of a reasonable participant in the securities market has not closely followed. Therefore, the amendments contained in Section 1 of this Act shall be retroactively applied to any actions, other than those actions given res judicata effect by a court of competent jurisdiction, which in the exercise of reasonable care would have been discovered as having accrued in the ten (10) years immediately preceding the effective date of this Act.
HB102

WWW Version

HB 102 (BR 280) - R. Damron

AN ACT relating to mortgage loan companies and brokers.
Create a new section of KRS Chapter 294 to require a mortgage loan company to
maintain a minimum net worth of $20,000; amend KRS 294.020 to exempt certain
lenders from KRS Chapter 294; permit certain exempted persons relief from having to
file a claim of exemption; amend KRS 294.220 to make it unlawful for a mortgage loan
compay to charge a fee for the issuance of an initial written loan payoff amount or
payment history for each calendar quarter; prohibit any person who engages in the
business regulated by KRS Chapter 294 without a license to collect any principal,
charges, or recompense.

HB 102 - AMENDMENTS

HCS - Retain the original provisions; delete the requirement of a minimum net
worth; provide an exemption for any mortgage loan involving housing initially
transferred by certificate of title under KRS Chapter 186A; require any natural person
making a loan with his or her own funds for the person's own investment to provide a
disclosure statement; delete penalty for acting as mortgage loan company without a
license or exemption and replace it with a provision that a person who engages in such
action shall not collect interest or charges but the unpaid principal balance of the loan
must be paid in full.

HFA (1, R. Damron) - Provide that the requirement of a disclosure by natural
persons not apply to persons making less than 5 mortgage loans per year; make
penalty for transacting mortgage loan business without a license or that the exemption
apply to persons willfully transacting business without a license or exemption.

SFA (1, R. Sanders Jr) - Create a new section of KRS Chapter 367 to provide that
inquiries made by a motor vehicle insurance company or a motor vehicle dealer to a
consumer reporting agency about the credit history of a consumer within a 90 day
period shall be treated by the consumer reporting agency as 1 inquiry for purposes of
determining the credit score of the consumer.

SFA (2/Title, R. Sanders Jr) - Make title amendment.

Jan 4-introduced in House
Jan 5-to Banking and Insurance (H); posted in committee
Feb 14-reported favorably, 1st reading, to Calendar with Committee Substitute
Feb 15-2nd reading, to Rules; floor amendment (1) filed to Committee Substitute
Feb 20-posted for passage in the Regular Orders of the Day for Wednesday,
February 21, 2001
Feb 21-3rd reading, passed 94-1 with Committee Substitute, floor amendment (1)
Feb 22-received in Senate
Feb 27-to Banking and Insurance (S)
Mar 1-reported favorably, 1st reading, to Calendar; floor amendments (1) and (2-
title) filed
Mar 2-2nd reading, to Rules
Mar 7-posted for passage in the Regular Orders of the Day for Wednesday, March
7, 2001; 3rd reading; floor amendments (1) and (2-title) withdrawn; passed 33-0
Mar 8-received in House; enrolled, signed by each presiding officer, delivered to Governor
Mar 15-signed by Governor (Acts ch. 98)
AN ACT relating to mortgage loan companies and brokers.

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

Section 1. KRS 294.020 is amended to read as follows:

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

(a) Any person **duly licensed, chartered, or otherwise subject to regular examination at least once every two (2) years by a state or federal financial institution regulatory agency**[doing business] under the laws of this state or any other state or the United States **as a bank**[relating to banks], bank holding **company**[companies], trust **company**[companies], credit **union**[unions], savings and loan **association**[associations], service corporation **subsidiary**[subsidiaries] of savings and loan associations, consumer **loan or finance company**[companies], industrial loan **company**[companies], insurance **company**[companies], or real estate investment **trust**[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, or wholly owned subsidiary of any institution listed in this paragraph if the institution maintains a place of business in Kentucky;

(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) 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;

(e) 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.

(g) Any mortgage loan involving housing initially transferred by certificate of title under KRS Chapter 186A.

(2) The following shall be exempt from all the provisions of this chapter except that they shall be subject to the examination or investigation provisions of KRS 294.170(4), (5), and (6), 294.180, and 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 KRS 294.220:

(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.

(4) Any person listed in subsection (1)(a), (b), (c), (d), or (e) of this section shall not be required to file with the commissioner a claim of exemption.

(5) (a) Any natural person making a loan under subsection (2)(b) of this section shall make the following disclosure, on a separate sheet of paper in minimum eighteen (18) point type, to the borrower:

DISCLOSURE

(Name and address of lender) is not licensed or regulated by the Kentucky Department of Financial Institutions.

(Name of lender) is making this mortgage loan with his or her own funds, for the person's own investment, without intent to resell the mortgage loan.

(The phone number and address of the Kentucky Department of Financial Institutions).

(b) A copy of the disclosure, signed by the borrower, shall be maintained by the natural person for a period not to exceed three (3) years after the date the mortgage loan is paid in full.

(c) This subsection shall not apply to a natural person under subsection (2)(b) of this section making less than five (5) mortgage loans per year.

Section 2. KRS 294.030 is amended to read as follows:

(1) (a) It is unlawful for any person to transact business in this state, either directly or
indirectly, as a mortgage loan company or mortgage loan broker if he is not licensed under this chapter, unless that person is exempt under KRS 294.020 and, if required by subsection (3) of Section 1 of this Act to file a claim of exemption, has filed a claim of exemption and the filed claim of exemption has been allowed by the commissioner.

(b) It is unlawful for any natural person to make a loan under subsection (2)(b) of Section 1 of this Act without making the disclosure required by subsection (5) of Section 1 of this Act.

(2) Neither the fact that a license has been issued nor the fact that any person, business, or company is effectively registered, constitutes a finding by the commissioner that any document filed under this chapter is true, complete, and not misleading. Nor does such fact directly or indirectly imply approval of the registrant by the commissioner or the Commonwealth of Kentucky. It is unlawful to make or cause to be made to any prospective customer or client any representation inconsistent with this subsection.

(3) Any person who willfully transacts business in this state in violation of subsection (1) of this section shall have no right to collect, receive, or retain any interest or charges whatsoever on a loan contract, but the unpaid principal of the loan shall be paid in full.

Section 3. 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; or
(f) To charge a fee for the issuance of an initial written loan payoff amount or payment history for each calendar quarter as set out in paragraph (e) of this subsection.

(3) Unless exempted by KRS 294.020, and, if required by subsection (3) of Section 1 of this Act to file a claim of exemption, has filed a claim of exemption and the filed claim of exemption has been allowed by the commissioner, 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.
HB 113 (BR 274) - B. Heleringer

AN ACT relating to trusts and estates.
Amend KRS 395.625 to delete the annual fiduciary settlement publication requirement for blocked accounts of not more than $1,500.

HB 113 - AMENDMENTS

HFA (1, B. Heleringer) - Increase specified amount from $1,500 to $2,500.

Jan 5-introduced in House
Feb 6-to Judiciary (H)
Feb 12-posted in committee
Feb 15-reported favorably, 1st reading, to Calendar
Feb 19-floor amendment (1) filed
Feb 20-3rd reading, passed 100-0 with floor amendment (1)
Feb 21-received in Senate
Feb 26-to Judiciary (S)
Mar 5-reported favorably, 1st reading, to Consent Calendar
Mar 6-2nd reading, to Rules
Mar 7-posted for passage in the Consent Orders of the Day for Wednesday, March 7, 2001; 3rd reading, passed 38-0; received in House
Mar 8-enrolled, signed by each presiding officer, delivered to Governor
Mar 15-signed by Governor (Acts ch. 21)
AN ACT relating to trusts and estates.

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

Section 1. KRS 395.625 is amended to read as follows:

Not less than ten (10) days prior to the date of hearing, the clerk shall cause notice of the filing of a settlement to be published pursuant to KRS Chapter 424, stating the name of the fiduciary, the trust, the nature of the account and the date of hearing, with a statement that exceptions must be filed before that time; except that with the court's approval the fiduciary may, in lieu of such publication, send a written notice thereof to all unpaid creditors and distributees, which notice shall be mailed at least ten (10) days before said date of hearing. The fiduciary in such cases shall file his affidavit that such notice has been mailed. The actual cost of the notice, or the proportionate part thereof, if more than one (1) settlement, shall be taxed as costs. If the value of the trust or estate is not more than two thousand five hundred dollars ($2,500) and the assets of the trust or estate are held in an account that may be accessed only upon order of the court, the provisions of this section shall not apply to settlements involving that trust or estate.
AN ACT relating to security interests.

Amend KRS 186A.190 to provide that the notation of a security interest on a certificate of title for a manufactured home shall remain effective for a period of 30 years rather than 14 years; amend KRS 355.9-507 to provide that a debtor's name change which makes a financing statement seriously misleading shall be effective to perfect a security interest in the collateral acquired by the debtor before the change, or within 4 months after the debtor notifies the secured party in writing of the change; the financing statement is not effective to perfect a security interest in collateral acquired by the debtor more than 4 months after the debtor notifies the secured party in writing of the change unless an amendment to the financing statement which renders the financing statement not seriously misleading is filed within 4 months after the change; effective July 1, 2001.

Jan 5-introduced in House
Feb 6-to Banking and Insurance (H)
Feb 7-posted in committee
Feb 14-reported favorably, 1st reading, to Calendar
Feb 15-2nd reading, to Rules
Feb 19-3rd reading, passed 92-2
Feb 20-received in Senate
Feb 23-to Judiciary (S)
Mar 1-reassigned to Banking and Insurance (S); reported favorably, 1st reading, to Consent Calendar
Mar 2-2nd reading, to Rules
Mar 5-posted for passage in the Consent Orders of the Day for Tuesday, March 6, 2001; taken from the Consent Orders of the Day, placed in the Regular Orders of the Day
Mar 7-3rd reading, passed 36-0; received in House; enrolled, signed by each presiding officer, delivered to Governor
Mar 15-signed by Governor (Acts ch. 65)
AN ACT relating to security interests.

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

Section 1. KRS 186A.190 is amended to read as follows:

(1) Except as provided in subsection (4) of this section, the perfection and discharge of a security interest in any property for which has been issued a Kentucky certificate of title shall be by notation on the certificate of title. The notation of the security interest on the certificate of title shall be in accordance with this chapter and shall remain effective from the date on which the security interest is noted on the certificate of title for a period of seven (7) years, or, in the case of a manufactured home, for a period of thirty (30) years, or until discharged under this chapter and KRS Chapter 186. The filing of a continuation statement within the six (6) months preceding the expiration of the initial period of a notation's effectiveness extends the expiration date for seven (7) additional years.

(2) Except as provided in subsection (4) of this section, the notation of security interests relating to property required to be titled in Kentucky through the county clerk shall be done in the office of the county clerk of the county in which the debtor resides. If the debtor is other than a natural person, the following provisions govern the determination of the county of the debtor's residence:

(a) A partnership shall be deemed a resident of the county in which its principal place of business in this state is located. If the debtor does not have a place of business in this state, then the debtor shall be deemed a nonresident for purposes of filing in this state;

(b) A limited partnership organized under KRS Chapter 362 shall be deemed a resident of the county in which its office is located, as set forth in its certificate of limited partnership or most recent amendment thereto filed pursuant to KRS Chapter 362. If such office is not located in this state, the debtor shall be deemed a nonresident for purposes of filing in this state;
(c) A limited partnership not organized under the laws of this state and authorized to do business in this state under KRS Chapter 362 shall be deemed a resident of the county in which the office of its process agent is located, as set forth in the designation or most recent amendment thereto filed with the Secretary of State of the Commonwealth of Kentucky;

(d) A corporation organized under KRS Chapter 271B, 273, or 274 or a limited liability company organized under KRS Chapter 275 shall be deemed a resident of the county in which its registered office is located, as set forth in its most recent corporate filing with the Secretary of State which officially designates its current registered office;

(e) A corporation not organized under the laws of this state, but authorized to transact or do business in this state under KRS Chapter 271B, 273, or 274, or a limited liability company not organized under the laws of this state, but authorized to transact business in this state under KRS Chapter 275, shall be deemed a resident of the county in which its registered office is located, as set forth in its most recent filing with the Secretary of State which officially designates its current registered office;

(f) A cooperative corporation or association organized under KRS Chapter 272 shall be deemed a resident of the county in which its principal business is transacted, as set forth in its articles of incorporation or most recent amendment thereto filed with the Secretary of State of the Commonwealth of Kentucky;

(g) A cooperative corporation organized under KRS Chapter 279 shall be deemed a resident of the county in which its principal office is located, as set forth in its articles of incorporation or most recent amendment thereto filed with the Secretary of State of the Commonwealth of Kentucky;

(h) A business trust organized under KRS Chapter 386 shall be deemed a resident
of the county in which its principal place of business is located, as evidenced by the recordation of its declaration of trust in that county pursuant to KRS Chapter 386;

(i) A credit union organized under KRS Chapter 290 shall be deemed a resident of the county in which its principal place of business is located, as set forth in its articles of incorporation or most recent amendment thereto filed with the Secretary of State of the Commonwealth of Kentucky; and

(j) Any other organization (defined in KRS 355.1-201) shall be deemed a resident of the county in which its principal place of business in this state is located, except that any limited partnership or corporation not organized under the laws of this state and not authorized to transact or do business in this state shall be deemed a nonresident for purposes of filing in this state. If the organization does not have a place of business in this state, then it shall be deemed a nonresident for purposes of filing in this state.

If the debtor does not reside in the Commonwealth, the notation of the security interest shall be done in the office of the county clerk in which the property is principally situated or operated. 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. In other respects the security interest is governed by the provisions of KRS Chapter 355.

(3) Except as provided in subsection (4) of this section, before ownership of property subject to a lien evidenced by notation on the certificate of title may be transferred, the transferor shall obtain the release of the prior liens in his name against the property being transferred. Once a security interest has been noted on the owner's title, no subsequent title may be issued by any county clerk free of such notation.
unless the owner's title is presented to the clerk and it has been noted thereon, that the security interest has been discharged. If this requirement is met, information relating to any security interest shown on the title as having been discharged may be omitted from the title to be issued by the clerk.

(4) Notwithstanding subsections (1), (2), and (3) of this section, a county clerk shall, following inspection of the vehicle by the sheriff, to determine that the vehicle has not been stolen, issue a new title to a vehicle, clear of all prior liens, to a person after he provides to the county clerk an affidavit devised by the Transportation Cabinet and completed by the person. In the affidavit, the person shall attest that:

(a) He possesses the vehicle;

(b) A debt on the vehicle was owed him for more than thirty (30) days before he provided the notices required by paragraphs (c) and (d) of this subsection;

(c) More than fourteen (14) days before presenting the affidavit to the county clerk, the person attempted to notify the owner of the vehicle and all known lienholders, including those noted on the title, by certified mail, return receipt requested, of his name, address, and telephone number as well as his intention to obtain a new title, clear of all prior liens, unless the owner or a lienholder objected in writing;

(d) More than fourteen (14) days before presenting the affidavit to the county clerk, the person had published a legal notice stating his intention to obtain title to the vehicle. The legal notice appeared at least twice in a seven (7) day period in a newspaper published, and with a statewide circulation, in Kentucky. The legal notice stated:

1. The person's name, address, and telephone number;

2. The owner's name;

3. The names of all known lienholders, including those noted on the title;

4. The vehicle's make, model, and year; and
5. The person's intention to obtain title to the vehicle unless the owner or a lienholder objects in writing within fourteen (14) days after the last publication of the legal notice; and

(e) Neither the owner nor a lienholder has objected in writing to the person's right to obtain title to the vehicle.

(5) No more than two (2) active security interests may be noted upon a certificate of title.

(6) In noting a security interest upon a certificate of title, the county clerk shall ensure that the certificate of title bears the lienholder's name, mailing address and zip code, the date the lien was noted, the notation number, and the county in which the security interest was noted. The clerk shall obtain the information required by this subsection for notation upon the certificate of title from the title lien statement described in KRS 186A.195 to be provided to the county clerk by the secured party.

(7) For all the costs incurred in the notation and discharge of a security interest on the certificate of title, the county clerk shall receive the fee prescribed by KRS 64.012. The fee prescribed by this subsection shall be paid at the time of submittal of the title lien statement described in KRS 186A.195.

(8) A copy of the application, certified by the county clerk, indicating the lien will be noted on the certificate of title shall be forwarded to the lienholder.

Section 2. KRS 355.9-507 is amended to read as follows:

(1) A filed financing statement remains effective with respect to collateral that is sold, exchanged, leased, licensed, or otherwise disposed of and in which a security interest or agricultural lien continues, even if the secured party knows of or consents to the disposition.

(2) Except as otherwise provided in subsection (3) of this section and KRS 355.9-508, a financing statement is not rendered ineffective if, after the financing statement is filed, the information provided in the financing statement becomes seriously
misleading under KRS 355.9-506.

(3) If a debtor so changes its name that a filed financing statement becomes seriously misleading under KRS 355.9-506:

(a) The financing statement is effective to perfect a security interest in collateral acquired by the debtor before the change, or within four (4) months after the debtor notifies the secured party in writing of the change; and

(b) The financing statement 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 an amendment to the financing statement which renders the financing statement not seriously misleading is filed within four (4) months after the change.

Section 3. This Act takes effect July 1, 2001.
HB 148 (BR 946) - D. Ford

AN ACT relating to safe deposit boxes.
Create new sections of KRS Chapter 286 to authorize the lessor of a safe deposit box to permit access to certain persons to conduct a will search or to obtain any document purporting to be a deed to a burial plot or to give funeral or burial instructions; describe the duties of the employee of the lessor if a will is found or if a deed to a burial plot or funeral or burial instructions are found in the safe deposit box.

HB 148 - AMENDMENTS

HCA (1, D. Ford) - Change the definition of "interested person" to delete "adult descendant of the lessee."
HCA (2, D. Ford) - Require the interested person to have a key before lessor permits opening of the safe deposit box.
SFA (1, K. Stine) - Amend to permit an adult child to qualify as an "interested person" who may gain access to a safe deposit box upon the death of that adult child's parent who has been leasing the safe deposit box.

Feb 6-introduced in House
Feb 7-to Banking and Insurance (H)
Feb 12-posted in committee; posting waived
Feb 14-reported favorably, 1st reading, to Calendar with committee amendments (1) and (2)
Feb 15-2nd reading, to Rules; posted for passage in the Regular Orders of the Day for Friday, February 16, 2001
Feb 16-3rd reading, passed 97-1 with committee amendments (1) and (2)
Feb 19-received in Senate
Feb 22-to Judiciary (S)
Feb 28-reported favorably, 1st reading, to Calendar; floor amendment (1) filed
Mar 1-2nd reading, to Rules
Mar 5-posted for passage in the Regular Orders of the Day for Tuesday, March 6, 2001
Mar 7-3rd reading, passed 37-0 with floor amendment (1); received in House; posted for passage for concurrence in Senate floor amendment (1)
Mar 8-House concurred in Senate floor amendment (1); passed 95-1
Mar 9-enrolled, signed by each presiding officer, delivered to Governor
Mar 20-signed by Governor (Acts ch. 141)
AN ACT relating to safe deposit boxes.

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

SECTION 1. A NEW SECTION OF KRS CHAPTER 286 IS CREATED TO READ AS FOLLOWS:

As used in Sections 1 to 2 of this Act, unless the context requires otherwise:

(1) "Financial institution" means a state or national bank, trust company, savings and loan association, or credit union;

(2) "Interested person" means the surviving spouse of the lessee, an adult child of the lessee, a parent of the lessee, a person named as the personal representative in a copy of a purported will produced by such person, a person designated by the lessee in writing acceptable to the lessor that is filed with the lessor before death of the lessee, or a person named in a court order to examine the contents of a safe deposit box for a purpose listed in subsection (1) of Section 2 of this Act;

(3) "Lessee" means a person who contracts with a lessor for the use of a safe deposit box;

(4) "Lessor" means a financial institution or safe deposit company that rents safe deposit facilities; and

(5) "Safe deposit box" means a safe deposit box, vault, or other safe deposit receptacle maintained by a lessor that may be used for the safekeeping and storage of property and documents.

SECTION 2. A NEW SECTION OF KRS CHAPTER 286 IS CREATED TO READ AS FOLLOWS:

(1) If satisfactory proof of the death of the lessee is presented and the interested person possesses a key to the lessee's safe deposit box, a lessor shall permit an interested person to open and examine the contents of a safe deposit box leased by a decedent in the presence of an employee of the lessor for one (1) or both of the following purposes:
(a) To conduct a will search; and

(b) To obtain any document purporting to be a deed to a burial plot or to give funeral or burial instructions.

(2) If the safe deposit box is opened for the purpose of conducting a will search, an employee of the lessor shall remove any document that appears to be a will and make a true and correct machine copy thereof, replace the copy in the box, and then deliver the original thereof to the person requesting the search.

(3) If the safe deposit box is opened for the purpose of obtaining any document purporting to be a deed to a burial plot or to give funeral or burial instructions, the employee of the lessor shall make a true and correct machine copy thereof, replace the copy in the box, and then deliver the original thereof to the person requesting the search.

(4) No contents of a safe deposit box other than a will and a document purporting to be a deed to a burial plot or to give funeral or burial instructions may be removed under this section.
SIGNIFICANT JUDICIAL DEVELOPMENTS AFFECTING FINANCIAL INSTITUTIONS:
(A List From A to Z)

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Louisville, Kentucky

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SECTION B
This outline is designed to provide general information on the subject matters covered. It is not intended to provide either a complete survey of all possible developments or a comprehensive explanation or analysis of those developments mentioned. Readers should consult the original source materials referenced. Furthermore, this outline is not intended nor should it be used as a substitute for specific legal advice or opinion. Finally, this outline is published with the understanding that the publisher is not engaged in rendering legal service.

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21st Annual Conference On
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April 20-21, 2001

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1. **Action Loan Co. Consent Decree.** *United States of America v. Action Loan Co.*, U.S. District Court, Western District of Kentucky, No. 3:00CV-511-H (8/24/00).

   a. Action Loan Company, Inc., of Louisville, Kentucky, and its owner and president, Gus Goldsmith, agreed to pay a $350,000 civil penalty and up to a total of $37,000 in consumer redress as part of a joint settlement with the Federal Trade Commission and the Department of Housing and Urban Development resolving allegations that they violated various federal lending and consumer protection laws when making loans secured by real or personal property to consumers. The consent decree also contained a number of recordkeeping and reporting requirements to assist the FTC in monitoring the defendants' compliance with the terms of the settlement.

   b. The FTC and HUD charged the defendants with violating:
      
      i. The federal Truth In Lending Act and Regulation Z by failing to include the cost of accident and health insurance in their disclosure of the finance charge and annual percentage rate of a consumer loan;

      ii. Section 5 of the FTC Act by misrepresenting that consumers were purchasing only credit life insurance, when in fact they were also purchasing accident and health insurance;

      iii. The Equal Credit Opportunity Act and the Fair Credit Reporting Act by failing to provide consumers with required adverse action notices; and

      iv. The FTC's Credit Practices Rule by routinely including "waiver of exemption" and "homestead exemption waiver" provisions in their credit contracts.

      v. The Real Estate Settlement Procedures Act by receiving illegal kickbacks for the referral of loans.

2. **Arbitration.**

   a. **Green Tree Financial Corp. v. Randolph,** 121 S.Ct. 513 (12/11/00). Claims alleging violations of the federal Truth In Lending Act may be the subject of arbitration pursuant to an arbitration clause contained in a manufactured home retail installment sales contract. The arbitration agreement was enforceable even though it was silent as to the costs of arbitration where the party opposing arbitration presented no evidence that the arbitration would be prohibitively expensive.

On remand from United States Supreme Court, the Eleventh Circuit considered the issue of whether the arbitration agreement was unenforceable on the alternative ground that the agreement precluded the Plaintiff from bringing the claim as a class action. The arbitration agreement was silent on the issue of class arbitration, but Plaintiff had previously taken the position that the applicable rule is that where an arbitration clause does not expressly authorize class arbitration, no class arbitration is allowed. The Eleventh Circuit held that Congress did not create a non-waivable right to bring TILA claims in the form of a class action, so non-class arbitration was required.

c. Circuit City Stores, Inc. v. Adams, 121 S.Ct. 1302 (3/21/01). A provision in a Circuit City employment application contained an arbitration clause requiring all employment disputes to be settled by arbitration. The Supreme Court held that the exclusion in 9 U.S.C. §1 of "contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce" is to be narrowly construed and interpreted in light of the understanding of Congress' commerce clause authority when the Federal Arbitration Act was enacted. Thus, the exclusion only applies to contracts of employment of transportation workers but not to other employment contracts.

d. Arbitration provisions in application for employment was unenforceable for lack of mutuality of consideration where the arbitration forum was "fatally indefinite." The employment application stated that the arbitration forum had "unfettered discretion in choosing the nature of that forum" and the arbitration forum appeared to be a for-profit entity with ties to the employer. Floss v. Ryan's Family Steak Houses, Inc., 211 F.3d 306 (6th Cir. 5/1/00).

3. Bank Premises -- Slip And Fall. PNC Bank, Kentucky, Inc. v. Green, Ky., 30 S.W.3d 185 (10/26/00). Bank customer slipped and fell on an icy sidewalk outside the bank branch. The Bank's intermittent efforts to spread a melting agent on the sidewalk did not make the Bank a guarantor of the customer's safety where the measures were "reasonably prudent measures to increase the safety of the premises" and did not "heighten or conceal the nature of the dangerous condition." Nor did the Bank have a duty to warn the customer of the "obvious natural condition" caused by the icy weather.

4. Board Of Director's Standard Of Care. McCall v. Scott, 239 F.3d 808 (6th Cir. 2/13/01).

a. Shareholder derivative action brought against the directors of Columbia/HCA Healthcare Corporation alleging that the directors wrongfully failed to take action to prevent and stop alleged systematic Medicare and Medicaid billing fraud.

b. Among other defenses, the directors relied upon the following provision of the company's Articles of Incorporation:
“TWELFTH: A director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director; provided, however, that the foregoing shall not eliminate or limit the liability of a director (i) for any breach of a director’s duty of loyalty to the Corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under Section 174 of the General Corporation Law of Delaware, or (iv) for any transaction from which the director derived an improper personal benefit.”

c. Court rejected director’s arguments that this provision exempted them from all but “intentional” misconduct. Rather, the Court held that “to the extent that recklessness involves a conscious disregard of a known risk, it could be argued that such an approach is not one taken in good faith and thus could not be liability [which is permitted to be] exempted.”

d. Remember the rules are likely to be somewhat different in the bank context:

i. KRS 287.065(2):

"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."

ii. 12 U.S.C. §1821(k):

"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 Corporation, which action is prosecuted wholly or partially for the benefit of the Corporation . . . 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 Corporation under other applicable law."

5. **Check Kiting.** *In re: Cannon*, 237 F.3d 716 (6th Cir. 1/17/01). Under UCC §4-210(a)(1), a collecting bank has a security interest in an item and any accompanying documents or the proceeds of either in case of an item deposited in an account to the extent to which credit given for the item has been withdrawn or applied. Because of this security interest, a bank which gave credit on checks ultimately paid as part of a check kiting scheme was protected from the avoidable
preference provisions of the Bankruptcy Code, at least as long as the bank acted in the ordinary course and without knowledge of the check kiting scheme.


   a. United States seller of cotton defrauded purchaser located in India by intentionally shipping non-conforming low quality cotton. Purchaser then sued collecting bank alleging that the collecting bank failed to act in good faith and breached its duties of care. The collecting bank's role was to receive shipping documents from the seller (a bill of lading, invoice and sight draft), forward the documents to the purchaser's bank, and then remit funds received from purchaser's bank to seller. Purchaser sought to hold collecting bank liable on the theory that the collecting bank knew or should have known, from its prior transactions with the seller, that seller had previously defrauded other buyers.

   b. Sixth Circuit affirmed summary judgment in collecting bank's favor based upon unrefuted testimony from the bank's officers that the bank had no knowledge of prior fraudulent activity. Furthermore, liability could not be imposed upon the collecting bank based upon inferences to be drawn from the commercial terms used in the shipping documents since under either UCC Article 4 or the Uniform Rules for Collections, a collecting bank is "not responsible for the 'form, sufficiency, accuracy, genuineness, falsification, or legal effect of any documents' reflecting the underlying agreement between the seller and buyer."

7. Customer Records. Ousley v. First Commonwealth Bank of Prestonsburg, Ky.App., 8 S.W.3d 45 (2/12/99). Bank's implied duty of good faith obligates a bank to provide its former customer with records of its accounts if the records remain in the bank's custody and if the customer is willing to pay the cost of retrieving the records.

8. Deeds. Hoheimer v. Hoheimer, Ky., 30 S.W.3d 176 (10/26/00). Series of deeds from parents to their daughter, conveying various undivided fee interests in their farm and without reservation and with no language reserving a life estate or otherwise limiting the conveyance, were unambiguous. Thus, extrinsic evidence could not be used by the parents to demonstrate that the parents did not intend to give up control of the farm while they were still alive. Preserving the integrity of the recorded deed system required that parol evidence not be available to attack an unambiguous deed.

9. Discovery -- Document Requests. Wal-Mart Stores, Inc. v. Dickinson, Ky., 29 S.W.3d 796 (9/28/00). "A person -- regardless of whether that person is opposing counsel -- signing a response to a request for production, which is made pursuant to CR 34.01, holds him or herself out as having personal knowledge of the answers given and is subject to deposition for the limited purpose of exploring his or her actual knowledge of the answers given including, but not limited to, the methods
employed to search for the documents requested and the scope of that search."

10. Exemptions. *J.G. Wentworth v. Jones*, Ky.App., 28 S.W.3d 309 (4/14/00). First $350/month of annuity which was purchased to fund structured settlement was exempt from garnishment pursuant to KRS 304.14-330. Sums in excess of $350/month could only be executed against with court approval, and the trial court did not abuse its discretion in refusing to authorize execution.

11. Fair Credit Reporting Act. *TRW, Inc. v. Andrews*, United States Supreme Court, Docket No. 00-1045. The Supreme Court has granted certiorari to review a decision of the United States Court of Appeals for the Ninth Circuit that the two-year statute of limitations for violation of the federal Fair Credit Reporting Act begins to run from the date the consumer knew or should have known that she was injured by the credit reporting agency’s alleged disclosure of inaccurate information. The Ninth Circuit rejected the reporting agency’s position that the statute of limitations began to run on the date of the disclosure.

12. Fraud – Aiding And Abetting.

   a. *Aetna Casualty and Surety Co. v. Leahy Construction Co.*, 219 F.3d 519 (6th Cir. 7/13/00). Bank could be potentially liable for aiding and abetting the scheme of a construction company to obtain construction bonds by defrauding the insurance company as to the amount of assets of the construction company. Specifically, the construction company obtained a four-day loan of $275,000 from the Key Bank and during the period the loan proceeds were held by the construction company, the construction company provided a bank statement to the insurance company showing these funds on deposit. In reliance upon its belief that the construction company had improved its asset position, the insurance company issues construction bonds ultimately causing it to incur over $2.5 million in losses.

   b. Applying the test of Restatement, Second, of Torts §876(b), the Sixth Circuit held that the evidence supported the jury’s verdict that Key Bank had actual knowledge that the loan was being used to deceive the insurance company, and therefore could be liable for aiding and abetting its customer’s fraudulent scheme under the following standard:

     "Ordinarily, a bank does not have an obligation to investigate or question its customers' facially legal transactions: A bank, however, is not immune from civil aiding and abetting claims, and to the extent that its knowledge or the primary party’s tortious conduct can be proven, either by director or circumstantial evidence, liability will attach if the other elements are present. We stress that the requirement is *actual* knowledge, and therefore evidence establish negligence, i.e., that a bank ‘should have known’ will not suffice."

   c. The other elements include "substantial assistance or encouragement to the
primary party in carrying out the tortious act."

d. Because the insurance company's agent arguably knew of the scheme, Key Bank argued that the insurance company was charged with the agent's knowledge and therefore could not show that it had been deceived. The Sixth Circuit agreed that the trial court instructions to the jury on this point were incorrect, and that a new trial on this point was required.


a. Bank improperly responded to creditor's garnishment by stating that it did not hold property belonging to, nor was it indebted to, the judgment debtor. The evidence indicated that when the garnishments were served, the Bank checked its computer screens which showed the end of day balances for the prior day and did not reflect any deposits received on the actual day the garnishment was received.

b. The Sixth Circuit rejected the District Court's ruling that the Bank was entitled to use its "ordinary course of business" procedures for checking account balances. Rather, the Sixth Circuit held that the Bank could place a "hold" on the account on the day it received the garnishment in order to check available funds and comply with the "snapshot" requirement of Kentucky's garnishment statute, KRS 425.501.

c. The Sixth Circuit also held that the District Court improperly dismissed the judgment creditor's claim that the Bank intentionally manipulated the judgment debtor's accounts to avoid garnishment by implementing the judgment debtor's request (after the first two garnishments were received) to create a "zero balance" account structure. The judgment creditor was entitled to litigate its claim that the Bank violated a "duty to refrain from conduct that would obstruct enforcement of the judgment."

d. Finally, the Sixth Circuit directed that the Bank pay the judgment creditor's attorneys' fees and the expenses of a court appointed expert based upon the Bank's civil contempt in violating a garnishment order.

14. Guaranty Agreements. Wallace Hardware Co. v. Abrams, 223 F.3d 382 (6th Cir. 7/27/00). In an action against a Kentucky guarantor, Sixth Circuit enforced a Tennessee choice of law provision in a guaranty agreement that would have been invalid if Kentucky law (KRS 371.065) applied. Factors favoring enforcement were that it was a commercial transaction in which the parties were represented by counsel, counsel for the guarantor specifically review the guaranty, and the guaranty did generally refer to types of debts being guaranteed.

15. Integration And No-Modification Clauses In Contracts. Cook v. Little Caesar Enterprises, Inc., No. 99-1163 (6th Cir. 4/24/00). Franchisee precluded from alleging that he was promised franchise territories beyond the territories recited in written franchise agreements. The Court relied heavily upon the fact that the franchise
agreements contained a merger clause and a clause prohibiting modifications other than in a writing signed by the parties.


a. Alexander v. S&M Motors, Inc., Ky., 28 S.W.3d 303 (6/15/00). An award of attorneys fees under the Kentucky Consumer Protection Act to a party successfully making a claim under the KCPA is optional and not mandatory. Trial court did not abuse its discretion in denying attorneys fee award where the attorneys fees requested were less than the amount of punitive damages awarded to the plaintiff as part of its relief under the KCPA.

b. Craig v. Keene, Ky.App., 32 S.W.3d 90 (6/16/00). The KCPA does not apply to real estate transactions by an individual homeowner. Thus, homeowners could not assert a claim under the KCPA against a builder for alleged problems with the construction of their home. Jury found in favor of the builder on the plaintiff's fraud and breach of implied warranty of habitability claims but found a violation of the KCPA. However, the jury did not award any compensatory damages. Trial court awarded attorney's fees to plaintiff's counsel. Court of Appeals reversed.

17. Marshaling Of Assets. In re Technologies International Holdings, Inc., 256 B.R. 476 (Bkrtcy.E.D. Ky. 12/28/00). Guarantor under absolute and unconditional guaranty agreement could not invoke the equitable doctrine of "marshaling of assets" to avoid the express provisions of the guaranty which waived any requirement to first proceed against the borrower or to realize or exhaust any collateral. In addition, marshaling is a remedy which can be invoked only by a secured creditor, and the guarantor was not a secured creditor.

18. Materialman's Lien and Mortgages. Metal Sales Mfg. Corp. v. Newton, Ky.App., 12 S.W.3d 691 (4/23/99). Construction lender recorded mortgage prior to date materialmen filed their lien statement. Thus, under KRS 376.010(2), the lender's mortgage would be superior to the materialmen's liens so long as the mortgage was given "for value without notice." Court of Appeals held that the "for value" requirement was not satisfied where the mortgage loan was a "roll over" of three prior bridge loans. The lender could not rely upon the future advances protection granted by KRS 382.520 because this statute provides superior priority only against "liens of encumbrances ... created after recordation." In this case, the Court of Appeals held that the materialman's lien was created before recordation because a materialman's lien exists from the time materials are first provided.

19. Paralegals And The Attorney-Client And Work-Product Privileges. Wal-Mart Stores, Inc. v. Dickinson, Ky., 29 S.W.3d 796 (9/28/00). Paralegal in Wal-Mart's in-house legal department was protected by the attorney-client and work-product privileges to the same extent as the in-house counsel with which she worked.

20. Punitive Damages. Commonwealth v. Vinson, Ky., 30 S.W.3d 162 (10/26/00). Punitive damages may be awarded against a defendant that commits an intentional
tort willfully and without justification even though the plaintiff is not awarded compensatory damages by the jury.

21. **Real Estate Closings And The Unauthorized Practice Of Law -- KBA U-58.**
   Countrywide Home Loans, Inc., et al. v. Kentucky Bar Association, Kentucky Supreme Court, No. 2000-SC-00206. On March 16, 2001, the Kentucky Supreme Court heard oral arguments on the issue of whether the Kentucky Bar Association unauthorized practice of law opinion U-58 establishes the correct standards for what activities non-lawyers may perform in connection with the closing of a consumer real estate closing. The Bar Association promulgated U-58 to address the growing practice of lay title insurance agencies closing such loans. The Kentucky Bankers Association is participating in the action to preserve the existing standards of U-31 which permit a bank’s lay employees to perform the ministerial acts of conducting a loan closing in which it is the mortgagee.

22. **Tax Liens.**
   a. **Blachy v. Butcher,** 221 F.3d 896 (6th Cir. 7/21/00). Under Michigan law, a constructive trust in favor of a creditor does not arise until the court’s judgment is entered, and therefore the constructive trust cannot be applied retroactively to defeat a federal tax lien that is filed prior to the date of the judgment. Even if Michigan law would generally allow a constructive trust to be applied retroactively to the date of the wrongdoing, federal law governs the priority of a federal tax lien against competing claims, and federal law would not permit such a retroactive application of a constructive trust to defeat a properly filed federal tax lien.
   b. **Hensley v. Harbin,** No. 98-6569 (6th Cir. 11/9/00). Federal judgment was inferior to a federal tax lien where the tax lien was filed before the amount of the judgment was finally established in the federal court action. The fact that the issue of liability was established prior to the filing of the tax lien did not give judgment creditor priority.

23. **Usury.**
   a. **Commonwealth v. Kentucky Title Loan, Inc.,** Ky.App., 16 S.W.3d 312 (6/11/99). Motor vehicle title loan company could not rely upon the usury limits available to "pawnbrokers" under KRS Chapter 226 because it did not take actual physical custody of the motor vehicles. In order to exceed the general lending limit of KRS 360.010, the company was required to be licensed as a petty loan company under KRS Chapter 288.
   b. **Begala v. PNC Bank, Ohio, N.A.,** 214 F.3d 776 (6th Cir. 6/7/00). National bank’s "payment holiday" program did not violate either the Truth In Lending Act, RICO, or the applicable usury rate under the National Bank Act. In determining the applicable maximum interest rate, the Sixth Circuit noted that under the "Most Favored Lender" rules of 12 U.S.C. §85, national bank could borrow the rates permitted to Ohio savings bank. Because Ohio law permits
savings banks to charge unlimited fines, interest and premiums on loans, the borrower could not complain about the interest rate. Is there any maximum interest rate under Kentucky law in light of these Ohio rules, the doctrine of interest rate exporting under the National Bank Act, and “super parity” under KRS 287.102(2)(a)?

24. Wills – Abatement of Bequests To Pay Estate’s Debts And Taxes. Houghland v. Lampton, Ky.App., 33 S.W.3d 536 (12/15/00). Where residuary estate was not sufficient to pay all of the debts, taxes and costs of administration, general rule is that all nonresiduary legacies are required to abate proportionally in the absence of a specific direction otherwise in the will. Will at issue did not provide the requisite “specific direction” in order to protect trust established under will from abatement.
NEW THIS MONTH:

* Maryland court reverses order compelling arbitration. (¶ 8)
* First Union settles Signet pension plan case. (¶ 23)
* Supreme Court upholds employment arbitration clause. (¶ 3)
* Alabama Supreme Court upholds arbitration clause signed by illiterate. (¶ 6)
* Internet gambling RICO case dismissed. (¶ 15)

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New cases and cases in which there have been significant developments since the last monthly report are marked *.
ANTITRUST

1. In Re: Visa Check/Master Money Antitrust Litigation (2d Cir. No. 00-7699). Wal-Mart, other large retailers and several trade associations of the retail industry filed suit claiming (among other things) that Visa and Mastercard rules requiring all merchants who accept Visa and Mastercard credit cards to accept also the debit cards of those two associations constituted an illegal tie-in in violation of the antitrust laws. The plaintiffs sought to have the suit certified as a class action on behalf of about three million merchants who accept the cards. The District court certified the class and the defendants appealed. On August 24, 2000, ABA and three cosponsors filed an amici curiae brief supporting Visa and Mastercard. The brief argues that the court mis-read Supreme Court precedent that does not allow a trial court to make preliminary determinations as to the merits of a case before deciding whether to certify it as a class action. Here, the lower court relied only upon the affidavit of a plaintiff witness that the class would be manageable and disregarded the opposing affidavit of a defense witness. Choosing between the testimony of the two witnesses, the brief contends, would not constitute a preliminary determination of the merits, but rather was necessary to determine the threshold question of the class’s manageability. Oral argument held February 5.

2. United States v. Visa, U.S.A. (S.D.N.Y. No. 98-CIV-7076). On October 7, 1998, Justice Department filed antitrust suit against Visa and Mastercard challenging the "rules" of both networks prohibiting their respective member banks from offering credit cards that compete with those two. The rules allegedly have the effect of eliminating real competition between Visa and Mastercard and hampering competition or potential competition from other networks. Trial has been completed; a verdict is pending.

ARBITRATION

* 3. Circuit City Stores v. Adams (S. Ct. No. 99-1379). On May 22, 2000, Supreme Court granted certiorari in a case involving mandatory arbitration clauses to which employees of a retail establishment agree as a condition of their employment. Oral argument case held November 6. On March 21, 2001, Court upheld the arbitration clause, resolving a conflict among the circuits over whether employment agreements were all exempt from the reach of the Federal Arbitration Act. The exemption that appears in Section 1 of the Act is, according to the Court, limited to the employment contracts of workers actually engaged in the interstate transportation business. On March 26, the Court vacated three other Ninth Circuit decisions against Circuit City on the same issue, and granted certiorari in EEOC v. Waffle House (No. 99-1823). Having just held that employees can be bound by their agreement to arbitrate, the Court will now decide whether EEOC, acting on behalf of employees, is likewise bound by the employees’ agreements to arbitrate. The circuits are split on that question.

4. Baron v. Best Buy (11th Cir. No. 99-14028). In this case that challenges the fairness and reasonableness of the arbitral forum chosen by a mandatory arbitration clause in a consumer finance contract, a federal court refused a motion to compel arbitration on September...

5. Betts v. Advance America (M.D. Fla. No. 6:99-CIV-ORL-99C). Putative class action suit was filed against payday lender claiming violation of usury laws. On April 27, 2000, plaintiff filed "Motion for Protective Order" directed at the lender's practice, since March, 1999, of requiring customers to agree to mandatory binding arbitration of any disputes arising between the parties to the payday loan arrangement. Plaintiff (who was herself never a party to any mandatory arbitration agreement with the lender) alleges that the arbitration clauses at issue would unlawfully diminish the size of the class she seeks to represent in that it infringes upon the court's duty to protect the interests of potential class members and interferes with the court's authority to effectuate the policies of the federal class action rule.

6. Johnnie's Homes v. Holt (S. Ct. Ala. No. 1991404). Alabama residents purchased a mobile home manufactured in Georgia from an Alabama dealer. The sales contract contained a mandatory arbitration clause which the buyers did not read because they were illiterate. They did not disclose their inability to read to the sellers and the sellers took no special pains to point out or explain the arbitration clause or, for that matter, any other of the boilerplate provisions of the contract. On January 12, 2001, state Supreme Court held that the transaction was covered by the Federal Arbitration Act because there was sufficient involvement of interstate commerce, and that the clause would be enforced despite the buyers' illiteracy in the absence of fraud, deceit or misrepresentation.

7. Crawford v. Cavalier Homes (S. Ct. Ga. No. SOOC1820). A state trial court refused to compel arbitration of a dispute between a consumer and his mobile home manufacturer, seller and lender, even though the consumer had signed a boilerplate contract in which he agreed to resolve all disputes by arbitration. The court held that the arbitration clause lacked mutuality, was unconscionable due to a disparity in bargaining power and that the defendants had failed to disclose the costs associated with arbitration. The Georgia Court of Appeals reversed on June 30, 2000, finding no unconscionability under either Georgia law or applicable Alabama law. Consumer appealed and Georgia Supreme Court agreed to entertain the case. Opening briefs filed November 16, 2000. On February 5, 2001, ABA, Georgia Bankers Association and other co-sponsors filed amici brief supporting lender.

8. Wells v. Chevy Chase Bank, FSB. (Ct. App. Md. No. 22). Credit card agreement contained "change of terms" clause, pursuant to which Bank added a mandatory arbitration clause and changed other terms as well. Class action plaintiffs filed suit challenging legitimacy of several of the other changes and Bank filed motion to compel arbitration. On August 16, 1999, court granted motion holding that plaintiffs had been properly notified of the change in terms adopting the arbitration agreement, in accordance with applicable Maryland law, that arbitration agreement was not an unenforceable waiver of jury trial, was not unconscionable did not impose excessive or chilling fees on the plaintiffs and did not deprive them of any substantive remedy (Balto. City Cir. Ct. No. 24-C-99-000202). The plaintiff appealed the grant of the motion to compel arbitration and the bank filed a motion to dismiss the appeal for lack of jurisdiction. On
March 8, 2001, Court of Appeals held that an order to compel arbitration was a final and appealable order under Maryland procedural law, even though it might not have been so under federal procedural law. The Federal Arbitration Act does not preempt state procedural law unless such law singles out arbitration clauses for special and unfavorable treatment. Maryland law does not. On the merits, the Court held that the parties had never agreed to mandatory arbitration. The contract between them called for mediation or arbitration "at the request of the claiming party." Here, the "claiming party," the plaintiffs, had never requested any such thing. Oddly enough, no participant in the case had advanced that argument to the court.

BANKRUPTCY

9. **First Tennessee Bank v. Stevenson (In re Cannon).** (6th Cir. No. 99-6446). Upon collapse of his check-kiting scheme, debtor declared bankruptcy. Less than 90 days beforehand, he had made a deposit in the bank which the bank applied to reimburse itself for prior bounced checks the debtor had written. Bankruptcy court held that Trustee was entitled to recover those deposits as avoidable preferences and on August 27, 1999, District Court affirmed, holding that the Bank's statutory security interest in items deposited into an account applied only to "valueless paper checks," thereby making the bank essentially an unsecured creditor (W.D. Tenn. No. 98-2507-G/Bre). The case was appealed to the Sixth Circuit. On January 17, 2001, the court reversed, holding that kited checks were not "valueless" and indeed were worth every penny of their face value for the period during which the bank extended provisional credit, and that the bank had a valid security interest in those checks. To hold otherwise "would wreck Article 4's (UCC) system of conditional credits."

CONSUMER PROTECTION

10. **National Home Equity Mortgage Association v. Face.** (4th Cir. No. 99-2331) In the Alternative Mortgage Transaction Parity Act of 1982, Congress granted housing creditors (even those not federally chartered) the authority to make alternative mortgages in accordance with OTS regulations notwithstanding contrary state law. States were permitted to "opt out" of this statute at any time before October, 1995. Virginia did not do so. In 1996, OTS "clarified" that the statute preempted state prohibitions against or limitations upon prepayment penalty clauses. Virginia Bureau of Financial Institutions nevertheless announced that it would enforce state's limitations on prepayment penalties. Trade association for home equity lenders filed suit. On September 10, 1999, court granted it summary judgment holding that Congress had not imposed any temporal limitation upon when OTS had to act in order for regulations to be granted preemptive effect (E.D. Va. No. 3:00cv398). Decision was appealed to the Fourth Circuit. On February 7, 2001, decision was affirmed. OTS and the Comptroller of the Currency derive their authority to make rules regarding prepayment penalties imposed by federally chartered institutions from HOLA and the National Bank Act, not from the Parity Act.

11. **Heaton v. Monogram Credit Card Bank** (5th Cir. No. 99-31341). Under Section 27 of Federal Deposit Insurance Act, a "state bank" can charge interest (and things like late fees) at rates authorized by law of state where the bank is located. Among other things, a state bank is
defined as one engaged in the business of receiving deposits. Louisiana resident challenged a late fee that was legal in Georgia (where the bank was located) but allegedly not legal in Louisiana. She contended that Monogram was not a "state bank" in that its only deposits were a few decade-old contributions from out-of-state affiliates of Monogram and that did not constitute being engaged in the business of receiving deposits. The Eastern District of Louisiana agreed (Civil Action No. 98-1823, Nov. 23, 1999) and the lender appealed. On March 29, American Financial Services Association, ABA, and Consumer Bankers Association filed supporting amici brief arguing that FDIC had necessarily determined, a dozen years ago, that Monogram was engaged in the business of receiving deposits as a predicate to its having granted deposit insurance to the bank. Only FDIC can change that determination, which is conclusive, and it is not subject to collateral attack by private party litigation. On November 2, 2000, Fifth Circuit held that the district court order was unreviewable as a "remand" to the state courts for lack of federal jurisdiction. A petition for rehearing and rehearing en banc was denied on January 5, 2001, and on the same day the Eastern District of Louisiana again determined that it did not have jurisdiction over the case and remanded it to the Civil District Court for the Parish of Orleans.

12. Turner v. Beneficial Corporation (11th Cir. No. 99-23381-F). Consumer filed Truth in Lending Act case as purported class action. District Court refused to certify a class, holding that there cannot be a class action for actual damages under the Act because questions of each "class" member's actual reliance upon alleged misstatements would predominate over common questions of law or fact. Consumer filed interlocutory appeal, which the Eleventh Circuit accepted, arguing that actual reliance is not required. Appellant's brief filed October 25, 1999. On December 6, 1999, American Financial Services Association, ABA and Consumer Bankers filed amici brief supporting lender, pointing out that legislative history of Truth in Lending Act made clear Congressional intent to require reliance. On December 21, 2000, a 3-judge panel of the court opined that the plain language of the statute requires a showing of detrimental reliance, but that another panel of the court, earlier in 2000, had reached the opposite conclusion (Jones v. Bill Heard Chevrolet, 212 F.3d 1356) and that the Turner panel was bound by that until a different decision is reached by an en banc decision of the court or by the Supreme Court. In January, 2001, on its own motion, the Eleventh Circuit vacated that opinion and granted an en banc hearing in the case. On February 22, the en banc court upheld District Court's refusal to certify the class, concluding that the statutory language pertaining to actual damages "as a result of" a faulty disclosure, together with the legislative history of the 1974 amendments to the Act showed an intent of Congress to require proof of reliance. The court explicitly overruled Jones v. Bill Heard to the extent that decision is inconsistent.

A case raising the same issue under the Consumer Leasing Act, Andry v. GMAC (E.D. La. No. 97-CV-2552), was accepted for interlocutory appeal by the Fifth Circuit (Case No. 99-30958). On January 20, 2000, American Financial Services Association, ABA and Consumer Bankers Association filed amici brief arguing that the same legislative history described above was applicable to Consumer Leasing Act. On November 2, 2000, the Fifth Circuit held that detrimental reliance was indeed an element to any claim for actual damages under Truth in Lending or the Consumer Leasing Act (Perrone v. GMAC, 232 F. 3d 433). On January 31, 2001, that case was petitioned to the Supreme Court (Case No. 00-1251).
13. Bank of America v. San Francisco (9th Cir. Nos. 00-16355, 00-16394). City Council of Santa Monica and voters of San Francisco, by referendum, barred imposition of bank ATM fees upon non-customers of owner banks. Two national banks and the California Bankers Association filed suit on November 3, 1999 alleging that municipal ordinances were preempted with respect to national banks by the National Bank Act as construed by the Comptroller of the Currency and that the ordinances could not be "severed" so as to be applied to state chartered banks only. On November 15, court granted a preliminary injunction to the plaintiffs. Cities filed notice of appeal. On March 3, 2000, ABA and two co-sponsors filed amici brief arguing that the preliminary injunction should be upheld as contributing to the public interest. Ninth Circuit affirmed on March 31 (Nos. 99-17590, 17591). District court entered permanent injunction on June 30. Notices of Appeal filed. July 14 (Santa Monica) and July 18 (San Francisco). Banks' briefs filed December 13. ABA and two co-sponsors filed supporting amici brief a week later.

14. Phanco v. Dollar Financial Group (C.D. Cal. No. 99-CV-1281); Wirdzek v. Monetary Management of California (E.D. Cal. No. F-99 5415 REC LJO). Phanco was filed on February 8, 1999; Wirdzek was originally filed in California state court but removed to federal court on March 30, 1999. Both cases allege that the rate of interest charged on so-called "pay day" loans (Customer writes personal check for principal and interest, receives principal on the spot, lender agrees not to deposit check for 14 days) exceed California legal limits and are offered without compliance with state disclosure laws. At issue in the cases is whether an out-of-state national bank (in a jurisdiction in which there are no or very high usury ceilings) is the true lender in these instances or whether the local check casher has engaged in a "rent-a-bank" scheme to evade the law.

15. In re Mastercard International Internet Gambling Litigation (E.D. La., MDL Nos. 1321, 1322). Internet gamblers used their respective credit cards to fund their activities and then became distressed when issuing banks actually expected them to pay their credit card bills. Assorted suits were filed against issuing banks and credit card associations charging RICO violations, seeking treble damages, attorneys fees and costs. Thirty-three such suits were transferred to the Eastern District of Louisiana by the Judicial Panel on Multidistrict Litigation. On February 23, 2001, court dismissed the two of those that had been designated the "test cases." The court held that internet gambling, except for gambling on "sporting events" rather than on games of chance, was not a violation of any federal statute and was not a violation of important enough state statutes. For violation of a state statute to constitute a "predicate offense" for RICO purposes, it must be punishable by at least one year in prison. Here, the applicable state gambling statutes were civil in nature. There thus being no "predicate offenses," there could be no RICO violation and no cause of action. (2001 U.S. Dist. LEXIS 2407).

16. Cason v. Nissan Motor Acceptance Corp. (M.D. Tenn. No. 3-98-0223). Auto dealers originate and technically make loans to customers, then immediately assign such loans to Nissan Acceptance. Nissan sets a "buy rate," the lowest interest rate at which it will take a dealer originated loan. The dealer is free to originate loans at a higher rate than that, with the
dealer and Nissan then splitting the difference. African-American borrowers alleged disparate treatment by a particular dealer in Nashville in violation of the Equal Credit Opportunity Act in that African-Americans ended up paying disproportionately greater discretionary finance charges and higher rates that otherwise identically situated white borrowers. Nissan, though it did not originate or make the loans, was also named as a defendant. On May 31, 2000, it filed a motion for summary judgment, claiming that only the dealer could be liable under the circumstances. On July 31, the Justice Department Civil Rights Division filed an amicus curiae brief opposing that motion, claiming that Nissan had a non-delegable duty to assure that loans it took by assignment from its dealers complied with ECOA.

17. Astryan v. Union Bank of California (Cal. Super. [L.A.] No. BC 212605). On June 25, 1999, class action suit was filed against six banks for allegedly selling confidential data concerning their credit card customers to telemarketing firms and others. Doing so was said to violate the state constitution's right to privacy and provisions of the state Business and Professions Code. A similar case, Hatch v. US Bank National Association (D. Minn.), settled on June 30 with the bank agreeing to allow customers to "opt out" of having their information shared with third parties. A private class action lawsuit, purporting to represent consumers in all 17 states where US Bank does business, was filed on June 11 (Korn v. U.S. Bank, No. Cv 99-893 MJD/JGL (D. Minn.)). Litigation was filed against Zions Bank and its affiliate, Digital Signature Trust, in U.S. District Court in Utah on August 10, 1999 (Arcanys v. Zions First National Bank, No. 2-99CV616C) alleging misuse by Zions of confidential information supplied by a loan applicant to the competitive benefit of Digital Signature. Eight days later, the Tenth Circuit voided FCC regulations that seriously limited the ability of telecommunications providers to use consumer proprietary network information. The court held that the regulations violated the right of the providers to engage in commercial speech protected by the First Amendment. The providers also contended that customer information belonged to the provider, that such information was a valuable property right, and that they could not be deprived of that right without due process under the Fifth Amendment. The court did not reach that issue. (U.S. West v. Federal Communications Commission, No. 98-9518).

CREDIT UNIONS

18. American Bankers Association v. National Credit Union Administration (D.C. Cir. No. 00-5195). On January 8, 1999, ABA sued to enjoin implementation of NCUA's new "field of membership" rules, alleging that in numerous respects the rule exceeds the limits on membership that Congress left in the law when it amended the Federal Credit Union Act in August, 1998. CUNA and NAFCU filed petitions to intervene on January 12, ICBA did so as well on January 15. On March 4, a small upstate New York federal credit union intervened in the case as a plaintiff, complaining of illegal competitive injury to the credit union as a result of NCUA's bias in favor of ever-larger FCUs. On March 10, court denied a motion for a preliminary injunction. With respect to most of the issues raised by the motion, the court found an insufficient likelihood of success on the merits; with respect to the one issue upon which there was a great likelihood of success, the motion was denied on the grounds of failure to show irreparable injury. ABA filed amended complaint on April 1 asserting specific instances where

ENFORCEMENT

19. Murphy v. Beck (S. Ct. No. 00-46). In 1942, Supreme Court held, in the D'Oench Duhme case, as a matter of federal common law, that the FDIC as receiver was not subject to suit over the misdeeds or breaches of contract of a failed institution that was not apparent on the books and records of the institution. Subsequent legislation in 1950 and in 1989 codified at least some of the D'Oench Duhme doctrine, and two subsequent Supreme Court decisions (Atherton and O'Melveny & Myers elliptically called into question the continuing validity of the "common law" rule. The circuits are split over whether any part of the common law rule remains or has been entirely superseded by legislation. The Supreme Court granted certiorari in October, 2000 to resolve the conflict. Oral argument held January 17, 2001.

PRODUCTS & SERVICES

20. Association of Banks in Insurance v. Duryee. (6th Cir. No. 99-3917). On November 6, 1998, ABI, ABA Insurance Association, Ohio Bankers Association and Huntington National Bank sued state Superintendent of Insurance for declaratory judgment and injunction against enforcement of state's "controlled business" statutes that do not allow licensing of banks as title insurance agents and place limitations upon the market that may be served by a banks' offering of other types of insurance. With respect to national banks located and doing business in places with a population not exceeding 5,000, those state laws are preempted by federal law. The Independent Insurance Agents of America and a coalition of other industry trade associations intervened in the case as defendants. On June 18, 1999, District Court granted declaratory judgment and permanent injunction in favor of the plaintiffs on all issues. The court held that (1) even a concession by the Insurance Commissioner that title insurance prohibitions were preempted did not prevent issuance of an injunction in light of Commissioner's history of obstructing bank insurance efforts; and (2) both the "controlled business" statutes and "principal purpose" statutes in effect in Ohio significantly interfered with the business of national banks in violation of the Supreme Court's Barnett standard (S.D. Ohio No C2-98-1120). On July 19, intervenor insurance trade associations filed a Notice of Appeal. The Commissioner did not appeal. Appellants' brief filed September 27; appellees' brief filed October 27. Oral argument held August 2, 2000. Subsequently, the parties were permitted to file additional briefs responding to questions from the panel as to the possible effect upon the outcome that the Gramm-Leach-Bliley Act would have. That Act had not been passed as of the time the original briefs were prepared.
21. Individual Reference Services Group v. Federal Trade Commission (D.D.C. No. 1:00CV01828). Title V of the Gramm-Leach-Bliley Act regulates the disclosure and re-disclosure of certain "nonpublic personal information," which it goes on to define as "personally identifiable financial information." The FTC, SEC and the five federal depository institution regulators have adopted implementing rules that are scheduled to go into effect on November 13, 2000. The rules further define "personally identifiable financial information" as any information a consumer provides in order to obtain a financial product or service or any other information a regulated institution obtains about a consumer in connection with providing such a product or service to the consumer. On July 28, 2000, a trade association representing consumer reporting agencies filed suit to enjoin the rules, contending that the rules exceed the statutory authorization by regulating the disclosure and re-disclosure of information (such as, e.g., names, addresses and phone numbers) that is clearly not "financial" information. The consumer reporting agencies claim that they will no longer be able to acquire such information from financial institutions nor repackage and sell such information as they are allowed to do under the Fair Credit Reporting Act (which Gramm-Leach-Bliley specifically preserves) and under the First Amendment to the Constitution. The plaintiff filed a motion for summary judgment in November, 2000.

TAX

22. Mellon v. United States. (Fed. Cir. No. 01-5015). Section 67 of the Internal Revenue Code allows taxpayers a deduction for certain miscellaneous expenses to the extent that those expenses exceed 2% of adjusted gross income. In the case of trusts and estates, a full deduction is permitted for costs that would not have been incurred if the property were not held in trust or in an estate. Mellon, as trustee or executor for numerous trusts and estates, contends that investment advice and management fees necessarily paid by the trusts and estates is entitled to a full deduction; the IRS contends that those fees are subject to the 2% limit because similarly situated taxpayers that are not trusts or estates could (though they need not) choose to incur the same expenses. On April 13, 2000, ABA filed amicus brief supporting Mellon and contending that, if the IRS position were correct, then the special provision for estates and trusts would be essentially meaningless. On July 17, court denied cross-motions for summary judgment. It held that the expenses incurred are potentially covered by the 2% rule, i.e., not exempt from it as a matter of law, but that there had to be a finding of fact concerning which expenses would or would not actually have been incurred if the property were not held in trust. When Mellon thereafter declined to present "evidence" on what it believed to be a pure question of law, the court entered judgment for the IRS. (Ct. Fed. Cl. No. 97-151 T and 20 consolidated cases). Mellon appealed to the Federal Circuit on October 18. The bank and the ABA as amicus curiae filed briefs on December 21, 2000.

TRUST

* 23. Franklin v. First Union. (E.D. Va. No. 3:99CV344). On May 5, 1999, class action complaint was filed on behalf of former Signet Bank employees who had participated in employer's 401(k) plan, which plan First Union purported to merge into its 401(k) program for its employees upon the acquisition of Signet Bank by First Union. The plaintiffs allege that the
"merger" violated requirements of the Signet plan, was done without necessary notice to participants or opportunity extended to them to make other arrangements, violated ERISA, deprived participants of vested rights and breached fiduciary duties owed to the participants. On September 7, 1999, a second suit (also captioned Franklin v. First Union) was filed in the same court by a putative class of pre-existing First Union employees alleging various misuses of the 401(k) plan of those employees for the bank's benefit rather than the employees' benefit, such as limiting investment choices to mutual funds operated by a bank sub where performance was allegedly mediocre and fees allegedly high. The litigation was settled in late March, 2001. News reports indicate that the bank agreed to pay $26 million to over 150,000 employees, past and present. Pleadings in both cases are posted on the internet. See www.firstunionsuit.com

MISCELLANEOUS

24. Louisiana Federal Land Bank Association v. Farm Credit Administration (D.D.C. No. 1:00CV01582). Farm Credit Administration has historically carved up the nation into exclusive territories for its various System institutions. It had allowed such institutions to purchase participation interests in loans originated outside their territories if they provided notice or acquired the consent of the sister institution in whose territory the loan did originate. On April 25, FCA abolished this requirement. On June 30, 2000, the Farm Credit Bank of Texas and five affiliated Land Bank Associations sued. It seems that in 1988 a different Farm Credit Bank failed and was sold to FCB-Texas. One of the terms and conditions of the purchase and assumption transaction was that FCB-Texas would acquire permanent territorial service rights over the territory of the failed institution, a deal later ratified by explicit federal legislation. The new rule is alleged to violate the Farm Credit Act as amended.

25. Waters v. Mellon Bank Corp. (E.D. Pa. No. 99 CV 2825). Blind customers and potential customers of bank filed suit on June 3, 1999, under Title III of the Americans with Disabilities Act. The complaint alleges that the bank's ATM machines are not sufficiently accessible to the visually impaired and that the bank should be compelled to install "voice guidance technology" in each such ATM. A similar suit was filed at the same time against PNC in the Western District of Pennsylvania. The PNC litigation was settled out of court in January, 2001. On May 24, 2000, a third suit was filed in U.S. District Court for the District of Columbia (National Federation of the Blind v. Chevy Chase Bank, FSB, No. 1:00CV01167) along with a companion suit against an ATM manufacturer and a drug store chain where its ATMs are located (RiteAid). (National Federation of the Blind v. Diebold, Inc., No. 1:00CV01168).

26. Guitard v. Gorham Savings Bank (Cumberland County [Maine] Superior Court No. CV-00-326). Depositors in mutual savings bank filed class action lawsuit on June 8, 2000, seeking a "dividend" from the Bank for the class that was equal to the amount of the Bank's undistributed profits in excess of the amount needed for the bank to qualify as a "well-capitalized" institution under federal and state standards. Plaintiffs contend that the Bank's Total Capital ratio is 23.43% whereas 10% is as much as the Bank needs to be regarded as well-
capitalized. Failure to distribute the difference to the "owners," i.e. the depositors, is said to be a breach of fiduciary duty on the part of the Trustees of the Bank.

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FINANCIAL INSTITUTION PRIVACY ISSUES

New Rules To Implement The Gramm-Leach-Bliley Act

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PNC Bank, N.A.
Louisville, Kentucky

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SECTION C
FINANCIAL INSTITUTION PRIVACY ISSUES
New Rules To Implement The Gramm-Leach-Bliley Act

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SECTION C
Introduction

In the past year, the federal financial institution regulatory agencies have issued one final and one proposed regulation as well as guidelines affecting financial institutions' customer information practices and disclosures. We now have a final regulation governing privacy disclosures and regulatory Guidelines on protecting the security of customer information. The proposed regulation implementing the affiliate sharing provisions of the Fair Credit Reporting Act ("FCRA") generated so much comment that the regulators were not able to issue a final regulation in time for the new FCRA disclosures to be included in the privacy disclosure statements being mailed before July 1, 2001.

While there are currently a number of privacy bills in state legislatures, none passed in the recent legislative sessions in Kentucky, Ohio or Indiana.

This presentation focuses on the new federal Regulation and Guidelines. Regulatory publications designed to assist financial institutions in complying with the Regulation and Guidelines are located at the end of the written materials.
REGULATION IMPLEMENTING TITLE V OF
THE GRAMM-LEACH-BLILEY ACT
(Pub., L 106-102) ("GLB")

In May, 2000, the federal financial institution regulatory agencies ("Agencies") issued
the final version of the privacy regulation ("Regulation") implementing Title V of GLB.
The following is a Section-by-Section analysis of the Regulation.

Section 2.2 RULES OF CONSTRUCTION

The Regulation contains additional examples as well as sample disclosure clauses to
illustrate the level of disclosure detail the Agencies believe appropriate (but not type size,
margin width, or the like). A financial institution using the sample clauses must be
certain they reflect the institution's practices. Further, if the institution uses statutory
terms, such as "nonaffiliated third party" or "nonpublic personal information," that are set
out in the sample disclosures, the institution "must provide sufficient information to
enable consumers to understand what the terms mean in the context of the institution's
notices."

The Regulation provides that (i) the examples are not exclusive, and (ii) compliance with
the examples constitutes compliance with the Regulation.
Section .3 DEFINITIONS

"Clear and Conspicuous" (Section .3(b))

A "clear and conspicuous notice" is "reasonably understandable and designed to call attention to the nature and significance of information in the notice" (Section .3(b)(1)).

Examples of "reasonably understandable" (Section .3(b)(2)(i))
- clear, concise sentences, paragraphs, and sections;
- short explanatory sentences or bullet lists where possible;
- definite, concrete, everyday words and active voice whenever possible;
- avoidance of multiple negatives;
- avoidance wherever possible of legal and highly technical business terms;
- Avoidance of imprecise explanations.

Examples of "designed to call attention" (Section .3(b)(2)(ii))
- Plain-language heading;
- Easy to read typeface and type size;
- Wide margins and ample line spacing;
- Bold face or italics for key words;
- Where form contains other information besides notice, use of distinctive type size, graphic devices (e.g., shading or sidebars).

Note: A financial institution may call attention to disclosure on its web site by:
- using text or visual cues to encourage scrolling down page if necessary to view entire notice;
- ensuring that other elements on web site, such as text, graphics and hyperlinks, do not distract from notice; and either
  (a) placing notice on screen consumers frequently access, such as page where transactions are conducted; or
  (b) placing a link on a screen that consumers frequently access that connects directly to the notice and conveys importance, nature and relevance of the notice.

"Collect" (Section .3(c))

The Regulation provides that "collect" means "to obtain information that the bank organizes or can retrieve by the name of an individual or by identifying number, symbol, or other identifying particular assigned to the individual, irrespective of the source of the underlying information."
"Consumer" / "Customer" (Section 3(e) and Section 3(h))

Consumers are entitled to privacy notices only if the institution intends to disclose nonpublic personal information about them to an unaffiliated third party for purposes not covered by the statutory exceptions set out in Section 502(e) of GLB. "Customers" are entitled to the privacy notices "at the time of establishing a customer relationship" and annually thereafter.

The Regulation defines "consumer" as an individual who obtains or has obtained from a financial institution a financial product or service that is to be used primarily for personal, family, or household purposes, or that individual's legal representative (Section 3(e)(1)).

- **Examples** where an individual is a bank's consumer:
  (i) applicant for credit, regardless of whether credit is extended;
  (ii) individual providing nonpublic personal information so bank may determine whether the individual may qualify for a loan, whether or not loan is extended;
  (iii) individual who provides nonpublic personal information in connection with seeking to obtain investment, financial, or economic advisory services;
  (iv) person who has a loan in which the bank holds an ownership interest or servicing rights even if these interests or rights are held in conjunction with one or more other institutions and even if the bank hires an agent to collect on the loan.

- **Examples** where an individual is not a bank's consumer if these are the only relationships with the bank:
  (i) an individual is a consumer of another financial institution for which the bank acts as agent or provides processing or other services;
  (ii) an individual has designated the bank as trustee for a trust;
  (iii) an individual is a beneficiary of a trust for which the bank is trustee;
  (iv) an individual is a participant in an employee benefits plan sponsored by the bank or for which the bank acts as trustee or fiduciary.

"Customer" / "Customer Relationship" (Section 3(h) and Section 3(i))

The Regulation defines "customer" as a consumer who has a "customer relationship" with a financial institution (Section 3(h)).

A "customer relationship" is a "continuing relationship" between a consumer and a financial institution under which the institution provides one or more "financial products or services" to be used primarily for personal family or household purposes.

- **Examples** where a consumer has a "customer relationship":
  (i) deposit or investment account;
  (ii) loan from the institution;
Examples where a consumer does not have a "customer relationship":
(i) isolated transactions, such as use of bank's ATM to withdraw cash from another institution, purchase of a cashier's check or money order, or wire transfer;
(ii) sale of loan without retention of servicing rights;
(iii) isolated sales of airline tickets, travel insurance, traveler's checks;
(iv) one-time provision of real estate or personal property appraisal;
(v) one purchase of personal checks from a check printer.

Note: A consumer ceases to be a customer entitled to privacy disclosures when a deposit account becomes "inactive" or a closed-end loan is paid, charged off, or sold without retention of servicing rights (see discussion on Section 5(b)(1) "Termination of Customer Relationship").

"Financial Institution"

The definition of financial institution is important for two reasons: (i) "financial institutions" are required to make privacy disclosures and (ii) disclosures pursuant to joint marketing agreements with "financial institutions" are not subject to opt out.

The Regulation defines "financial institution" as any institution the business of which is engaging in activities that are "financial in nature or incidental to such financial activities as described in Section 4(k) of the Bank Holding Company Act of 1956."

Examples of "financial institutions":
- Banks, savings and loans, credit unions;
- Insurance companies;
- Securities brokers, underwriters, and distributors;
- Investment companies (mutual funds).

The FTC defines "financial institution" as an entity "significantly engaged" in financial activity. The business must sell to or perform services for individuals (not businesses) to be included.
• FTC Examples of "financial institutions":
  • Retailer extending credit through a proprietary card;
  • Personal property or real estate appraisals;
  • Internet company that compiles, or aggregates, an individual's on-line accounts at that company's web site;
  • Hardware and software manufacturers that sell to individuals;
  • Automobile dealership to the extent that it regularly leases automobiles on a nonoperating basis for longer than 90 days (as to its leasing business);
  • Career counselor for positions in financial services industry;
  • Check printer that sells directly to consumers;
  • Business that wires money to and from consumers;
  • Check cashing business;
  • Accountant or tax preparation service;
  • Travel agency where travel business is operated in conjunction with a traditional financial service (e.g., sale of travelers checks, insurance, etc.);
  • Real estate settlement service company;
  • Mortgage broker;
  • Investment advisory company and credit counseling service;
  • Debt collectors.

"Nonpublic Personal Information" / "Publicly Available Information" (Section 3(n) and Section 3(p)).

Section 509(4)(A) of GLB defines "nonpublic personal information" as "personally identifiable financial information" (i) provided by a consumer to a financial institution; (ii) resulting from any transaction with the consumer or any service performed for a consumer; or (iii) otherwise obtained by a financial institution except for "publicly available information" derived without using nonpublic personal information. Bank customer lists are always classified as "nonpublic." For practical purposes, nearly all information a financial institution has about its consumer customers must be treated as nonpublic personal information.

The Regulation defines "nonpublic personal information" as:

(i) personally identifiable financial information; and
(ii) any list, description, or other grouping of consumers (and publicly available information pertaining to them) that is derived using any personally identifiable financial information that is not publicly available (Section 3(n)(i)).

Nonpublic personal information does not include:

(i) publicly available information, except for certain customer lists derived using nonpublic information;
(ii) lists of consumers derived without using nonpublic personally identifiable financial information (e.g., list of subscribers to a magazine).
Examples of customer lists derived using nonpublic information:
• List of deposit account holders.

Example of customer list derived using only public information:
• List of mortgage loan customers where mortgages are matter of public record.

"Personally Identifiable Financial Information" (Section 3(o))

- Personally identifiable financial information is information:
  (i) a consumer provides to obtain a financial product or service;
  (ii) about a consumer resulting from any transaction involving a financial product
       or service between a financial institution and a consumer;
  (iii) otherwise obtained about a consumer "in connection with providing a
        financial product or service to that consumer" (Section 3(o)(1)).

- Examples of personally identifiable information:
  (i) application data;
  (ii) transaction data (balance, payment history, overdraft history, debit or credit
       card purchase information);
  (iii) fact that individual is or was a customer;
  (iv) other information if disclosed in a manner that indicates a customer
       relationship;
  (v) information provided or otherwise obtained in connection with loan collection
      or servicing;
  (vi) any information collected through an internet "cookie";
  (vii) consumer report information.

Note: Aggregate or blind data without personal identifiers such as account numbers,
names or addresses is NOT personally identifiable information.

"Publicly Available Information" (Section 3(p))

Publicly available information is information a financial institution "has a reasonable
basis to believe" is lawfully available to the general public from:
  (i) government records (e.g., real estate or security interest filings);
  (ii) widely distributed media (e.g., telephone book, web site);
  (iii) disclosures required to be made by law (Section 3(p)(1)).

- Examples of reasonable basis for belief information is public:
  (i) information is included in mortgage in a jurisdiction where mortgages are
      public record;
  (ii) financial institution has verified that telephone number is listed or consumer
       has said number is not unlisted (Section 3(p)(3)).
SUBPART A
PRIVACY AND OPT OUT NOTICES

Section __.4 INITIAL PRIVACY NOTICE

• Time of providing notice:
  - To customer - in most cases, not later than when financial institution "establishes
    a customer relationship;"
  - To consumer - before financial institution discloses nonpublic personal
    information, except pursuant to an exception set out in Section __.14 or Section
    __.15 ..

• Examples of "establishing customer relationships;"
  (i) opening a credit card account;
  (ii) signing deposit account agreement, obtaining credit, purchasing insurance;
  (iii) agreeing to obtain financial or investment advice for a fee;
  (iv) becoming a client for credit counseling or tax preparation.

Note: Special rules for loans:
• A customer relationship is established when a financial institution originates a loan or
  purchases loan servicing rights;

• A customer relationship is terminated when a loan or loan servicing rights are sold;

• A new privacy notice is not required for each new product;

• Initial notices may be delivered "within a reasonable time after" the relationship is
  established if:
  (i) customer has no choice;
      Examples: bank buys deposits or servicing rights
  (ii) providing notice when account is established would "substantially delay
      transaction" and customer agrees to receive notice at a later time;
      Examples:
      • account opened by telephone
      • student loan account where loans are disbursed without prior
        communication between bank and customer

• Initial notice where customer relationship is established on web:
  If a customer relationship is established on a web site, the customer must receive the
  initial privacy notice at the time the relationship is established. The notice may be
  provided at the same time the financial institution provides notices required by other
  consumer protection statutes, such as Truth in Lending.

Note: Trade association or regulatory "best practices" may require a financial institution
  to post its privacy notices on its web sites, even if customer relationships are not
established via the web. Topics such as web site security and the use of "cookies" are often mentioned as appropriately included in a web site privacy statement.

- **Joint accounts**: Bank may provide one notice to account holders jointly.
Section __.5 ANNUAL PRIVACY NOTICE

The Regulation provides that:

- Customers must receive an annual privacy notice. "Annual" means "once in any 12 consecutive month period," which may be defined as a calendar year.

Example: Customer opens account on August 1, 2001. Customer must get an "annual notice" some time before 12/31/2002 and at the same time each year thereafter.

- A consumer is a "former customer," not entitled to receive an annual notice when:
  (i) the customer's deposit account becomes "inactive" under the bank's policies;
  (ii) the customer's closed-end loan is paid in full, charged off, or sold without retention of servicing rights;
  (iii) customer receives no statements or notices on an open-end credit account or account is sold without retention of servicing rights;
  (iv) customer has received no communication for 12 consecutive months except for annual privacy notices or promotional material.
Section _.6 CONTENT OF INITIAL AND ANNUAL PRIVACY NOTICES

Initial, annual, and revised privacy notices must include at least the following information:
(1) Categories of nonpublic personal information collected.

Examples:
- information from the consumer;
- information about the consumer's transactions with the financial institution or its affiliates;
- information about the consumer's transactions with nonaffiliated third parties;
- information from a consumer reporting agency.

(2) The categories of nonpublic personal information the institution discloses (or reserves the right to disclose). The categories listed for information collection may be used with few examples for each category;

(3) The categories of affiliates and nonaffiliated third parties to which the institutions discloses (or reserves the right to disclose) information, except pursuant to the statutory exceptions set out in Section _.14 and Section _.15. The following categories may be used with a few illustrative examples of each:
- financial service providers
- non financial companies
- others

(4) Categories of nonpublic personal information disclosed about former customers and categories of affiliates and nonaffiliated third parties to whom disclosed, except pursuant to statutory exception;

(5) If a financial institution discloses information to a nonaffiliated service provider or financial institution joint marketing partner and no other statutory exception applies, a separate statement of the categories of information disclosed and the categories of third parties with whom the bank has contracted;

Examples:
- list categories of information disclosed, using same categories and examples used under (2);
- state whether third party is a service provider performing marketing services on behalf of bank or bank and another financial institution; or
- state that disclosure is to another financial institution with whom bank has a joint marketing agreement.

(6) An explanation of consumer's right to opt out of disclosures to nonaffiliated third parties, including opt out methods;

(7) Fair Credit Reporting Act affiliate sharing notice and opt out;
Note: Last fall, the Agencies issued for comment a proposed regulation implementing the affiliate sharing provisions of the FCRA. Because a final regulation would have been issued too late for the FCRA disclosures to have been included in the initial privacy disclosure mailings, the Agencies have stated that the final FCRA rule will not apply to disclosures sent before the later of January 1, 2002 and the effective date of the FCRA rule.

(8) Policies and practices with respect to protecting the confidentiality and security of nonpublic personal information;

Examples:
- description in general terms of who has access to information;
- state that financial institution has security practices and procedures in place to ensure the confidentiality of the information in accordance with the bank's policy.

(9) General statement about disclosure pursuant to statutory exceptions, which may be satisfied by a statement that the financial institution "makes disclosures to other nonaffiliated third parties as permitted by law;"

- A financial institution may use a short form initial notice that says that the institution policies are available on request by, for example, a toll-free telephone number, if it intends to disclose nonpublic personal information about non-customer consumers. The financial institution must still provide the Section .7 third party sharing opt out notice.

- If a financial institution does not disclose, and does not wish to reserve the right to disclose, nonpublic personal information about customers or former customers either to affiliates or nonaffiliated third parties except as authorized by Sections .14 and .15, the financial institution may provide a simplified disclosure statement that sets out:

1. The categories of nonpublic personal information collected (Section .6(a)(1));
2. The fact that the institution does not disclose nonpublic personal information about customers or former customers to affiliates or nonaffiliated third parties except as permitted by law; and
3. the bank's polices and practices with respect to protecting the confidentiality and security of nonpublic personal information.
Section 7.7 FORM OF OPT OUT NOTICE; OPT OUT METHODS

• Form of Opt Out Notice:
The notice must be clear and conspicuous and accurately explain the right to opt out of disclosures to nonaffiliated third parties. The notice must state:
   (i) that the financial institution reserves the right to disclose nonpublic personal information about a consumer to a nonaffiliated third party;
   (ii) that the consumer has the right to opt out of the disclosure;
   (iii) a "reasonable means" to opt out.

• Elements of an Adequate Opt Out Notice:
   (i) categories of nonpublic personal information disclosed or which may be disclosed;
   (ii) categories of nonaffiliated third parties to which information may be disclosed;
   (iii) statement of opt out right;
   (iv) identification of products or services to which opt out would apply.

• "Reasonable" Opt Out means:
   (i) check off boxes on form with opt out notice;
   (ii) reply form with opt out notice (prepaid postage not required);
   (iii) electronic means (e.g., e-mail, web site process);
   (iv) toll-free telephone number.

• "Unreasonable" Opt Out means:
   (i) only opt out is by consumer writing a letter;
   (ii) only opt out is by check off provided with original but not subsequent notice.

• Financial institution may specify "reasonable" opt out method and not honor opt outs by other means.

• Opt out notice may be provided with initial notice or at a later time with a copy of the initial notice.

• Joint Account Notice and Opt Out Methods:
  • Financial institutions may send one notice per account or notices to each account owner, but the notices must explain effect of opt out;
  • If a financial institution sends one notice to address of primary account owner, the bank must accept opt out direction from either account owner;
  • A financial institution may:
    (i) treat an opt out by either account owner as applying to both parties to the account; or
    (ii) permit account owners to make different opt out choices but in this case, bank must:
        (a) Permit account owners to opt out for each other;
        (b) If both opt out, they must be able to do so with one telephone call or
one response form;
(c) If only one opts out, bank may not disclose information about that party or information about that party jointly with another party.

Other Opt Out Rules
• Financial institution must process an opt out as soon as "reasonably practical after receipt."
• Consumer may opt out at any time.
• An opt out is good until consumer revokes it in writing or electronically, if consumer agrees.
• For terminated account, opt out continues for all information collected prior to termination.
Section _.8 REVISED PRIVACY NOTICES

If financial institution changes its nonaffiliated third party disclosure policy, it must provide a revised disclosure statement and opt out and give customers a reasonable opportunity to exercise the opt out before disclosure.

Examples of revised policy triggers:
• disclosure of new category of information;
• disclosure to a new category of third party;
• disclosure about a former customer who did not get previous notice and opt out.
Section 9 DELIVERY OF PRIVACY AND OPT OUT NOTICES

Financial institutions must deliver notices so that each consumer can "reasonably expect" to receive notice in writing, or if the consumer agrees, electronically.

Examples of permissible delivery:
- hand deliver a printed copy to consumer;
- mail printed copy to consumer's last known address;
- for consumer who banks electronically, post notice on the electronic site and require consumer to acknowledge receipt of notice as a necessary step to obtain a product or service;
- for an isolated transaction, such as an ATM transaction, post notice on the ATM screen and require consumer to acknowledge receipt of the notice as a necessary step to completing transaction.

Examples of impermissible delivery:
- only post branch office sign or publish advertisement;
- send notice via e-mail to consumer who does not bank electronically;
- oral notice - either in person or by telephone.

- Annual notice delivery may be accomplished by posting notice on web site for those customers who bank by web and agree to receive notices on web site. Notice must be continuously posted.

- No annual notice need be sent to a customer who has requested "no contact," provided annual notice is available on request.

- Customers must be able to retain notice or obtain notice in writing at a later time.

- Joint Notice with Other Financial Institutions:
A financial notice may provide a joint notice from it and one or more of its affiliates or other financial institutions, as identified in the notice by name, so long as the notice is accurate for all institutions named.
SUBPART B
LIMITS ON DISCLOSURES

Section ___.10 LIMITS ON DISCLOSURE OF NONPUBLIC PERSONAL INFORMATION TO NONAFFILIATED THIRD PARTIES

Except pursuant to one of the statutory exceptions set out in Sections ___.13, ___.14, and ___.15, a financial institution may not disclose nonpublic personal information unless:
• the institution has provided the Section ___.4 initial notice;
• the institution has provided the Section ___.7 opt out notice;
• the institution gives the consumer a reasonable opportunity to opt out (at least 30 days from date notice is mailed or received electronically if the consumer consents to electronic receipt);
• the consumer has not opted out.

• For an isolated transaction, such as purchase of a cashier’s check, the bank may require the consumer to decide on opt out before the transaction is completed;

• Opt out applies to all information collected about the consumer, whether collected before or after opt out is exercised;

• Partial opt outs are permitted. A financial institution may permit a consumer to select the items of information or nonaffiliated third parties to which the opt out will apply.
Section ___ .11 LIMITS ON REDISCLOSURE AND REUSE OF INFORMATION

The revised Regulation sets out the following redisclosure and reuse limits:

• If a financial institution receives nonpublic personal information pursuant to a statutory exception (Section ___.14 and Section ___.15), the financial institution may:
  (i) disclose information to affiliates of the disclosing institution;
  (ii) disclose information to its own affiliates, who in turn are subject to disclosure restrictions;
  (iii) disclose the information only pursuant to a Section ___.14 or Section ___.15 statutory exception in the ordinary course of business to carry out the activity covered by the exception under which the financial information received the information.

Example: If a bank gets the customer list of another institution in order to provide account processing services, the bank may disclose the data in response to a properly authorized subpoena, but the bank could NOT use the data for its own marketing purposes.

• Credit Bureau Sale of Header Information
  The FTC has taken the position that if a credit bureau receives information from a financial institution pursuant to the credit bureau disclosure exception (Section ___.15(a)(5)), the credit bureau may not sell the "header information" to direct marketers or individual reference services. The credit bureaus have challenged the FTC's position.

• If a financial institution receives nonpublic personal information outside a Section ___.14 or Section ___.15 statutory exception, the financial institution may disclose the information to:
  (i) affiliates of the disclosing institution;
  (ii) its own affiliates, subject to disclosure limitations;
  (iii) to any other person, if disclosure would have been lawful by the disclosing institution.

Example: If a bank receives a customer list outside a Section ___.14 or Section ___.15 exception, the bank (subject to any contract limitations) could use the list for its own purposes, disclose the list to a third party if disclosure would have been permitted under the disclosing bank's privacy policy, (assuming customer on the list had not opted out), and disclose the list pursuant to a Section ___.14 or Section ___.15 exception. Similarly, if a bank could be persuaded to disclose in its privacy policy that it shares customer information with credit bureaus for purposes other than credit reports so that the customer would have an opt out to such disclosure, the credit bureau receiving the information could sell it to direct marketers.

• If a financial institution discloses nonpublic personal information pursuant to a Section ___.14 or Section ___.15 statutory exception, the third party may disclose the
information to:
(i) the disclosing financial institution's affiliates;
(ii) its own affiliates, subject to disclosure restrictions;
(iii) pursuant to a Section __.14 or Section __.15 exception in the ordinary course of business to carry out the activity covered by the exception under which it received the information.

• If a financial institution discloses information outside a Section __.14 or Section __.15 statutory exception, (unless otherwise limited by contract), the third party may disclose the information to:
  (i) the disclosing institution's affiliates;
  (ii) its own affiliates, subject to disclosure restrictions;
  (iii) any other person, if disclosure would have been lawful by the disclosing institution.
Section 12 LIMITS ON SHARING ACCOUNT NUMBERS FOR MARKETING PURPOSES

The Regulation contains a general prohibition against disclosing transaction account numbers or access codes to nonaffiliated third parties for marketing purposes but provides for the following exceptions:

• Disclosure of the account number or access code may be made to a financial institution's service provider solely in order to perform marketing of the institution's own products and services so long as the agent or service provider is not authorized to directly initiate charges to the consumer's account.

• Disclosure of the account number or access code is permitted to a participant in a private label credit card program or an affinity or similar program where program participants are identified to the consumer when the consumer enters the program.

• Disclosure of an encrypted account number or access code is permitted so long as the recipient does not receive the means to decode the account number or access code. Encrypted numbers are generally used only for tracking purposes.

• A transaction account does not include a closed-end account to which third parties cannot initiate charges. (Mortgage loan accounts are not exempted if third parties can initiate charges to the account, such as for insurance products.)

Note: there is no restriction on disclosing account numbers to companies providing services pursuant to a Section __.14 or Section __.15 statutory exception.
SUBPART C
EXCEPTIONS

Section __.13 EXCEPTION TO OPT OUT FOR SERVICE PROVIDERS AND
JOINT MARKETING

Despite industry requests to treat all service providers under the general statutory
exceptions of Section __.14 or Section __.15, the Regulation requires special
disclosures for marketing service providers similar to those for third party financial
institution joint marketing partners.

• A financial institution may disclose nonpublic personal information to a nonaffiliated
third party that performs marketing or market research services for or functions on the
institution's behalf if the financial institution (i) provides the consumer with the Section
___4 initial privacy notice; and (ii) enters into a contract that prohibits the third party
from disclosing or using the information other than for the purposes for which the
information was disclosed or under a Section __.14 or Section __.15 exception to carry
out the purpose of disclosure.

• The services may include marketing of products or services offered jointly with
another financial institution.

• A joint agreement means a written contract to jointly offer, endorse, or sponsor a
financial product or service.

• Some suggested clauses are located in the Appendix.
Section __.13 EXCEPTION TO OPT OUT FOR SERVICE PROVIDERS AND JOINT MARKETING

Despite industry requests to treat all service providers under the general statutory exceptions of Section __.14 or Section __.15, the Regulation requires special disclosures for marketing service providers similar to those for third party financial institution joint marketing partners.

- A financial institution may disclose nonpublic personal information to a nonaffiliated third party that performs marketing or market research services for or functions on the institution's behalf if the financial institution (i) provides the consumer with the Section __.4 initial privacy notice; and (ii) enters into a contract that prohibits the third party from disclosing or using the information other than for the purposes for which the information was disclosed or under a Section __.14 or Section __.15 exception to carry out the purpose of disclosure.

- The services may include marketing of products or services offered jointly with another financial institution.

- A joint agreement means a written contract to jointly offer, endorse, or sponsor a financial product or service.

- Some suggested clauses are located in the Appendix.
Section 15 OTHER EXCEPTIONS TO NOTICE AND OPT OUT REQUIREMENTS

One of the most important Section 15 exceptions is "consent." The Regulation does not specify a consent format, however, the Agencies note that "any financial institution that obtains the consent of a consumer to disclose nonpublic personal information should take steps to ensure that the limits of the consent are well understood by both the financial institution and the consumer." Consent is not required for disclosure in the ordinary course of business to effect a transaction, for example, to permit verification of funds or disclosures to or by appraisers, flood insurers, attorneys, insurance agents, or mortgage brokers. The Section 15 statutory exceptions are listed in below.

(1) With the consent or at the direction of the consumer.

(2) (i) To protect confidentiality or security of bank's records;
    (ii) To protect against or prevent actual fraud, unauthorized claims, or other liability;
    (iii) For required institutional risk control or for resolving customer disputes or inquiries;
    (iv) To persons holding a legal or beneficial interest relating to the consumer;
    (v) To persons acting in a fiduciary or representative capacity for the consumer.

(3) To provide information to insurance rate advisory organizations, guaranty funds, bank rating agencies, persons assessing compliance with industry standards, the institution's attorneys, accountants, and auditors.

(4) To the extent permitted or required by law and in accordance with the federal Right to Financial Privacy Act to law enforcement agencies, functional regulators, state insurance authorities, the FTC, self-regulatory organizations, investigation in a matter related to public safety.

(5) (i) To a consumer reporting agency in accordance with the FCRA;
    (ii) From a consumer report by a consumer reporting agency.

(6) In connection with proposed or actual sale, merger, transfer, or exchange of all or part of a business unit.

(7) (i) To comply with Federal, state, or local laws, rules or other applicable legal requirements.
    (ii) To comply with "properly authorized" civil, criminal, or regulatory investigation, or subpoena or summons by Federal, state or local authorities.
    (iii) To respond to judicial process or government regulatory authorities having jurisdiction over a financial institution for examination, compliance, or other purposes as authorized by law.
Section __.16  PROTECTION OF THE FAIR CREDIT REPORTING ACT

The Regulation does not limit the ability of affiliated companies to share customer information as permitted by the FCRA so long as customers receive the FCRA disclosure and opt out notice.
Section .17 RELATION TO STATE LAWS

State laws granting greater privacy protections are NOT pre-empted. The FTC, in consultation with the OCC, will determine if a state law provides greater protection.
Section .18 EFFECTIVE DATE; TRANSITION RULE

- The effective date of the Regulation was November 13, 2000 but full compliance is not required until July 1, 2001.

- By July 1, 2001 financial institutions must have provided the Section .4 initial privacy notice to all consumers who are customers on July 1, 2001.

Note: Notices must go out by May if the institution wishes to continue sharing information with nonaffiliated third parties on an uninterrupted basis so that customers will have a sufficient time to exercise an opt out.

- Marketing service agreements and joint marketing agreements entered into prior to July 1, 2000 must be modified to meet the Section .13 requirements by July 1, 2002.
Interagency Guidelines Establishing Standards
For Safeguarding Customer Information

In compliance with Sections 501 and 505(b) of the Gramm-Leach-Bliley Act ("GLB"), on February 1, 2001 the federal financial institution regulatory agencies ("Agencies") published final guidelines establishing standards for the safeguarding of consumer information ("Guidelines"). The Guidelines are effective July 1, 2001, but service provider agreements entered into after March 3, 2001 (thirty days after publication of the Guidelines) must have specific language requiring the service provider to implement policies and procedures designed to achieve the regulatory objectives of the Guidelines (see, Section II). For the most part, the Guidelines afford compliance flexibility and are consistent with security-related supervisory guidance previously issued by the Agencies and the FFIEC.

1 Section 501 of GLB requires the Agencies to establish appropriate standards relating to administrative, technical and physical safeguards to protect the security, confidentiality and integrity of customer information. The SEC had elected not to issue customer information security guidelines for the institutions subject to its jurisdiction.
I. Objectives of the Guidelines

The Guidelines establish a process for developing and implementing a consumer customer information security program “designed” to:

1. Ensure the security and confidentiality of customer information;
2. Protect against any anticipated threats or hazards to the security or integrity of such information; and
3. Protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer.

II. Process of Implementing the Guidelines

The Guidelines require each financial institution to engage in a five-step process:

A. Assess Risk

1. Assess risks to customer information by identifying “reasonably foreseeable” internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems. “Customer information systems” includes “any methods used to access, collect, store, use, transmit, protect or dispose of customer information.”

2. Assess the likelihood of such risks and potential damage, taking into consideration the “sensitivity” of the information.

3. Assess the sufficiency of policies, procedures, customer information systems and other arrangements to control risks.

B. Manage and Control Risk

1. Prepare a comprehensive written information security program (“ISP”) designed to control the identified risks. The ISP should be appropriate to the complexity of the institution and the nature and scope of its activities. The ISP should include, as appropriate, certain elements, listed in their entirety in Attachment A. Examples of practices to be considered are: encryption, dual control, employee background checks and monitoring systems. Whether a particular risk control element is appropriate will depend on the institution’s assessment of the sensitivity of the customer information involved and the complexity of the
Oversee Service Provider Arrangements

1. Exercise due diligence in selecting service providers.
   The Guidelines include in the definition of "service provider" "any person or entity that maintains, processes, or is otherwise permitted access to customer information through its provisions of services directly to the financial institution." The Agencies acknowledge that the level of oversight of the variety of persons and entities that provide services to a financial institution will depend on the institution’s analysis of the risks posed by disclosure of customer information to each such provider. While part of the due diligence process in selecting a service provider should include determining whether the service provider has adequate controls to ensure that a subservicer will protect customer information in accordance with the Guidelines, a financial institution is not obligated to have a contract with the subservicer or supervise its activities. The elements in overseeing service provider arrangements are:

   C. **Oversee Service Provider Arrangements**

   The Guidelines include in the definition of "service provider" "any person or entity that maintains, processes, or is otherwise permitted access to customer information through its provisions of services directly to the financial institution." The Agencies acknowledge that the level of oversight of the variety of persons and entities that provide services to a financial institution will depend on the institution’s analysis of the risks posed by disclosure of customer information to each such provider. While part of the due diligence process in selecting a service provider should include determining whether the service provider has adequate controls to ensure that a subservicer will protect customer information in accordance with the Guidelines, a financial institution is not obligated to have a contract with the subservicer or supervise its activities. The elements in overseeing service provider arrangements are:

   1. Exercise due diligence in selecting service providers.

   2. Require service providers by contract to implement appropriate measures designed to meet the objectives of the Guidelines (see, Section I). Contracts signed prior to thirty days after publication of the Guidelines need not be amended until July 1, 2003.

   3. Depending on the institution’s assessment of the risk presented by the service provider, review, as appropriate, audits, test results or other equivalent evaluations (e.g., SAS 70 reports) of the service provider.

   D. **Adjust the Program**

   Adjust the ISP in light of factors such as, changes in technology, the sensitivity of customer information, and the institution’s changing business arrangements, for example, mergers, acquisitions, alliances and...
joint ventures, outsourcing arrangements and changes to customer information systems.

E. Involve the Board of Directors

1. A financial institution's board of directors, or an appropriate board committee, must approve the ISP. If the ISP is prepared at the holding company level, each regulated institution's board (or designated board committee) must determine the appropriateness of the ISP for that institution.

2. Each board (or designated board committee) must “oversee” the implementation and maintenance of the ISP and, accordingly, must receive at least annually a report on the institution's compliance with the Guidelines. The report should discuss matters such as, risk assessment, risk management, and control decisions, service provider arrangements, test results, security breaches or violations, management responses and recommendations for change.
ATTACHMENT A

Elements of a Security Program

1. Access controls on customer information systems, including controls to authenticate and permit access only to authorized individuals and controls to prevent employees from providing customer information to unauthorized individuals who may seek to obtain this information through fraudulent means;

2. Access restrictions at physical locations containing customer information, such as buildings, computer facilities, and records storage facilities to permit access only to authorized individuals;

3. Encryption of electronic customer information, including while in transit or in storage on networks or systems to which unauthorized individuals may have access;

4. Procedures designed to ensure that customer information system modifications are consistent with the bank's information security program;

5. Dual control procedures segregation of duties, and employee background checks for employees with responsibilities for or access to customer information;

6. Monitoring systems and procedures to detect actual and attempted attacks on or intrusions into customer information systems;

7. Response programs that specify actions to be taken when the bank suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies; and

8. Measures to protect against destruction, loss, or damage of customer information due to potential environmental hazards, such as fire and water damage or technological failures.
SOME SUGGESTED CONFIDENTIALITY PROVISIONS FOR THIRD PARTY
JOINT MARKETING OR SERVICE AGREEMENTS

Section ___. Confidentiality of Customer Information

1. Company agrees that all information about individuals provided by Bank to
   Company, including but not limited to names, addresses, telephone numbers, account
   numbers, customer lists, and demographic, financial and transaction information
   ("Customer Information"), shall be deemed confidential and proprietary to Bank.
   Company shall not use the Customer Information for any purpose other than as
   required for the performance of Company's obligations under this Agreement, and
   Company shall not duplicate or incorporate the Customer Information into its own
   records or databases.

2. Company agrees that any dissemination of the Customer Information within
   Company's own business entities shall be on a "need to know" basis for the sole
   purpose of the performance of Company's obligations hereunder.

3. Company shall not disclose the Customer Information to any third party, including an
   affiliate of Company or a permitted subcontractor, without prior written consent of
   Bank and the written agreement of such third party to be bound by the terms of this
   Section ___. Unless otherwise prohibited by law, Company shall (i) immediately
   notify Bank of any legal process served on Company for the purpose of obtaining
   Customer Information and (ii) permit Bank adequate time to exercise its legal options
   to prohibit or limit disclosure.

4. Company shall establish and maintain policies and procedures designed to insure the
   confidentiality, integrity, and security of the Customer Information.

5. Not later than the earlier of thirty (30) days following termination of this Agreement
   or thirty days following the completion of a project for which the Customer
   Information has been provided, Company shall at the Bank's discretion either (i)
   return the Customer Information to Bank or (ii) certify in writing to the Bank that
   such Customer Information has been destroyed.

6. Company shall notify Bank promptly upon the discovery of the loss, unauthorized
   disclosure or unauthorized use of the Customer Information.

7. Company shall permit Bank to audit Company's compliance with the provisions of
   this Section ___. at any time during Company's regular business hours.

8. In addition to any other rights Bank may have under this Agreement or in law, since
   unauthorized use or disclosure of the Customer Information may result in immediate
   and irreparable injury to Bank for which monetary damages may not be adequate, in
   the event
Company or any officer, director, employee, agent or subcontractor of Company uses or discloses or in Bank's sole opinion, any such party is likely to use or disclose the Customer Information in breach of Company's obligations under this Agreement, Bank shall be entitled to equitable relief, including temporary and permanent injunctive relief and specific performance. Bank shall also be entitled to the recovery of any pecuniary gain realized by Company from the unauthorized use or disclosure of the Customer Information.

9. The provisions of this Section __. shall survive the termination of this Agreement.
ADDENDA
TO: CHIEF EXECUTIVE OFFICER AND COMPLIANCE OFFICER

SUBJECT: FDIC Creates Privacy Rule Handbook to Assist Banks With Compliance

The attached Privacy Rule Handbook was produced by the Federal Deposit Insurance Corporation (FDIC) to help financial institutions comply with the final rule governing the privacy of consumer financial information and implement effective consumer privacy policies.

The Gramm-Leach-Bliley Act of 1999 (GLBA) established new requirements for financial institutions to provide new privacy protections to consumers. Specifically, Title V of GLBA requires a financial institution to issue privacy notices and provide consumers with an opportunity to opt out of certain types of information sharing. The FDIC developed and adopted a final regulation with other financial institution regulators to implement the GLBA privacy provisions. The FDIC’s rule, 12 C.F.R. Part 332, was distributed to FDIC-supervised banks with Financial Institution Letter (FIL) 34-2000, dated June 5, 2000.

Although the privacy rule’s effective date is November 13, 2000, compliance is not mandatory until July 1, 2001. Mandatory compliance was extended in the final rule to provide banks with sufficient time to develop the necessary notices and procedures to implement the rule. It is imperative that banks use this interim period to develop a privacy compliance strategy to achieve full compliance by July 1, 2001.

This Handbook is designed to help banks prepare for the July 1, 2001, deadline. First, the Handbook explains the basic requirements of the privacy rule. Second, the Handbook provides suggestions for implementing the requirements of the privacy rule to meet the July 1 deadline. Third, the Handbook suggests activities to monitor and maintain compliance over time. Finally, the Handbook describes in greater detail key terminology in the rule and provides other helpful resources.

The Privacy Rule Handbook does not impose any new requirements on banks. Rather, it provides a summary of the rule’s requirements and suggestions to help banks develop and implement effective consumer privacy policies and procedures. The Handbook uses the term “bank” to mean those financial institutions that must comply with Part 332.

For more information about the privacy rule, please contact the FDIC regional office responsible for supervising your bank, or call Ken Baebel, Assistant Director in the Division of Compliance and Consumer Affairs, on (202) 942-3086.

Attachment: Privacy Rule Handbook

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, NW, Room 100, Washington, DC 20434 (800-276-6003 or 202-416-6940).
Section One:
Overview of privacy rule requirements

The privacy rule governs when and how banks may share nonpublic personal information about consumers with nonaffiliated third parties.

The rule embodies two principles—notice and opt out. In summary:

- All banks must develop initial and annual privacy notices. The notices must describe in general terms the bank’s information sharing practices.
- Banks that share nonpublic personal information about consumers with nonaffiliated third parties (outside of opt out exceptions delineated in the privacy rule) must also provide consumers with:
  - an opt out notice
  - a reasonable period of time for the consumer to opt out

Exceptions to opt out: A consumer cannot opt out of all information sharing. First, the privacy rule does not govern information sharing among affiliated parties. Second, the rule contains exceptions to allow transfers of nonpublic personal information to unaffiliated parties to process and service a consumer’s transaction, and to facilitate other normal business transactions. For example, consumers cannot opt out when nonpublic personal information is shared with a nonaffiliated third party to:

- market the bank’s own financial products or services
- market financial products or services offered by the bank and another financial institution (joint marketing)
- process and service transactions the consumer requests or authorizes
- protect against potential fraud or unauthorized transactions
- respond to judicial process
- comply with federal, state, or local legal requirements

Prohibition on sharing account numbers: The privacy rule prohibits a bank from disclosing an account number or access code for credit card, deposit, or transaction accounts to any nonaffiliated third party for use in marketing. The rule contains two narrow exceptions to this general prohibition. A bank may share account numbers in conjunction with marketing its own products as long as the service provider is not authorized to directly initiate charges to the accounts. A bank may also disclose account numbers to a participant in a private label or affinity credit card program when the participants are identified to the customer. An account number does not include a number or code in encrypted form as long as the bank does not also provide a means to decode the number.
**Limits on reuse and redisclosure:** The privacy rule limits reuse and redisclosure of nonpublic personal information received from a nonaffiliated financial institution or disclosed to a nonaffiliated third party. The specific limitations depend on whether the information was received pursuant to or outside of the notice and opt out exceptions.

**State Law:** A provision under a State law that provides greater consumer protection than provided under the GLBA privacy provisions will supersede the Federal privacy rule. The bank will be obligated to comply with the provisions of that State law to the extent those provisions provide greater consumer protection than the Federal privacy rule. The Federal Trade Commission determines whether a particular State law provides greater protection.

### Content of notices:

The initial, annual, and revised notices include, as applicable:

- categories of information a bank collects (all banks)
- categories of information a bank may disclose (all banks, except a bank that does not intend to make any disclosures or only makes disclosures under the exceptions may simply state that)
- categories of affiliates and nonaffiliates to whom a bank discloses nonpublic personal information (all banks sharing nonpublic personal information with an affiliate or with a nonaffiliated third party)
- information sharing practices about former customers (all banks)
- categories of information disclosed under the service provider/joint marketing exception (only those banks relying on this exception)
- consumer’s right to opt out (only those banks that disclose outside of exceptions)
- disclosures made under the Fair Credit Reporting Act (only those banks providing the FCRA opt out notice)
- disclosures about confidentiality and security of information (all banks)

A revised notice may be required when a bank changes its information sharing practices.

The following table reflects the rule’s requirements for delivering initial, annual, and revised notices to consumers and customers.

<table>
<thead>
<tr>
<th>Type of notice</th>
<th>Who gets it</th>
<th>Delivery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial privacy notice</td>
<td>All existing bank customers, all new bank customers after July 1, 2001, customers who are not customers</td>
<td>No later than July 1, 2001</td>
</tr>
<tr>
<td></td>
<td>All existing bank customers</td>
<td>When the customer relationship is established</td>
</tr>
<tr>
<td></td>
<td>New bank customers</td>
<td>Only if the bank intends to share nonpublic personal information about the consumer with a nonaffiliated third party</td>
</tr>
<tr>
<td>Annual privacy notice</td>
<td>Customers</td>
<td>At least once in any period of 12 consecutive months while the customer relationship continues</td>
</tr>
<tr>
<td></td>
<td>Customers</td>
<td>Only if the bank intends to share nonpublic personal information about the consumer with a nonaffiliated third party</td>
</tr>
<tr>
<td>Revised privacy notice</td>
<td>Customers and consumers who are not customers</td>
<td>Before the bank shares nonpublic personal information in a manner not described in the most recent notice delivered to the customer or consumer</td>
</tr>
<tr>
<td></td>
<td>Customers</td>
<td>Only if the bank intends to share nonpublic personal information about the consumer with a nonaffiliated third party</td>
</tr>
</tbody>
</table>

**Opt Out Notice**

The final rule provides that an opt out notice is adequate if it:

- identifies all the categories of nonpublic personal information the bank intends to disclose to nonaffiliated third parties
- states the consumer can opt out of the disclosure
• provides a reasonable method for the consumer to opt out, such as a toll-free telephone number

The table below summarizes the rule's requirements for delivering an opt out notice.

<table>
<thead>
<tr>
<th>Type of notice</th>
<th>Who gets it</th>
<th>Delivery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opt out notice (banks that share nonpublic personal information outside of exceptions)</td>
<td>• customers and consumers who are not customers</td>
<td>• before the bank shares nonpublic personal information about the customer or consumer (and the information sharing is not permissible under the privacy rule) opt out exceptions</td>
</tr>
</tbody>
</table>

The opt out right: If a bank intends to share nonpublic personal information outside the exceptions, it must also:

• provide consumers with a reasonable opportunity to opt out. Examples in the privacy rule give consumers 30 days to respond to the opt out notice when the bank delivers the notice by mail or electronically
• comply with a consumer's opt out direction as soon as reasonably practicable when the direction is received after the initial opt out period elapses
• comply with the opt out direction until revoked in writing by the consumer

Delivering notices: The initial, annual, revised, and opt out notices may be delivered in writing or, if the consumer agrees, electronically. An oral description of the notice is not sufficient.

Section Two
Get Ready for July 1, 2001

A bank's strategy for achieving full compliance by July 1, 2001, will vary depending on the complexity of the bank and the progress it has already made in complying with the requirements of the rule. The level of effort a bank will expend depends in large part on:

• the bank's previous efforts to assess or disclose information sharing practices
• the bank's decisions about sharing nonpublic personal information after July 1, 2001
• the volume, if any, of consumers and customers who must receive an opportunity to opt out before information sharing with nonaffiliated third parties can take place.

Nearly all banks, however, can take the following four steps to create a comprehensive and effective privacy compliance strategy:

• establish a timeline for compliance
• develop privacy policies and notices
• deliver notices
• prepare to respond to consumers

1. Establish a timeline for compliance

A timeline designating important checkpoints prior to July 1, 2001, is a good place to start and can be instrumental to ensuring timely compliance.
A specific process for certifying completion of the various steps identified in the bank's privacy compliance strategy will help managers keep track of progress. When establishing due dates for specific activities, build in time to receive input and feedback from senior management and other stakeholders. Every bank should consider:

- **Involving the Board of Directors:** A board-approved privacy policy is not required by the rule, but it can be an effective way to involve the board of directors in developing a privacy compliance strategy. A board-sanctioned privacy policy can be useful in communicating the bank's overall privacy commitment and strategy to the entire organization.

- **Involving representatives from each bank department:** Most likely a senior bank officer will oversee development and implementation of the privacy compliance strategy. Nevertheless, participation from each department in the bank will help ensure nothing is overlooked. This approach will also help policy makers identify information sharing practices or consumer privacy issues unique to a specific department or to a financial product or service.

2. **Develop privacy policies and notices**

Use this opportunity to evaluate and establish institutional privacy objectives, and communicate to potential customers and consumers the bank's customer service philosophy.

- Create a comprehensive inventory of information collection and information sharing practices at the bank. The inventory will help ensure practices are properly disclosed in the bank's privacy notices. For every department, review:
  - all applications and forms used to collect information about consumers
  - marketing practices
  - vendor contracts
  - electronic banking and Internet activities
  - fee income accounts
  - record retention policies

**Affiliates:** If a bank has any affiliates, the inventory should include information-sharing practices with affiliates. Although the privacy rule does not place any restrictions on information sharing with affiliates, it does require disclosure of those practices in the initial and annual notices. Furthermore, the privacy rule requires the initial and annual notices to include applicable Fair Credit Reporting Act affiliate information sharing opt-out notices.

- **Assess current information collection and information sharing practices** in light of the privacy rule obligations and the bank's objectives. Determine which practices should continue after July 1, 2001. This may be a good time to involve the bank's Board of Directors. Consider:
  - whether any current practices would be prohibited under the rule
  - which practices must be disclosed in the privacy notices and whether opt out rights apply
  - whether account numbers are shared only as permitted by the rule
  - whether information received from other financial institutions is shared only as permitted by the rule's reuse and resale limitations
  - whether to adopt voluntary privacy standards developed by relevant trade associations. Those standards could be good indicators of industry norms and consumer expectations

- **Draft privacy notice(s).** Create a list of information collection and information sharing practices that must be disclosed to consumers. This list can help you categorize practices per the rule requirements and decide how to structure notices. The privacy rule provides a variety of disclosure options. For example, banks may develop:
  - one initial privacy notice that covers all the information sharing practices of the bank
  - an assortment of initial notices for different customer relationships or different types of financial products or services
  - one initial notice that covers the practices of the bank along with one or more of its affiliates Likewise, the opt out notice may be structured in a variety of ways.

When drafting privacy notices, consider:

- **Sample clauses** provided in Appendix A in the rule. Banks may use the sample clauses to the extent they accurately reflect the bank's practices.
Most likely, the initial and annual privacy notices will be identical. If required, the opt out notice may be combined with the initial and annual notices.

- Fair Credit Reporting Act requirements and information security standards. The federal banking agencies have issued two proposed rules that may affect the compliance strategy and the content of privacy notices.

The Proposed Security Standards for Customer Information describe the agencies' expectations for implementing technical and physical safeguards to protect customer information. The Proposed Fair Credit Reporting Regulations cover the opt out provisions of the Fair Credit Reporting Act.

Both proposals will be finalized in the near future. When issued, the final rules will be available on the FDIC's Web site: www.fdic.gov. In the meantime, the proposals are posted on the Web site.

3. Deliver notices

- Identify consumers and customers who must receive the initial and opt out notices. It is important to identify all groups of existing customers, consumers, and former customers who must get the initial privacy notice and opt out notification. Some banks may need to coordinate several databases and a variety of departments to identify everyone who must receive a notice.

   Opt out notices for joint account holders: The privacy rule allows banks to provide a single privacy and opt out notice when two or more consumers jointly obtain a financial product or service. However, any of the joint consumers may exercise the right to opt out. The opt out notice provided to joint account holders must explain how the bank will treat an opt out direction by a joint consumer and must give one joint consumer the ability to opt out on behalf of all the joint consumers.

- Establish timeframes for mailing or otherwise delivering notices. Remember:
  - All existing bank customers must receive an initial privacy notice no later than July 1, 2001.
  - Existing bank customers, consumers who are not customers, and former bank customers have the right to opt out if the bank is sharing nonpublic personal information about them with nonaffiliated third parties outside the exceptions.
  - Information sharing subject to opt out cannot continue after July 1, 2001, until the initial and opt out notices are delivered and a reasonable opt out period has elapsed. Therefore, banks that intend to share nonpublic personal information outside the exceptions after July 1, 2001 should deliver notices well before July 1.

4. Prepare to respond to consumers

- Develop opt out procedures. All banks sharing nonpublic personal information outside of the exceptions will need to develop procedures for consumers to exercise an opt out, as well as procedures for processing and complying with opt out directions. The opt out procedures should include:
  - tracking the initial opt out opportunity (e.g., the first 30 days after the initial notice is delivered)
  - recording opt outs received from consumers
  - maintaining the opt out mechanism(s), such as a toll-free telephone number, electronic mail, or an opt out form with boxes to check
  - complying with opt out directions received after the initial opt out opportunity elapses

- Respond to public inquiries. Customer service representatives and other bank employees should be prepared to answer questions from consumers about the new privacy notices. Depending on the number of employees answering consumer phone calls, it may be a good idea to provide scripts to help employees respond to questions from the public. In addition, it may be helpful to have extra copies of the privacy notice readily available for mailing or handing out to consumers.

Section Three:
Maintaining Compliance Beyond
July 1, 2001
The following activities can help a bank achieve and maintain compliance with the privacy rule.

- Develop controls to monitor ongoing compliance. Consider mechanisms for monitoring:
  - delivery of initial and annual notices to customers
  - delivery of initial notice to consumers who are not customers, if applicable
  - compliance with opt out directions, if applicable
  - accuracy of privacy notices, including prior approval for:
    - new marketing arrangements
    - new or renewed vendor contracts
    - disclosure of account numbers
    - affiliate-referral programs
    - reuse of consumer information received from another financial institution

- Train employees. All employees should understand the bank’s policies and procedures for complying with the privacy rule. Some employees will need to be able to explain the bank’s privacy policies to customers and to businesses providing services to the bank.

- Audit for compliance. Periodic audits will help management assess risk and verify the effectiveness of the compliance program. The Federal Financial Institutions Examination Council (FFIEC) will release interagency privacy examination procedures before July 1, 2001. The exam procedures will be a useful tool in developing a privacy audit program.

The interagency exam procedures will be mailed directly to insured depository institutions as soon as they are finalized. The procedures will also be available on the FDIC’s Web site at www fdic gov when complete.

Section Four:
Learn the Lingo

Learning the lingo will help you understand and comply with the privacy rule. This section provides an explanation of key terminology.

Who must comply with the FDIC’s privacy rule?

The FDIC’s privacy rule refers to financial institutions that must comply with the rule as “you.” For example, when the rule states that “you must provide a notice” it means all entities subject to this rule must provide a notice. The following definition of “you” explains the types of entities subject to the rule:

You: The banks that must comply with the FDIC’s rule are -

(1) FDIC-supervised banks

(2) insured state branches of foreign banks

(3) subsidiaries of FDIC-supervised banks and insured state branches of foreign banks, with certain exceptions, such as insurance and securities or brokerage subsidiaries

Although the FDIC’s rule only applies to certain banks and some of their subsidiaries, all financial institutions must comply with similar privacy rules adopted by their supervisory agencies. For example, although securities subsidiaries of FDIC-supervised banks do not have to comply with the FDIC’s privacy rule, they do have to comply with a similar privacy rule adopted by the Securities and Exchange Commission.

Who is protected by the privacy rule?

The privacy rule protects “consumers.” All consumers receive the same privacy protections.

However, a subset of consumers defined as customers must receive certain disclosures, such as an annual privacy notice, that need not be provided to consumers who are not customers.

Thus, it is important to know the distinction between consumers and customers to understand the different disclosure
requirements under the privacy rule.

**Consumer:** Any individual who is seeking to obtain or has obtained a financial product or service from a bank for personal, family, or household purposes is a consumer of that bank. The definition of consumer includes individuals who:

- apply for a financial product or service (e.g., a loan or a deposit account) for personal, family, or household purposes
- actually obtain a financial product or service (e.g., a loan or a deposit account) for personal, family, or household purposes

**Customer:** As the following diagram reflects, customers are a subset of consumers. A customer is a consumer with whom a bank has a **continuing relationship.** Although the rule does not define "continuing relationship," it provides examples of transactions that are and are not considered continuing relationships. Consumers who have a deposit account, obtain a loan, or obtain an investment advisory service are considered customers. See Section 332.3(i).

Additional guidance regarding the customer relationship can be found in the Supplemental Information (the preamble) of the rule, which notes that a continuing relationship is established "where a consumer typically would receive some measure of continued service following, or in connection with, a transaction." See page 35168, Federal Register, Vol. 65, No. 106.

The next diagram depicts the relationship between all individuals who do business with a bank and those who meet the regulatory definitions for consumers and customers. As the diagram shows, only a portion of the individuals who conduct business with a bank are consumers under the privacy rule. For example, individuals are not considered consumers under this rule if they are commercial clients, grantors or beneficiaries of trusts for which the bank is trustee, or participants in an employee benefit plan that the bank sponsors.

What type of information is protected by the privacy rule? The rule identifies three primary categories of information:

- publicly available information
- personally identifiable financial information
- nonpublic personal information

**Nonpublic personal information** is the category of information protected by the privacy rule. The definitions for publicly available information and personally identifiable financial information work together to describe and define nonpublic personal information.

- **Publicly available information** is any information a bank reasonably believes is lawfully publicly available. The nature of the information, not the source of the information, determines whether it is publicly available information for purposes of the privacy rule. For example, even if a bank obtains customers' telephone numbers or the assessed value of their residences directly from the consumers, this information will be considered publicly available if the bank has a reasonable basis to believe the information could have been lawfully obtained from a public source. A reasonable belief exists if a bank has determined that (a) the information is of the type that is generally available to the public and (b) the individual has not blocked such
information from public disclosure. This means, for example, that a bank can consider a customer's phone number to be publicly available, but only if the bank takes steps to determine the phone number is not unlisted.

- **Personally identifiable financial information** is any information a bank collects about a consumer in conjunction with providing a financial product or service. This includes:
  - information provided by the consumer during the application process (e.g., name, phone number, address, income)
  - information resulting from the financial product or service transaction (e.g., payment history, loan or deposit balances, credit card purchases)
  - information from other sources about the consumer obtained in connection with providing the financial product or service (e.g., information from a consumer credit report or from court records)

**Personally identifiable financial information** also includes any information that "is disclosed in a manner that indicates that the individual is or has been your consumer." See Section 332.3(o)(2)(i)(D). Thus, the very fact that an individual is a consumer of a bank is personally identifiable financial information.

- **Nonpublic personal information**, the category of information protected by the privacy rule, consists of:
  1. Personally identifiable financial information that is not publicly available information; and
  2. Lists, descriptions, or other groupings of consumers that were either
     a. created using personally identifiable financial information that is not publicly available information, or
     b. contain personally identifiable financial information that is not publicly available information.

A list is considered nonpublic personal information if it is generated based on customer relationships, loan balances, or other personally identifiable financial information that is not publicly available. A list is also considered nonpublic personal information if it contains any nonpublic personal information.

For example, in jurisdictions where mortgage documents are public records, the names and address of all individuals for whom a bank held a mortgage would not be nonpublic personal information since it was generated using publicly available information and contained only publicly available information. The list would become nonpublic personal information, however, if it contained current loan balances or if it was generated using only those customers with current mortgage loan balances in excess of a certain amount.

The two categories of nonpublic personal information are depicted in the following diagram.

![Diagram of nonpublic personal information]

**Who are nonaffiliated third parties?**

The privacy rule restricts information sharing with nonaffiliated third parties. The rule defines nonaffiliated third parties as persons or entities except affiliates and persons jointly employed by a bank and a nonaffiliated third party. Affiliates generally include a bank's subsidiaries, its holding company, and any other subsidiaries of the holding company. See Section 332.3(a), Section 332.3(d), and Section 332.3(g).

The privacy rule does not impose limitations on information sharing with affiliates. It does, however, require disclosure of such information sharing policies and practices. (Note: The rules governing the sharing of information between a bank and its affiliates are set forth in the Fair Credit Reporting Act.)

Although the privacy rule most commonly uses the term "nonaffiliated third parties," there are some instances in which a distinction is made between nonaffiliated financial institutions and all other nonaffiliated third parties. Readers should pay particular attention to these distinctions. See Section 332.13.
Other Resources

A variety of resources are available to help banks understand the privacy rule and related issues. Some of the most significant are listed below. All FDIC material can be found at www.fdic.gov.


Last Updated 01/23/2001 communications@fdic.gov
New Rights to Privacy: You Now Hold the Key to How Much Information Financial Institutions Can Share

You'll be able to limit the personal information that banks and other financial institutions provide to other companies. Here's help for you in deciding what's best.

Watch your mail. You'll soon be receiving an important message from your bank and other financial institutions you've had dealings with over the years. It's a notice explaining that you, for the first time, can decide whether certain information these institutions have about you can be shared with or sold to other companies that are not part of the same parent organization.

The federal Gramm-Leach-Bliley Act of 1999 created this new opportunity for you as a way to balance your right to privacy with financial institutions' need to share information for normal business purposes. Some consumers don't object to information sharing—they want their names on mailing and telephone lists so they can easily find out about new products and services. But other consumers want fewer solicitations and more privacy. If you're in the latter category, you have some important new responsibilities if you want to take advantage of your new rights. "You need to be observant," says Ken Baebel, Assistant Director of the FDIC's Division of Compliance and Consumer Affairs. "You need to look for these notices, which may come as part of a monthly statement or as a separate mailing. You also need to understand whether an institution intends to share personal information with other companies and, if so, what you can do to prevent information sharing, if that's what you want. Otherwise, it will be up to the institution to decide who gets details about you and your finances."

You can expect to receive a lot of these notices in the coming months because the new law applies to many types of financial institutions. The law covers banks, savings and loans, credit unions, insurance companies and securities firms. It even includes some retailers and automobile dealers that collect and share personal information about consumers to whom they extend or arrange credit. Also, while the rules from the FDIC and other federal agencies say these notices to consumers must be accurate, clear and conspicuous, we know there's a lot to consider before you decide what's best for you. That's why FDIC Consumer News has developed the following question-and-answer format to help you understand your new rights to financial privacy and what you need to do to exercise those rights.

What kinds of personal information do financial institutions collect and share with other businesses?

Many financial institutions collect information about their customers as a regular part of their business of providing products or services. Examples: When you apply for a loan, you provide your name, phone number, address, income, and details about your assets. When the institution is considering your application, it may collect additional details from other sources, such as credit reports prepared by credit bureaus. And as you use a financial product—a credit card, for example—your institution will have a record of how much you buy and borrow, where you like to shop, and whether you repay your balance on time. Some (but not all) financial institutions share this information with other entities—including completely unaffiliated companies such as retailers, telemarketers, airlines and non-profit organizations—to help them target consumers who might be interested in their products or programs.

How does the Gramm-Leach-Bliley Act protect my financial privacy?
First, the new law requires each financial institution to tell its customers about the kinds of information it collects and the types of businesses that may be provided that information. This disclosure, called the privacy notice, is intended to help you decide whether you are comfortable with that information-sharing arrangement. The notice has to be mailed to you by July 1, 2001, by any institution where you already have an account. If you open an account with a different institution after July 1, you must be given a copy of the privacy notice at that time. Financial institutions also are required to send a privacy notice to customers once a year.

Second, the law says that if your financial institution intends to share your information with anyone outside its corporate family, it also must give you the chance to "opt out" or say "no" to information sharing under certain circumstances. Even consumers who are not technically customers of a financial institution—such as former customers or people who unsuccessfully applied for a loan or credit card—will have the right to opt out of information sharing with outside companies.

Third, the law requires that financial institutions describe how they will protect the confidentiality and security of your information.

When I receive a privacy notice, what should I look for?

We encourage you to read the entire notice carefully. You may, though, want to focus on your financial institution's descriptions of the following:

- The kind of information it shares with other parts of the same company, likely to be described as "members of our corporate family" or "our affiliates";
- The information it shares with other companies or organizations that are not part of the same corporate group as your financial institution, perhaps called "nonaffiliated third parties";
- What information you can prevent your financial institution from sharing with other companies or organizations; and
- How you go about opting out, if that's what you want to do.

Will the privacy notice list exactly what information the financial institution wants to share, and with whom?

No. The regulations say the privacy notice must describe the basic categories of information a financial institution collects and shares with other entities, and give examples. But a financial institution is not required to list every type of information it may gather or share, or tell you the names of specific companies or organizations that may buy or receive your information. If you have questions or concerns, contact your financial institution at the address or phone number listed in its privacy notice.

"You need to look for these notices. You also need to understand whether an institution intends to share personal information with other companies."

Ken Baebel, FDIC consumer affairs expert

What kind of information can I stop an institution from sharing?

You have a general right to block the sharing of non-public personal information with outside companies and organizations, but there are exceptions (as explained in the next question and answer). Also, your institution may remind you that a law passed several years ago, the Fair Credit Reporting Act, gives you limited rights to stop selected information-sharing with affiliates.

What information can't I prevent from being shared, even if I opt out?

Under the new law, you cannot bar an institution from providing personal information to outside companies and organizations if, for instance:

- The information is needed to help conduct normal business. Example: Your bank can send personal information to outside firms that help market the institution's products, handle its data processing (for your loan payments, checking account statements, electronic banking transactions or credit card purchases), or mail account statements.
- The information is needed to protect against fraud or unauthorized transactions, or is provided in response to
a court order.

- The institution reasonably believes the information is "publicly available." Robert Patrick, an FDIC consumer law attorney in Washington, explains that publicly available information "includes your name, address, and telephone number as they appear in the telephone book, information about your home mortgage recorded in county records, or information that would be found on your driver's license if that information is available from your state's department of motor vehicles."

- The information is used as part of a "joint marketing agreement." That's a situation in which two or more financial institutions—say, a bank and insurance company—agree to jointly offer, endorse or sponsor the same products or services.

In addition, the Fair Credit Reporting Act says an institution has a right to give an affiliate any information obtained from your transactions with that institution. Example: Your bank can give an affiliated insurance company details about your deposit accounts. This could be useful information if, say, the insurer wants to offer you an annuity as an investment when one of your CDs is about to mature. Even though you cannot prevent this information from being shared, the bank still must tell you about these practices in its privacy notice.

How do I know if I should opt out?

It depends on how the information is shared... and it depends on your viewpoint. If a financial institution widely shares your personal information with other businesses, you'll get more mail, phone calls or other unsolicited promotions than if you decide to opt out. Some consumers see information sharing as a plus because it helps them shop from home or find out about new products and services, including potentially good deals on a new loan, insurance policy or investment. Other consumers say they don't want so many solicitations from telemarketers and mail advertisers, and they don't want a lot of other businesses and people knowing about their finances or spending habits. You must decide what's best for you.

"If you opt out, your bank will still be able to share personal information about you with outside entities in certain circumstances, but you will be putting a limit on at least some information sharing," adds the FDIC's Patrick. "If you don't opt out, your bank can sell information about you to any business or person, and there are few restrictions on how that information might be used."

The FDIC's Baebel suggests that you review your institution's privacy notice and "ask yourself if you're comfortable with the types of businesses receiving your personal information, and with what they are likely to do with the information." If you have questions or concerns, he says, contact your institution. "Banks and other financial institutions are interested in maintaining good customer relations," Baebel adds. "They should be more than willing to explain how they use your information, how they protect that information, and the circumstances in which they share information with other businesses or people."

You can also get general guidance by contacting the government agencies listed in "For More Help or Information Regarding Your Rights to Financial Privacy".

Before I decide whether to opt out, am I entitled to a copy of the information my bank might share with other companies, and will I have a chance to correct errors?

The Gramm-Leach-Bliley Act doesn't require your bank to give you access to the information it collects or a chance to make changes. However, if you have concerns, you can ask your bank if it will voluntarily let you see your personal records and comment on their accuracy. Banks do let customers review their personal information under certain circumstances.

How much time will I have to decide whether to opt out?

Federal regulations didn't set strict deadlines. The rules instead say that a consumer must be given a reasonable opportunity to opt out. You'll probably have about 30 days to reply to an opt-out notice delivered by mail. In limited instances, though, such as when you're using another bank's ATM machine, you may be asked to make a decision about opting out right then and there. If an institution doesn't get a response from you by its deadline, it can assume that you have decided not to opt out.

"If you opt out, your bank will still be able to share information about you with outside entities in certain circumstances, but you will be putting a limit on at least some information sharing." Robert Patrick, FDIC attorney
If I decide to opt out, do I have to notify the institution in a certain way?

Yes, most likely. That's because the institution can establish a procedure that everyone must use to opt out, provided that it is reasonable. So, be sure to check the instructions that come with your privacy notice. For example, your bank may require you to call a certain telephone number, not just any number at the bank. Or, it may require you to complete a form and mail it to a specific address. Patrick adds that "even if you call the bank to opt out, it's a good idea to also notify it in writing and to keep a copy of your written notice for your records."

What if I decide against opting out now but I later change my mind, or what if I forget to opt out by the due date?

You can always opt out, even months or years from now. But, be aware that any opt-out request only covers the sharing of information in the future. There is no requirement that a financial institution contact the organizations it has already shared your information with and tell them they cannot use that information any more.

If I have an account at a bank jointly with other people, do we all need to agree on whether to opt out?

If the bank sends separate notices to each account holder, each person can choose for himself or herself. However, because the rules allow banks to provide a single opt-out notice when two or more customers have a joint account, it's important to pay attention to what the bank says about opt-out requests. If, for example, the bank sends separate notices to two owners of a joint account and only one of them responds, the bank may continue sharing the other person's information. "If you receive an opt-out notice from a bank where you have a joint account, be sure to discuss that information with the other people who share that account with you," Patrick says. "That way, if any of you decide to opt out, you can do so properly."

Final Thoughts

Your right to financial privacy is important. And thanks to the new privacy law, you now have more of a say in how much of your information financial institutions may share with other companies. It's up to you to take advantage of these protections. Watch for the privacy notices from your financial institutions, read them carefully and follow the instructions if you decide to exercise your right to opt out. If you have questions, contact your financial institution or one of the federal regulatory agencies on our "For More Help..." and "For More Information" pages. We hope that the information we've provided here will help you understand your rights... and help you make decisions that are right for you.
TO: Chief Executive Officers and Compliance Officers of All National Banks, Federal Branches and Agencies, Service Providers and Software Vendors, Department and Division Heads, and All Examining Personnel

PURPOSE

The purpose of this bulletin is to alert you to the joint-agency issuance of the attached final "Guidelines Establishing Standards for Safeguarding Customer Information" and to highlight provisions of these guidelines. The guidelines are mandated by Section 501 of the Gramm-Leach-Bliley Act of 1999 (GLBA), and are effective July 1, 2001. The guidelines affect all national banks, federal branches and federal agencies of foreign banks, and any subsidiaries of such entities (except brokers, dealers, persons providing insurance, investment companies, and investment advisors). The guidelines describe the Office of the Comptroller of the Currency’s (OCC’s) expectations for the creation, implementation, and maintenance of a comprehensive information security program.

BACKGROUND

Section 501 of the GLBA requires the OCC and other federal banking agencies to establish appropriate standards for the administrative, technical, and physical safeguards for customers’ “nonpublic personal information.” The OCC has done so by issuing guidelines that require each national bank to establish an information security program.

A bank’s information security program must be designed to ensure the security and confidentiality of customer information, protect against any anticipated threats or hazards to the security or integrity of such information, and protect against unauthorized access to or use of such information that would result in substantial harm or inconvenience to any customer.

Because the guidelines codify existing agency guidance, banks should already have existing information security programs that identify and control risks to information and information systems. While the guidelines cover only “customer information” as that term is defined, the...

1 Certain functionally regulated subsidiaries, such as brokers, dealers, and investment advisors will be subject to security regulations issued by the Securities and Exchange Commission. Insurance entities may be subject to security regulations issued by their respective state insurance authorities.

Date: February 15, 2001
OCC encourages banks to use the approach provided by the Guidelines to protect all customer and bank records.

Highlights of the Guidelines

The guidelines allow each institution the discretion to design an information security program that suits its particular size and complexity and the nature and scope of its activities. The guidelines take a process-based approach that is consistent with OCC guidance, notably OCC Bulletin 98-3 ("Technology Risk Management"), issued February 4, 1998; and OCC Bulletin 2000-14 ("Infrastructure Threats -- Intrusion Risks"), issued May 15, 2000.

Role of the Board of Directors. The board of directors or an appropriate committee of the board is responsible for approving the bank’s written information security program and overseeing the program’s development, implementation, and maintenance, including assigning responsibility for its implementation. At least once a year, bank management should report to the board or an appropriate committee of the board on the overall status of the information security program and the bank’s compliance with the guidelines.

Identify and Assess Risk. The bank should first assess risks to its customer information. A bank’s risk assessment should identify reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems. Additionally, the risk assessment should consider the likelihood and potential damage of these threats, taking into consideration the sensitivity of customer information. Finally, the assessment should consider the sufficiency of existing policies, procedures, customer information systems, and other arrangements intended to control the risks identified.

Manage and Control of Risk. The bank should design an information security program to control the identified risks, commensurate with the sensitivity of the information and the complexity and scope of the bank’s activities. The guidelines highlight eight security measures that banks should consider and adopt if appropriate.

The information security program also should include training for bank staff and regular testing of the key controls, systems, and procedures. The nature and frequency of the tests should be determined by the bank’s risk assessment. To ensure objectivity, tests should be conducted or reviewed by third parties or staff who are independent of those who develop or maintain the security programs.

Oversee Service Provider Arrangements. Banks also have an obligation to oversee their service providers. Banks that use service providers should exercise appropriate due diligence in selecting them, including conducting a review of the measures taken by the service providers to protect customer information. The contract between the bank and the service provider must require the provider to implement appropriate measures designed to meet the objectives of the guidelines. Wherever indicated by a bank’s risk assessment, the bank should monitor its service providers to confirm they are implementing the agreed-upon security measures. As part of this
monitoring, a bank should review audits, summaries of test results, or other equivalent evaluations of its service providers.

Adjust the Program. Risks to customer information change over time with changes in technology, the sensitivity of customer information, internal or external threats to information, and the bank’s own business arrangements, such as mergers and acquisitions, alliances and joint ventures, outsourcing arrangements, and changes to customer information systems. Therefore, banks should monitor, evaluate, and adjust, as appropriate, their information security program. The OCC expects banks to make the appropriate changes to their information security programs before any bank-initiated changes are made to their customer information systems, such as changes to accommodate new services.

Implement the Guidelines. The guidelines are effective on July 1, 2001. However, there is a two-year grandfathering provision for service provider contracts. Existing service provider contracts (namely, contracts entered into until March 5, 2001) do not have to be renegotiated to comply with the Guidelines until July 1, 2003.

RESPONSIBLE OFFICE

Questions regarding this banking issuance should be directed to John Carlson, senior advisor for Bank Technology, (202) 874-5013; Aida Plaza Carter, director for Bank Information Technology Operations, (202) 874-4740; or Deborah Katz, senior attorney, Legislative and Regulatory Activities Division, (202) 874-5090.

Clifford A. Wilke
Director, Bank Technology Division

Attachment--66 FR 8616
TO: Chief Executive Officers and Compliance Officers of All National Banks, Department and Division Heads, and All Examining Personnel

PURPOSE

This advisory is to help prepare you for the implementation of the new Privacy of Consumer Financial Information regulation, 12 CFR 40. The regulation becomes fully effective on July 1, 2001, and it affects all national banks, large and small, including most of their subsidiaries. A questionnaire is attached to assist you in your preparations and in performing a self-assessment. During the 2001 quarterly reviews conducted with your bank, your examiner-in-charge or bank portfolio manager will include a discussion of this advisory, the results of your self-assessment, and your progress toward full compliance with the provisions of 12 CFR 40. The extent of that discussion will be determined by the size of the institution involved, the nature of its information collection and sharing practices, and any concerns the examiner may have regarding the state of the bank's preparedness.

BACKGROUND

Title V of the Gramm-Leach-Bliley Act (GLBA) of 1999 sets forth provisions addressing the obligations of a financial institution with respect to the privacy of consumers' nonpublic personal information. The Office of the Comptroller of the Currency's (OCC's) implementing regulation, 12 CFR 40, Privacy of Consumer Financial Information, provides for disclosures to consumers of a financial institution's privacy policy and the rights of consumers to direct their financial institution not to share their nonpublic personal information with third parties (opt out). A copy of the regulation is included in OCC Bulletin 2000-21 ("Privacy of Consumer Financial Information"), issued June 20, 2000. In addition, OCC Bulletin 2000-25 ("Privacy Laws and Regulations"), issued September 8, 2000, provides information and guidance regarding the various federal laws and regulations relating to the disclosure of consumer financial information.

Many who commented on the proposed rule stated that they needed more time than was provided in the statute to comply with the regulation. Commenters noted that they needed extra time to assess existing information practices, prepare new disclosures, develop software to track opt outs, train employees, and create management oversight, internal review, and auditing systems to ensure compliance. As a result of the comments, the agencies exercised their authority under section 510(1) of the GLBA and extended the mandatory compliance date. Financial institutions...
are expected to be in full compliance with the regulation by July 1, 2001. Full compliance means that an institution has delivered a privacy notice to its customers and, where applicable, has afforded its customers a reasonable opportunity to opt out of information sharing before July 1, 2001. These institutions may continue to share nonpublic personal information after that date for customers who do not opt out.

PRIVACY PREPAREDNESS MEASURES

Senior management and the boards of directors of national banks and their subsidiaries are strongly encouraged to ensure that their institutions take all appropriate steps before the mandatory compliance date so that their institutions will comply fully with the privacy regulation by the July 1, 2001, deadline. The term "bank" in this advisory includes national banks, federal branches and agencies of foreign banks, and subsidiaries of a national bank or federal branch or agency, except subsidiaries that are brokers, dealers, persons providing insurance, investment companies, investment advisers, and entities subject to regulation by the Commodity Futures Trading Commission.¹ These steps should include

- Assessing existing information practices by conducting an inventory of information collection, disclosure, and security practices;

- Evaluating agreements with nonaffiliated third parties that involve the disclosure of consumer information;

- Where necessary, establishing mechanisms to permit and process opt-out elections by consumers;

- Developing or revising existing privacy policies to reflect the new regulatory requirements;

- Determining how to deliver privacy notices to consumers;

- Establishing employee training and compliance programs; and

- Developing an implementation plan.

Assessing Existing Information Practices. Banks are encouraged to assess their existing practices with respect to nonpublic personal information in order to (1) accurately represent them in their privacy policies; (2) determine the extent to which disclosures to third parties fall within the statutory exceptions; (3) evaluate which information disclosures, if any, would trigger opt-out rights for consumers; and (4) determine whether any practices are prohibited, e.g., impermissible sharing of account numbers with third parties. This exercise should also assist banks in evaluating the desirability of continuing or altering existing practices.

¹ Certain functionally regulated subsidiaries, such as brokers, dealers, and investment advisers will be subject to privacy regulations issued by the Securities and Exchange Commission. Insurance entities may be subject to privacy regulations issued by their respective state insurance authorities.
Evaluating Agreements with Nonaffiliated Third Parties that Involve Disclosure of Consumer Information. Banks should determine whether their agreements with nonaffiliated third parties that involve the disclosure of nonpublic personal information meet the regulatory requirements for maintaining the confidentiality of the bank’s consumer information. For instance, if a bank discloses customer lists to a nonaffiliated third-party service provider to market the bank’s own products or services, or to a nonaffiliated financial institution pursuant to a joint marketing agreement, section 40.13 of the regulation requires the bank to enter into a contract limiting the third party’s use or disclosure of that information. Additionally, banks should consider how best to maintain the confidentiality of the consumer information they disclose pursuant to other nonaffiliated third-party arrangements, such as routine service agreements. Under the regulation, any nonaffiliated third party that receives nonpublic personal information from a bank is limited in its ability to use or disclose the information. Banks are encouraged to inform their service providers to familiarize themselves with these limitations. Moreover, banks that obtain nonpublic personal information from other nonaffiliated financial institutions also face limits on their use or disclosure of this information.

Establishing Mechanisms to Handle Opt-Out Elections. Banks that disclose information to nonaffiliated third parties outside the statutory exceptions must provide their consumers with a mechanism to opt out of that information sharing. Banks must ensure that they meet the regulatory requirements for providing consumers with a clear and conspicuous opt-out notice and a reasonable means to do so (e.g., a convenient mechanism for opting out and a reasonable period of time (e.g., 30 days)). In addition, banks must devise the means to record, maintain, and effectuate opt-out elections by consumers.

Developing a Privacy Policy. The regulation requires that all banks, even those that do not share nonpublic personal information, provide privacy notices to customers. Institutions must develop or revise existing privacy notices to conform them to the new privacy requirements. The notices must meet the clear and conspicuous standards, and they must accurately reflect the bank’s privacy practices. In developing their privacy practices and notices, banks may want to evaluate the competitive aspects of their policies and obtain consumer input (e.g., as to whether consumers understand and accept the policy).

Delivering Privacy Notices. Banks must determine the mechanism to deliver initial, annual, and revised privacy notices and opt-out notices to customers, consumers, and joint account holders. Methods of delivery may include hand delivery, mail, and electronic delivery where the consumer is conducting business with the bank electronically and agrees to electronic disclosures. Banks should deliver privacy notices to customers, and where applicable, afford them a reasonable opportunity to opt out of information sharing before July 1, 2001.

Establishing Training Programs. All bank employees should have a general understanding of the bank’s privacy policies; however, certain employees require more detailed knowledge. Customer service personnel, personnel who process requests for consumer information or who provide such information to third parties, and other employees in contact with consumers must have a thorough understanding of the bank’s privacy policies and practices. They should be prepared to answer questions about the bank’s privacy policies and practices, address whether an individual consumer’s records are shared, direct consumers through the bank’s complaint

Date: January 22, 2001
process, and if applicable, provide notices to consumers. Bank training programs should be
customized for the audience, should be ongoing, and should provide follow-up when problems
are noted.

Establishing Compliance Programs. Banks should ensure that their compliance personnel are
involved in the privacy preparations. Compliance should evaluate the bank's privacy practices
and measures undertaken to ensure regulatory conformance. Internal controls, policies, and audit
procedures should be developed, and audits/compliance reviews scheduled, in time for the
July 1, 2001, implementation date. Implementation problems and compliance deficiencies
identified by the compliance staff should receive immediate attention by senior management.

Developing an Implementation Plan. To ensure timely and adequate compliance with the new
privacy requirements, banks should develop a privacy action plan that takes into consideration
the above measures, as appropriate. The plan should be approved by senior management and the
board, and should include target dates, goals, and responsible parties. Also, it should call for
testing and progress reports.

Attached to this advisory is a privacy preparedness questionnaire that may be used to perform a
privacy self-assessment. It sets forth measures for implementation and compliance. The
questionnaire is a general guide that addresses a broad scope of application, and as a result, some
questions may not be applicable to your financial institution. During the 2001 quarterly reviews
of your bank, examiners will inquire about your privacy policies and preparations, and the results
of any self-assessment. They will use the attached questionnaire to ask applicable questions
about your privacy readiness and may also offer suggestions to improve your compliance efforts.
Results of these reviews will allow the OCC to determine which national banks may be at higher
risk for noncompliance requiring priority in examination scheduling.

Questions concerning this advisory may be directed to your supervisory office or the Community
and Consumer Policy Division at (202) 874-4428.

Ralph E. Sharpe,
Deputy Comptroller for Community and
Consumer Policy

Attachment
Privacy Preparedness Questionnaire

Assessing Existing Information Practices

1. What are your information-sharing practices?

- What information is shared with affiliates and nonaffiliates (including sharing within and outside of the regulatory exceptions contained in 12 CFR 40.13, 40.14, 40.15), what is the purpose of the sharing, and is information shared on former customers?
- Are account numbers or access numbers/codes disclosed to nonaffiliated third parties?
- What information do you share on consumers who are not customers?
- Do you route requests for nonpublic personal information to a central point or use other control measures?
- Will any of your current information-sharing practices be prohibited by the regulation?

2. What kinds of information do you collect from consumers and customers for the various financial products and services offered by the bank?

3. Do you obtain information about consumers and customers from other financial institutions? If so, do you use or share the information for other purposes?

4. Are your safeguards for protecting customer information consistent with Section 501(b) of the Gramm-Leach-Bliley Act?

- Has the board approved the written information security program?
- Are your safeguards adequate to: a) ensure security and confidentiality of customer records and information, b) protect against any anticipated threats or hazards to the security or integrity of customer records and information, and c) protect against unauthorized access to, or use of, such records or information that could result in substantial harm or inconvenience to any customer?
- Has your information security program been tested in accordance with the regulatory guidelines?

Evaluating Agreements with Nonaffiliated Third Parties that Involve Disclosure of Consumer Information

5. What arrangements, agreements, or contracts exist with nonaffiliated third parties that involve disclosing consumer information? Do contracts or agreements detail responsibilities regarding the use, disclosure, and protection of consumer information?

6. What changes need to be made to conform the arrangements, agreements, or contracts to the regulation?
UPDATE ON BANKRUPTCY
AND OTHER INSOLVENCY ISSUES

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SECTION D
# UPDATE ON BANKRUPTCY AND OTHER INSOLVENCY ISSUES

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B. Plan Confirmation

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SECTION D
UPDATE ON
BANKRUPTCY AND OTHER INSOLVENCY ISSUES

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I. INTRODUCTION

This outline reviews selected developments in bankruptcy case law during approximately the last year. This material concentrates on developments of interest to lenders, and particularly Sixth Circuit and Kentucky decisions. Decisions of interest during the past year demonstrate continued development of the law on subjects such as the various ramifications of fraud, the status of retirement funds, and other subjects that are of particular interest to financial institutions today.

Bankruptcy reform legislation is again moving through Congress and, if passed by both houses, may face a more receptive executive branch. However, it is still uncertain when any reform measure will actually be enacted. Certain of the provisions of the two versions are reviewed below.

II. NEW BANKRUPTCY CASES

A. Dischargeability and Discharge

The general discharge available to debtors, and the dischargeability of particular debts, continue to see development in the case law. The Bankruptcy Code provides for the discharge of debts under 11 U.S.C. §§ 727, 1141, 1228 and 1328. A debtor may be denied a discharge generally, usually for bankruptcy-related misconduct. Particular debts may be excepted from discharge for reasons related to the nature of the debts themselves. These 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.

In re Keeney, 227 F.3d 679 (6th Cir. 2000). In this case, the Sixth Circuit affirmed the bankruptcy court’s order denying the debtor a discharge for concealing a “beneficial interest” in property and making a false oath. Through this decision, the Sixth Circuit joined other courts in adopting the doctrine of “continuing concealment.”

In 1971, Mary Jean Smith obtained a judgment against Milton Keeney, but had been unable to collect it. Keeney filed for bankruptcy protection in 1996. Between 1992 and the

1 Many thanks to our associates Joshua Denton, Adam Goebel, Heather Pennington and Lee A. Webb for their very valuable research and drafting assistance.
bankruptcy filing, two tracts of real property were purchased in the names of Keeney’s parents. However, Keeney and his wife lived on or otherwise used the property, he or his business made the mortgage payments and improvements, and he paid no rent to his parents. Keeney claimed in the bankruptcy proceeding to have no interest in the properties. Smith objected to discharge, arguing that the real estate conveyances were made in an effort to conceal that the property was actually Keeney’s. The bankruptcy court denied the debtor discharge under 11 U.S.C. §727(a)(2)(A), because he found that the debtor had continuously concealed his beneficial interest in the property. The bankruptcy court further found that the debtor had violated 11 U.S.C. §727(a)(4)(A) by making a false oath when he omitted the property from his bankruptcy schedules. The U.S. District Court (J. Coffman) upheld the bankruptcy court.

On appeal, the Sixth Circuit adopted the doctrine of continuing concealment. It held that the bankruptcy court’s finding that debtor had concealed his beneficial interest in the two properties by placing them in his parents’ names, with the requisite intent to defraud, was not clearly erroneous. The Court rejected the debtor’s argument that he had nothing to conceal because he had no interest in the property, finding that a beneficial interest would be inferred from his payment for and use of the properties. The Court rejected the debtor’s claim that the action was time-barred. It held that the debtor’s concealment of his interest in the property continued until the time of the filing of the bankruptcy, and this brought the debtor’s actions within the reach of §727(a)(2)(A).

The Sixth Circuit also rejected the debtor’s argument that, because the statute of limitations had run, precluding the plaintiff from recovering the separate property under Kentucky law, his actions could not constitute a violation of §727(a)(2)(A). The Court held that, even when no creditors are harmed by the concealment, a violation of §727(a)(2) may nevertheless occur because proof of harm is not a required element of a cause of action under §727. The court also rejected the debtor’s argument that, because he had no interest in the subject property, he could not have made a false oath concerning it. The Court found complete financial disclosure to be prerequisite to the privilege of discharge.

In re Bailey, 254 B.R. 901 (6th Cir. BAP 2000). Ms. Bailey filed a complaint in bankruptcy court asserting that a $20,000 debt owed to her by her former husband, the debtor, was nondischargeable under 11 U.S.C. §523(a)(5) because it was in the nature of support. The bankruptcy court agreed and the debtor appealed. The Sixth Circuit BAP noted that the state court that awarded plaintiff an absolute divorce repeatedly identified the award as being for maintenance, support, and alimony. The court noted that an award that is designated as support by a state court and that has other indicia of a support obligation should be conclusively presumed a support obligation by the bankruptcy court. These indicia include the award being contingent upon events such as death or remarriage, the relative disparity of earning power, the need for economic support and stability, the presence of minor children, and other factors. Once a non-debtor spouse demonstrates that these indicia are present, the burden of proving the obligation is nondischargeable pursuant to §523 is satisfied. The burden then shifts to the debtor spouse to demonstrate that, although the debt is of the type that may not be discharged in bankruptcy, its amount is unreasonable in light of the debtor’s financial circumstances. Because the indicia cited in the bankruptcy court’s factual findings supported the conclusion that the obligation was in the nature of support, the BAP concluded that the bankruptcy court’s findings
were not clearly erroneous and held the debt nondischargeable pursuant to 11 U.S.C. §523(a)(5). The court did remand for additional factual findings regarding the amount of the nondischargeable debt, because the record was insufficient to establish for the bankruptcy court’s ruling on that point.

**In re Vitanovich, 2001 Bankr. LEXIS 226 (6th Cir. BAP 2001).** In this case, the bankruptcy court found the plaintiff bank’s claim was nondischargeable under 11 U.S.C. §523(a)(2)(A) (false pretenses, false representation or actual fraud other than a statement of financial condition), because the debtor incurred the debt as part of an elaborate and ongoing check kiting scheme. The “overwhelming circumstantial evidence” showed the debtor’s scheme involved high dollar amounts, multiple transactions, careful planning and control by the debtor. On appeal the BAP for the Sixth Circuit adopted the position of the Seventh Circuit which holds that actual fraud as used in 11 U.S.C. §523(a)(2)(A) is not limited to misrepresentations and misleading omissions, but can include an overall scheme designed to deprive or cheat another of property or a legal right. Under this interpretation, the BAP agreed with the bankruptcy court that the debtor had engaged in actual fraud and was not entitled to the fresh start provided by the bankruptcy code. The BAP upheld the bankruptcy court’s finding of nondischargeability. It distinguished this case from cases like **In re Rembert, 141 F.3d 1277 (6th Cir. 1998)**, involving an allegation of a misrepresentation.

**In Miller, 250 B.R. 294 (E.D. Ky. 2000).** Here, Judge Howard made an attorney fee award against a creditor who lost its nondischargeability action. 11 U.S.C. §523(d) requires the court to award attorneys fees to a debtor and against a creditor when the debtor prevails in a nondischargeability action under 11 U.S.C. §523(a)(2) unless the creditor was “substantially justified” in its position. The plaintiff filed a complaint seeking to have the debtor’s $1,181.58 debt to it declared nondischargeable. The debtor’s motion for summary judgment was granted, and he sought attorney fees under 11 U.S.C. §523(d).

The court noted that the Supreme Court has interpreted the term “substantially justified” to mean justified in substance or in the main -- that is “justified to a degree that could satisfy a reasonable person.” The court may also apply a three part standard of reasonableness: (1) a reasonable basis in law for the theory propounded; (2) a reasonable basis in truth for the facts alleged; and (3) a reasonable connection between the facts alleged and the legal theory advanced. The court also held that the determination should turn on a totality of the circumstances.

The court then analyzed the creditor’s claim. It noted that, under **In re: Rembert, 141 F.3d 277 (6th Cir. 1998)**, a key element in establishing nondischargeability of the type at issue here is whether the debtor intended to deceive the creditor. This is whether the debtor subjectively intended to repay the debt. The debtor apparently submitted affidavit proof on his intent and the creditor had no contrary proof. The court also noted that there was no proof of the facts necessary for a presumption of nondischargeability (i.e. limits on luxury goods or cash advances within 60 days of the petition). The court then assessed the connection between the facts alleged and a valid legal theory. It noted that the creditor alleged that the debtor knew that he did not have the ability to repay the debt, but that it is intent to pay, not ability to pay that is a factor in determining nondischargeability based on false pretenses. In addition, all of the allegations in the plaintiff’s complaint were made only on the basis of the bankruptcy schedules and the bank’s own records. The bank did not attend the 341 meeting or try to conduct a Rule
2004 examination. While these failures on the plaintiff’s part were not dispositive, the court considered them probative because either one of these actions would have provided information concerning material facts. Finally, the court held:

Creditors who challenge the dischargeability of debts based on the fraud exception contained in 11 U.S.C. 523(a)(2)(A) are well advised to consider whether they can offer facts which can support a finding of fraud under the standards set out in In re Rembert, supra. Allegations that focus on charges incurred or payments not made are not sufficient in and of themselves. A minimal amount of pre-filing investigation might have resulted in a better decision on the part of the plaintiff concerning the filing and pursuit of this adversary proceeding.

Id. at 297.

In re Wells, 246 B.R. 268 (E.D. Ky. 2000). Here, James and Paula Wells incurred a debt to Fifth Third Bank that was secured by a certificate of deposit owned by debtor James’ mother, Norma McDowell, in the amount of $28,000. The Wellses defaulted and the CD was liquidated and applied against the debt. The debtors then filed a Chapter 7 proceeding and did not list Ms. McDowell as a creditor. There was some suggestion that the omission was deliberate. The trustee filed a report of no distribution, the Wellses were granted a discharge and the case was closed in early 1996. In 1999, Paula Wells moved to reopen the case to add McDowell as a creditor. McDowell asserted that the debtors’ deliberate failure to list her as a creditor was fraudulent and the court should overrule the motion to reopen and amend schedules to list her as a creditor. McDowell cited In re: Rosinski, 759 F.2d 539 (6th Cir. 1985) for the proposition that the reopening should not be allowed if the failure to include the creditor in the original schedules can be shown to have prejudiced the creditor or been part of the scheme to defraud and was done intentionally. However, McDowell did not allege any ground for the nondischargeability of the debt and there were no assets to distribute. The court concluded that McDowell’s case was more like that in In re Madaj, 149 F.3d 467 (6th Cir. 1998), which held that, in a no asset chapter 7 case, the state of mind of the debtors in failing to list the objecting creditor is irrelevant. The debtors’ failure to list the claim, even if intentional, does not turn an “innocent” loan into a fraudulent one. The court held that the discharge entered in the proceedings discharged the debtors from their obligations to McDowell, even though the debt to her had not been scheduled. It was not necessary to reopen the case and schedule McDowell’s debt to accomplish that result.

In re Crump, 247 B.R. 1 (Bankr. W.D. Ky. 2000). This case involves a creditor’s claim that a debt to it is nondischargeable because of the debtor’s failure to remit the proceeds from the sale of the creditor’s collateral. The debtor was a farmer. Most, if not all, of his assets were encumbered to a local bank. Debtor was also heavily indebted to the Mayfield Grain Co. on an open account. His farming operation was struggling, and he was unable to pay off his annual debts to the bank or his other creditors. Following a disastrous crop year in 1998, Mayfield Grain became concerned that he might not be able to pay off his account and asked him to sign a security agreement on existing crops, with no advance of additional funds. He agreed and did so.
The debtor’s farming operation worsened further. He sold his grain and deposited the various checks received from the sale of the grain into his farm account for the payment of farm expenses. This was a violation of the security agreement, which required Debtor to remit the proceeds generated from the sale of the collateral. He eventually filed a bankruptcy proceeding. Mayfield Grain sought to have the debtor’s debt to it declared nondischargeable under 11 U.S.C. §523(a)(6). That statute states that “a discharge under section 727 . . . of this title does not discharge an individual from any debt -- (6) for willful and malicious injury by the Debtor to another entity or to the property of another entity.”

The bankruptcy court discussed the holdings of Kawaauhau v. Geiger, 523 U.S. 57 (1998) and In re: Markowitz, 190 F.3d 455 (6th Cir. 1999), which analyzed the scope of the “willful and malicious injury” exception set forth in §523(a)(6). The court (Judge Roberts) concluded that “only acts done with intent to cause injury -- and not merely acts done intentionally -- can cause willful and malicious injury.” Markowitz, 190 F.3d 463; Geiger 523 U.S. at 61. Based on the evidence adduced at trial, the court concluded that Debtor’s intent was to keep his farming operation afloat, not to harm the creditor or its collateral. That evidence included the Debtor’s attempt to minimize his farming costs by using less fertilizer and performing the majority of farm work with borrowed equipment, the reduction of his own cost of living by trading in his truck for a less expensive truck and selling his $100,000 home to buy a $24,000 mobile home and his work at a separate job. The court also found it significant that Debtor executed the security agreement in favor of Plaintiff after he had already incurred substantial debt, solely for the purpose of protecting Plaintiff, and that Debtor did not seek additional credit or obtain any funds at any time after executing the agreement. The court found all of this an indication of Plaintiff’s good intent rather than malicious intent. Lastly, the court found Plaintiff’s own conduct reinforced Debtor’s admittedly erroneous understanding that the security agreement permitted him to funnel the proceeds of his grain sales back into the farming operation rather than remitting them to the Plaintiff. In several instances, the Plaintiff was the purchaser of Debtor’s crop, and allowed the Debtor to take the check for the proceeds of the grain with him, without retaining any portions thereof. That finding supported the conclusion that Debtor not only lacked intent to harm the Plaintiff or its collateral, but also supported the conclusion that the Plaintiff acquiesced in the Debtor’s handling of the proceeds. The court declined to except Plaintiff’s claim from discharge under §523(a)(6).

B. Plan Confirmation

In re Tenn-Fla Partners, 226 F.3d 746 (6th Cir. 2000). Here, the Sixth circuit addressed the issue of the revocation of a Chapter 11 plan of reorganization procured by fraud. The debtor was a partnership that held a single asset, an apartment complex in Orlando, Florida. In 1999, the partners refinanced the first mortgage on the property with approximately $12 million in tax-exempt bonds issued by the Florida Housing Finance Authority. First Union National Bank of Florida served as the indenture trustee for the bondholders. In 1992, the debtor partnership filed a voluntary Chapter 11 petition. The filing of the petition was preceded by a downturn in the Orlando real estate market, which Debtor alleged reduced the value of the apartment complex well below the debt securing the property. The case revolved around the appropriate valuation of the property. On January 21, 1994, after extensive Chapter 11 proceedings, the bankruptcy court confirmed an amended plan proposed by the debtor under which the partnership would purchase...
the property and outstanding bonds for slightly under $10 million. Approximately two weeks after the confirmation order was entered, the debtor entered into a contract to sell the property and the bonds for approximately $12.5 million. This sale resulted in a net recovery to the debtor of approximately $2.5 million over the amount necessary to pay the bondholders and other creditors under the confirmed plan. The bank asked the bankruptcy court to revoke the confirmation order and to award it attorney fees, expenses, and punitive damages.

The bankruptcy court found the debtor provided misleading and incomplete disclosures to the court, including the fact that it had serious contacts with several motivated and qualified purchasers at prices far exceeding what the debtor represented was the market value of the property. The court found the debtor’s misrepresentations were motivated by its desire to protect the investment of its insider partners. The bankruptcy court found that the debtor concealed or failed to disclose material information it was under a duty to disclose. This duty to disclose arose from three separate sources: (1) a duty to comply with the disclosure requirements of § 1125; (2) a plan proponent’s duty to propose a plan in good faith; and (3) the fiduciary duty of a debtor in possession. The result was that the debtor concealed the true value of the property, and fraudulently induced the court to confirm the debtor’s proposed plan. Accordingly, the bankruptcy court revoked the order of confirmation and awarded the bank attorney’s fees and expenses. The court refused to impose a reward of punitive damages. The Sixth Circuit Court of Appeals affirmed, agreeing that the bankruptcy court’s factual findings supported the conclusion that the debtor perpetrated an actual fraud upon the court. This finding supported the court’s revocation of the confirmation order pursuant to 11 U.S.C. §1144, which permits revocation of such an order if such order was procured by fraud. The court upheld the award of attorney’s fees and costs to appellee because the debtor’s fraud upon the court caused the appellees unnecessarily to incur additional legal expenses. Lastly, the court upheld the denial of punitive damages. Such an award lies in the discretion of the trial court, and the Sixth Circuit found no abuse of discretion.

*Barbosa v. Soloman, 235 F.3d 31 (1st Cir. 2000)*. In this case, the bankruptcy court addressed the ability of the trustee and creditors to amend a bankruptcy plan after confirmation to reach the proceeds of sale of property that the debtor sold after confirmation but before discharge. In the case, the property sold was a two family building that was subject to a lien in the amount of $114,000 held by Melon Mortgage Company. As part of the bankruptcy plan Melon entered into a stipulation that the market value of the property was $64,000. This agreement, with minor modifications, was in the confirmed plan along with the requirement that the debtors pay unsecured equal claims at ten percent. In compliance with 11 U.S.C. §1327 the confirmation order provided that “the provisions of the confirmed plan bind the debtors and all creditors; the confirmation of the plan vests all property of the estate in the debtors; and all property vesting in the debtors is free and clear of any claim or interest of any creditor, except as provided in the plan or this order.”

After the court entered this order the debtors sought leave to sell the property free of liens or encumbrances. The court granted leave and the property was sold for $137,500 to a good faith purchaser. Thereafter, the trustee moved to compel the debtors to modify their plan in order to pay the excess of the proceeds to the debtors’ unsecured creditors. The trustee proposed that the debtors pay a dividend of 100% to the unsecured creditors rather than the 10% outlined in the
confirmed plan. The bankruptcy court granted the trustee’s motion. This was upheld by the district court. The debtors appealed, contending that the district court erred in ruling that the proceeds were part of the bankruptcy estate based on 11 U.S.C. §1327 and §521(a)(6). They relied on language quoted in the bankruptcy court’s confirmation order, which stated that all of the property vested in the debtor. They also argued that the bankruptcy court and district court erred in applying §1329 of the code to allow the modification of the confirmed plan without the showing of a substantial and unanticipated change in the debtors’ financial circumstances from the time of confirmation. They argued that the property sale was contemplated by the parties and the court when the confirmation plan was entered into. As a result, they argued that the modification requested by the trustee and Melon was precluded by res judicata.

In deciding these issues the court noted that there is a conflict between §1327 and §1306(a). While §1327 appears to vest all the property in the debtor at the time the confirmation order is entered, §1306(a) provides for the continuing existence of the bankruptcy estate until the case is closed, dismissed, or converted to a case under Chapter 7, 11, or 12 of the title. Property of the estate at the time of confirmation vests in the debtors free of any claims from the creditors, but the estate does not cease to exist and it continues to be funded by the debtors’ regular income and postpetition assets. In the present case, receiving of proceeds from the sale alters the debtors’ financial circumstances, which brings into play §1329 of the Code.

The court declined to find that the trustee’s motion was barred by res judicata. The court believed that approach would be contrary to the clear language of the statute, as §1329(a) allows the parties a right to request a modification in response to changes in the debtors financial circumstances. There is no reference to the requirement that a substantial or unanticipated change occur before a modification could be granted. In addition, there is no language indicating that res judicata was contemplated in this context. The court did caution that, as a practical matter, parties requesting modifications of Chapter 13 plans must advance a legitimate reason for doing so and they must strictly conform to the three limited circumstances set out in §1329. This requirement accords finality to confirm plans without requiring specific threshold tests that were not contemplated by the statute. Accordingly, the trustee and Melon were not precluded by res judicata from seeking an amendment to the plan. Given the fact that the debtors realized a 215% gain on the stipulated value of the property, the court concluded that the bankruptcy court did not abuse its discretion in granting the amendment. The court states that it is antithetical to the bankruptcy system to allow a debtor to “strip down a mortgage, under pay the unsecured creditors, obtain a super discharge under §1328(a) of the code while selling the property mortgaged for a price at two times its estimated value for purposes of the strip down, in keeping the proceeds.”

C. Property of the Estate

In re Newpower, 233 F.3d 922 (6th Cir. 2000). Here, the Sixth Circuit addressed whether money which a debtor has embezzled prepetition becomes property of his bankruptcy estate. The court held that the funds themselves were not property of the estate, but that goods purchased with those funds would be deemed property of the estate. Here, Mr. and Mrs. Robert Kitchen and Mr. Newpower formed New Properties, Inc. (“NPI”) to purchase and develop real estate. The Kitchens transferred money to Mr. Newpower in order to purchase properties.
However, Mr. Newpower took the funds personally and did not purchase the real property as agreed upon. Mr. Newpower eventually plead guilty to embezzlement and filed for bankruptcy protection. The Kitchens also had a lawsuit against the transferees of the funds. They sought stay relief and abandonment so they could proceed with the state court action. The bankruptcy court concluded that the funds which were transferred by the NPI account to a third party, without passing through Newpower's personal account, were not property of the estate and the Kitchens could proceed with their action to recover those funds from the recipients. However, the bankruptcy court concluded that money that actually passed through Mr. Newpower's hands, or was used to purchase assets in his name, was property of the estate. The district court concluded that the bankruptcy court erred by concluding that property traceable to the Kitchens' embezzled funds was property of the debtor's estate.

The Sixth Circuit cited Michigan state law for the proposition that a thief has no title in the property he steals. However, also under Michigan law, when titled property is obtained by fraud, the title is voidable, but not void. Thus, the critical difference between larceny and false pretenses is the passage of title. The court held that NPI never intended to pass title to the funds taken by the debtor, so that the funds the debtor embezzled directly from NPI were never property of his estate. However, the court then concluded that this is not true with respect to property that the debtor purchased for himself with the stolen money. The seller of that property intended to pass both title and possession to the thief and obtained good title to the money the thief provided. As a result, the court concluded that the thief obtained legal title to the goods purchased, so they became part of his estate. In a nonbankruptcy situation, a constructive trust could be imposed in favor of the original owner of the funds on the proceeds held by the embezzler. However, a constructive trust is an equitable interest exempted from a bankrupt's estate only if that trust was declared by the court in a separate prepetition proceeding or a state statute provides for the property to be held in trust for a particular purpose. There is a separate concurrence that is the majority opinion with respect to certain automatic stay related issues in this case.

In re Wilcox, 233 F.3d 899 (6th Cir. 2000). Here, the Sixth Circuit addressed the question of whether a debtor's property interest in assets held by the trustees of a municipal employees' retirement plan is to be turned over to the trustee in bankruptcy for the benefit of creditors. 11 U.S.C. §541(c)(2) states, "a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title." Resolution of this case revolved around whether the terms of the plan (which provided that the debtor's interest is "unassignable" and hence not subject to execution or attachment) were "enforceable under applicable non-bankruptcy law."

The debtor was a city employee and participant in the city's contribution retirement plan, the terms of which were incorporated in Detroit's city charter. The fund consisted of employee contributions. The terms of the plan permitted the withdrawal of funds from the debtor's retirement account only upon his death, the termination of his employment, or his retirement. None of those conditions had been met at the time of the bankruptcy. The debtor entered into a loan agreement with a credit union and, despite the anti-assignment provision of the retirement plan, purported to pledge his interest in the plan as collateral for the loan. Months after taking out the loan, debtor filed for bankruptcy under Chapter 7. In determining whether the
bankruptcy trustee could reach the proceeds of debtor’s retirement plan, the Sixth Circuit sought to determine whether the restriction on a transfer of debtor’s interest in the trust was enforceable under non-bankruptcy law. The trust was funded through the voluntary contributions of city employees, and therefore was “self-settled” and could not be considered a spendthrift trust under Michigan law. Because the plan was not a spendthrift trust, both the bankruptcy court and the district court on appeal found that the anti-alienation provision prohibiting transfers via garnishment, attachment, or bankruptcy, was not enforceable under federal or state law. The district court also concluded that because the city charter provision which incorporated the contribution plan had no enforcement mechanism, it was not enforceable for purposes of §541(c)(2).

The Sixth Circuit noted that an inquiry under § 541(c)(2) has three parts; (1) whether the debtor has a beneficial interest in a trust; (2) whether there is a restriction on the transfer on that interest; and (3) whether the restriction is enforceable under nonbankruptcy law. The Court noted that, here the debtor definitely had a beneficial interest in a trust and there was a restriction on the transfer. The decision revolved around whether that restriction was enforceable under non-bankruptcy law. The Sixth Circuit rejected the bankruptcy and district court’s conclusions on this point because it found that they conflicted with the Supreme Court’s holding in Patterson v. Schumate, 504 U.S. 753 (1992), that state law other than spendthrift trust law can serve as “enforceable non-bankruptcy law” under §541(c)(2). The Sixth Circuit also rejected the charter’s lack of enforcement mechanism as dispositive, in light of Patterson, which looked to other indicia of enforceability than simply the existence of a statutory right to file a civil action, including the statutory requirement that plan trustees and fiduciaries discharge their duties, and the court’s own ability to enforce anti-alienation provisions. The Sixth Circuit noted that Michigan courts have enforced various provisions of the Detroit city charter at issue here, including those relating to the retirement plan, without regard to the availability of a statutory right of action. It noted that the non-alienation provision of the Detroit plan is enforceable by the retirement system itself, which controls the distribution of funds. The court found that the anti-assignment provision of the Detroit city charter was “enforceable” non-bankruptcy law for the purposes of 11 U.S.C. §541(c)(2).

In re Brucher, 2001 WL 223844 (6th Cir. 2001). In this case, the Sixth Circuit addressed the question of whether an Individual Retirement Account (“IRA”) can be exempted from a bankruptcy estate pursuant to 11 U.S.C. §522(d)(10)(E), which exempts a debtor’s right to receive “payments under a stock, pension, profit sharing, annuity, or a similar plan or contract on account of . . . age.” Here, the Debtor had an IRA valued at $7,900. He claimed an exemption for $6,880 under 11 U.S.C. §522(d)(5) and claimed the rest as exempt under 11 U.S.C. §522(d)(10)(E). The bankruptcy court disallowed the exemption, the district court reversed and allowed the exemption. The Sixth Circuit affirmed the allowance of the exemption.

The trustee argued that the debtor’s right to receive payment under his IRA was not a right to receive payment on account of age under a plan or contract “similar” to a pension plan or contract. The Sixth Circuit adopted the Fifth Circuit’s analysis of this issue in the case of In re Carmichael, 100 F.3d 375 (5th Cir. 1996), which held that (1) IRAs are “substitutes for future earnings in that they are designed to provide retirement benefits to individuals” as are the four types of plans or contracts specifically listed in §522(d)(10)(E); (2) the exception in §(d)(10)(E)
(iii) denies exemption to those similar plans or contracts that fail to qualify under §408 of the Internal Revenue Code (a provision which deals exclusively with IRAs), thus indicating that at least some if not all IRAs were intended to be included in the phrase “similar plan or contract;” (3) Congress did not intend to penalize self-employed individuals for their choice of the form in which their retirement assets are held; and (4) exempting IRAs is consistent with the “fresh start” policy which the exemptions are intended to advance.

In re Booth, 2001 Bankr. LEXIS 219 (6th Cir. BAP 2001). In this case, the bankruptcy court granted the Trustee’s motion for turnover of a pro rata portion of a postpetition profit sharing payment that the debtor received from his employer. The debtor appealed, claiming that, because he filed his bankruptcy petition before his employer calculated its profits at the end of the year, he had no legal or equitable interest in the profit sharing when he filed, and therefore no part of the payment was property of the estate. The BAP affirmed the bankruptcy court’s decision. Although it agreed with debtor that his interest in the profit sharing payment was contingent and unenforceable at the time he filed the bankruptcy it concluded that, to the extent his interest in the profit sharing plan was based upon pre-petition employment, his interest came within the broad concept of property of the estate found in 11 U.S.C. §541(a)(1). In determining whether the debtor had an interest in the property, the BAP looked to state law. Under Ohio law, a contingent interest is fully alienable and may be attached by creditors. Therefore, debtor’s contingent interest in the profit sharing plan became property of the estate under §541(a)(1) when the bankruptcy petition was filed. The U.S. Supreme Court’s holding in Segal v. Rochelle, 382 U.S. 375 (1966), and the nearly unanimous view of most circuit and district court cases also support the conclusion that a debtor’s contingent interest is to be considered property of the estate if sufficiently rooted in the debtor’s prepetition past. The BAP also rejected debtor’s alternative argument that his interest in the profit sharing program was excluded from property of the estate pursuant to §541(c)(2) which provides, “a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title.” The court acknowledged that the collective bargaining agreement in this case contained a restriction against transfer, however it found that the debtor had not shown the existence of either an express trust or a constructive trust under Ohio law. Therefore, it held that §541(c)(2) did not apply.

In re Rushing, 246 B.R. 291 (W.D. Ky. 2000). Here, the bankruptcy court (Judge Roberts) found that pension fund contributions made on behalf of the debtor by his employer under a plan established pursuant to the Employee Retirement Income Security Act of 1974 (“ERISA”), were not property of the estate and were not subject the bankruptcy court’s jurisdiction. In that case, the Chapter 7 trustee sought to recover funds in the debtor’s pension plan which were made within 120 days of the debtor’s bankruptcy filing. The pension plan did not maintain individual accounts, nor were the participants allowed to make individual contributions. Benefits were payable to participants only upon the completion of specific eligibility requirements and in accordance with the terms of the plan. While the debtor in this action had satisfied the criteria to be eligible to receive future benefits from the pension plan, he had not satisfied the eligibility requirements to receive such current distributions (i.e., age, disability, years of service). The court held that, pursuant to 11 U.S.C. §541(c)(2) and ERISA’s anti-alienation provision in §206(d)(1), of 29 U.S.C. §1056(d)(1), and the United States Supreme Court’s construction of same, the contributions at issue were not property of the estate and
therefore not subject to the bankruptcy court’s jurisdiction. KRS 427.150(2)(f) did not change the conclusion. Kentucky’s statutory provision provides an exemption for pension funds, with the exception of those contributions made within 120 days prior to the debtor’s bankruptcy filing. The bankruptcy court held that ERISA preempts the provision relating to an ERISA-covered pension plan.

D. Secured Claims Issues and Preferences

_In re Nolan_, 232 F.3d 528 (6th Cir. 2000). Here, the Sixth Circuit addressed an issue of first impression for the courts of appeal, and on which there was a split of authority among the federal district courts. The issue was whether a Chapter 13 debtor may, pursuant to §1329, modify a confirmed plan in order to surrender collateral for a secured claim, and then reclassify any deficiency as an allowed, unsecured claim to be paid back at the general cents-on-the-dollar rate set forth in the plan for unsecured debts. The Sixth Circuit held that the debtor may not. The debtor filed a petition for relief under Chapter 13 in August, 1997. The creditor, Chrysler Financial Corporation, filed a proof of claim showing the debtor owed it $12,291 for the purchase of an automobile. In September, 1997, the bankruptcy court confirmed the debtor’s Chapter 13 plan, under which Chrysler was allowed a secured claim of $8,200 with interest at 10% per annum, leaving an unsecured claim of $4,091. In August, 1998, debtor filed a motion to modify her plan and incur credit. She asked the court to permit her to surrender her vehicle to Chrysler, reclassify the deficiency owed on that vehicle as an unsecured claim, and incur credit in the amount of $10,000 to purchase another car. The bankruptcy court granted debtor’s motion. The district court reversed on appeal.

The Sixth Circuit affirmed the district court’s disposition of the case, holding that a debtor cannot modify a plan under §1329(a) by surrendering the collateral to a creditor, having the creditor sell the collateral and apply the proceeds towards the claim and having any deficiency classified as an unsecured claim. The court set forth five reasons for its holding. First, the court found that the proposal would violate §1329(a)’s prohibition against adding claims to the class of unsecured creditors. Second, §1325(a)(5)(B)(ii) provides that a plan cannot be confirmed unless the property to be distributed on account of a claim is not less than the allowed amount of the claim. To permit a debtor to modify the plan to bifurcate a claim that has already been classified as fully secured into a secured claim and an unsecured claim would violate the statutory mandate that a secured claim is fixed in amount and status and must be paid in full once it has been allowed. Third, the court found that to permit such a modification of a confirmed Chapter 13 plan would work an injustice on the creditor by permitting the debtor to shift the burden of depreciation to the secured creditor once the collateral no longer has a value which justifies full payment of the balance of the secured claim. The court found Congress surely did not intend to “allow debtors to reap a windfall by employing a subterfuge that unfairly shifts away depreciation, deficiency, and risk voluntarily assumed by the debtor through... confirmation of the Chapter 13 plan.” Fourth, §1329(a) permits only the debtor, the trustee, and holders of unsecured claims to bring a motion to modify a plan. To permit a debtor to modify a plan to revalue or reclassify a secured claim whenever the collateral depreciated, but to prohibit the secured creditor from seeking to reclassify its claim in the event that the collateral appreciated, would be inequitable. Fifth, and lastly, the court rejected the argument that the
language of §1329, which permits the modification of “payments,” can be interpreted to permit modification of “claims.”

In re Dublin Securities, Inc., 214 F.3d 773 (6th Cir. 2000). In this case, the Sixth Circuit interpreted the statute of limitations set forth in 11 U.S.C. §546(a), which states “an action or proceeding under §544, 545, 547, 548, or 553 of this title may not be commenced . . . two years after the appointment of a trustee under §702, 1104, 1163, 1302, or 1202 of this title . . . .” The debtor, Dublin Securities, initially filed a Chapter 11 bankruptcy petition in August 1993. Nearly a year later, the debtor converted to a Chapter 7 liquidation. In August, 1994, the court appointed a Chapter 7 trustee for the estate. In May, 1996, approximately 21 months later, the trustee filed several adversary proceedings against various individuals and businesses alleging that the defendants were recipients of fraudulent and preferential transfers in violation of 11 U.S.C. §544(b). The defendants moved to dismiss the complaints claiming the two year statute of limitations set forth in §546(a) had run because, under 11 U.S.C. §1107(a), a debtor in possession not only has the same power as a trustee to avoid preferences and fraudulent transfers but, according to the defendants, also has all of the limitations that the code imposes upon trustees as well. The defendants argued that, pursuant to §1107(a), the debtor in possession not only has the same power as a trustee to avoid preferences and fraudulent transfers but, according to the defendants, also has all of the limitations that the code imposes upon trustees as well. The defendants argued that, pursuant to §1107(a), the debtor in possession is bound by the two year statute of limitations set forth in §546(a)(1). More importantly, defendants argued that that the statute accrues and begins to run against a later appointed trustee at the time the debtor in possession is appointed. The Sixth Circuit rejected this argument, finding instead that logic and the clear language of the statute support the conclusion that the §546(a) statute of limitations for bringing avoidance actions begins to run upon the actual appointment of a trustee. To hold otherwise, the court found, would create “incentives for shady dealing” by permitting a debtor in possession to accomplish preferential or fraudulent transfers to friends, family members, or valuable business associates, then to allow the limitations to run before converting to a straight bankruptcy. The case deals with the pre-1994 amendment version of §546.

In re Cannon, 237 F.3d 716 (6th Cir. 2001). This is a check-kiting case in which the Sixth Circuit faced what it called a “collision between Article 4 of the UCC . . . and the Bankruptcy Code.” Debtor engaged in a check-kiting scheme involving First Tennessee Bank and two other banks. Mr. Cannon opened an account containing $7,500 at Hibernia Bank, then wrote two checks on that account totaling $163,350 which he deposited at First Tennessee. First Tennessee extended a provisional credit to Mr. Cannon for the checks on the day of the deposit. The checks, naturally, were returned for insufficient funds. On January 24, 1994, First Tennessee turned the checks over to its collection officer. However, on that same day, Mr. Cannon successfully covered the charge back by transferring money from a different account. Eventually First Tennessee discovered the check-kiting scheme, and Mr. Cannon was forced into bankruptcy.

The chapter 7 Trustee initiated an adversary proceeding on February 21, 1996, seeking to avoid the January 24, 1994 transfers by debtor to cover the charge backs. The trustee claimed these were preferential transfers which unduly benefited First Tennessee. The bankruptcy court held that the check kiting scheme created an antecedent debt and that the provisional credit extended by First Tennessee was unsecured. The bankruptcy court then found that First Tennessee recovered more in the January 24 transfer than it would have received as an unsecured
The bankruptcy court also rejected First Tennessee's new value defense. The district court agreed that First Tennessee had a security interest in the deposits to Mr. Cannon's accounts. However, it deemed the interest "valueless" because the Hibernia account did not have sufficient funds to support the two checks. The Sixth Circuit reversed.

The Sixth Circuit framed the issue as whether the provisional credits allowed by Article 4 and the Expedited Sums Availability Act (12 U.S.C. §§ 4001-4010) are "debts" within the meaning of the Bankruptcy Code, and if they are, whether or not the satisfaction of those debts is a voidable transfer under 11 U.S.C. §547(b). Section 547(b) allows the trustee to avoid:

Any transfer of an interest of the debtor in property--

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by debtor before such transfer is made;

(3) made while the debtor was insolvent;

(4) made--

(A) on or within ninety days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if - -

(A) the case were a case under chapter 7 of this title;

(B) transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

First Tennessee conceded that the first four factors of §547(b) had been met, but asked the court to consider its debt as being fully secured. The Sixth Circuit agreed. Under Tennessee's version of Article 4 (Tennessee Code §47-4-210(a)(1)), a "collecting bank has a security interest in an item and any accompanying documents or the proceeds of either in case of an item deposited in an account, to the extent to which credit given for the item has been withdrawn or applied." Therefore, when First Tennessee granted the debtor a provisional credit for the checks, it received a security interest in the check. Because appellant had a valid security interest, the satisfaction of that interest was not a preferential transfer. The court rejected the argument that because the checks were worthless when written, appellant bank could not have a
valid security interest in the checks or their proceeds. The kited checks were worth their face value during the period which appellant bank extended a provisional credit to the debtor. The purpose of the security interest granted by Article 4 is to cover situations where a deposited check is dishonored by the drawer institution by giving the depositor bank an expansive security interest in the check and its proceeds. To hold otherwise would be to destroy Article 4's system of conditional credits, by considering every single conditional credit to be an unsecured debt, avoidable as a preferential transfer. The result would be to thwart the current check clearing system set up by Article 4 and federal banking laws. The court distinguished Cannon from In re Montgomery, 983 F.2d 1389 (6th Cir. 1993), wherein the court allowed the bankruptcy trustee to avoid approximately $3 million in transfers made to a depositor bank as part of check kiting scheme. The case was distinguishable because the depositor bank had knowledge of the debtors' kiting at the time the debtors shifted the kiting scheme to other banks. Thus the depositor bank was not an innocent depositor, but rather it was a knowledgeable third party creditor of the debtors. Thus, the transfers were considered avoidable preferences.

In re Oakwood Markets, Inc., 203 F.3d 406 (6th Cir. 2000). Here, defendant Oakwood Properties, Inc. entered into lease agreements with the debtor in 1995 to rent property and equipment at a rate of $12,825 per month, collectively. On March 6, 1996, three creditors filed an involuntary Chapter 11 bankruptcy petition against the debtor, which was later converted to a Chapter 7 proceeding. On March 5, prior to the filing of the petition, Oakwood Properties received two checks from the debtor in the amount of $12,825.00 (current rent) and $802.63. (arrearage). Oakwood deposited the checks, and debtor's bank honored them on March 7, the day after the bankruptcy petition was filed. On April 2, 1996, an order for relief under Chapter 11 was entered. The case was later converted into a Chapter 7 proceeding. Oakwood occupied the premises for only a few days in March because of a foreclosure sale which the bankruptcy court permitted to go forward. The trustee sought to avoid the debtor's two March payments to Oakwood as post-petition transfers under 11 U.S.C. §549 and to recover those payments for the benefit of the estate under 11 U.S.C. §550. The bankruptcy court granted judgment to Oakwood on the current rent check and to the trustee on the arrearage check. The district court affirmed.

This Sixth Circuit held that the "date of honor" rule applies in the context of 11 U.S.C. §549(a), because the rule encourages the prompt submission of checks to the bank and provides a date certain upon which parties to the transfer can rely, and upon which courts can base a ruling in the event of litigation. Although Oakwood received the checks on March 5, the day before the bankruptcy petition was filed, the checks were not honored by debtor's bank until March 7, 1996, the day after the commencement of the case. Therefore, the transfers were subject to avoidance under §549(a). The court went on to hold, however, that the $12,825 transfer was excepted from avoidance under 11 U.S.C. §549(b) because Oakwood had given the debtor value in exchange for the transfer. Although the underlying lease between Oakwood and the debtor was executed in 1985, because the lease terms required the debtor to pay each month's rent in advance on the first of the month, debtor's March 1996 rental payment was a transfer for value, not a satisfaction of a pre-existing debt. The payment of $802.63, however, was not excepted from avoidance under 11 U.S.C.§549(b) because it was payment for an arrearage. The Sixth Circuit also approved of the bankruptcy court's conclusion that the extent of "value given" must be determined from "giver's" (i.e., Oakwood's) perspective. Finally, the court held that the fact that the debtor subsequently lost its right to occupy the premises and use the equipment when its
leasehold interest in the premises was sold at a foreclosure sale, did not preclude a finding that Oakwood had transferred the value of an entire month’s rental of the property. Oakwood did not seek to re-occupy the premises or take back the leased equipment after the foreclosure sale, but rather honored the possessory right of the party that had obtained the leasehold interest at the sale. As a result, the amount of the value that the debtor received was not limited to the few days that it actually occupied the premises.

In re Weathington, 254 B.R. 895 (6th Cir. BAP 2000) addressed the issue of the proper valuation for a vehicle for purposes of redemption in a Chapter 7 bankruptcy. The creditor argued that the appropriate value should be the replacement value as defined by the U.S. Supreme Court in Associates Commercial Corp. v. Rash, 520 U.S. 953 (1997), which addressed valuation in a cramdown context. The debtor argued that the appropriate valuation would be the liquidation value. The bankruptcy court selected liquidation value and the BAP agreed. The court held that the liquidation value in a redemption context is fully consistent with the Rash analysis as well as the legislative history of §722.

Under §722 an individual debtor may redeem tangible personal property intended for personal family or household use from a lien securing the debt if such property is exempt in other §522 or has been abandoned by §554 by paying the holder the lien the amount of the allowed secured claim of the lien holder. The court concluded that valuation under §722 is not controlled by Rash. Rash addressed the appropriate valuation of a secured claim when a Chapter 13 debtor uses the cramdown provision of §1325(a)(5)(B) in order to retain a vehicle. In Rash, the proposed disposition or use of the collateral was of paramount importance to the valuation question. Rash concluded that the value of property retained when the debtor utilizes the cramdown provision is “the cost that the debtor would incur to obtain a like asset for the same proposed use.” However, the disposition of collateral in a Chapter 7 redemption is different.

In a chapter 13 cramdown, the proposed use is the debtor’s retention of the vehicle through the life of the plan. The creditor suffers risk of depreciation and subsequent default. To the contrary, in a chapter 7 context, the proposed use and disposition of the collateral is, in reality, repossession and the sale of the collateral in the manner most beneficial to the creditor. Using the liquidation value, therefore, places the creditor in the exact same position it would have occupied had it repossessed the collateral. The court concluded that this view best reflects the congressional intent and enacting §722.

In re Vaughn, 244 B.R. 631 (Bankr., W.D.Ky. 2000). Here, the trustee moved the court to set aside various transfers by the debtors preceding the filing of their bankruptcy action on the grounds that the transfers were fraudulent or preferential in nature. The court found that the trustee was precluded by 11 U.S.C. §550(c) from recovering as a preference the transfer at issue from Exchange Bank. Christopher Vaughn was the debtors’ grandson. The debtor, Walter Vaughn, was in the business of farming. In 1997, Christopher helped Walter with his tobacco crop by assisting with its cultivation and harvest. In consideration, he and Christopher agreed that Christopher would be paid an agreed upon share of the tobacco proceeds when the crop was sold. The crop was sold to New Enterprise Tobacco Floor, Inc. At the time of the sale, Christopher owed a debt of $4,893.62 to Exchange Bank. Coincidentally, New Enterprise was a guarantor of that loan. Walter and Christopher agreed that Christopher’s share of the crop proceeds would be paid directly to Exchange Bank to pay off the note. In accordance with this
agreement, Walter instructed New Enterprises to pay the $4,893.62 directly to Exchange Bank. After this transfer was made, Christopher's note was marked paid in full and the collateral was released. Exchange Bank had no dealings with Walter in relation to its loan to Christopher nor in establishing the mechanism for repayment. Exchange Bank was not a creditor to Walter nor did it have any kind of an insider relationship with him. Nearly six months after the transfer at issue the debtor filed for bankruptcy.

The trustee sought to avoid the transfer from New Enterprise to Exchange Bank as a preferential transfer under 11 U.S.C. §547(b). Under that section the trustee may set aside transfers made within the 90 day period preceding the filing of bankruptcy. The preference period is extended to one year when the transfer is made to or for the benefit of an insider.

Exchange Bank, the entity to whom the transfer was made, was not an insider. However Christopher, for whose benefit the payment was made, was an insider. The court applied §550(c) to this case. That section unequivocally states that the trustee may not recover a preferential transfer from a transferee that is not an insider, if the transfer occurred outside of the general 90 day preference period. The trustee, therefore, was precluded from recovering the funds at issue from Exchange Bank. The trustee also sought to have the transfer set aside as a fraudulent transfer under §548. The debtor, by affidavit, offered evidence that the payment to Exchange Bank was simply based on an agreement with Christopher in consideration for his work on the tobacco crop. This affidavit testimony was not rebutted. The court found that §548(a)(1) did not apply because the transfer was not made (with actual intent to hinder, delay, or defraud any entity... ) nor did §548(a)(2) apply because there is no evidence that would support the finding that the farming services that debtor received from Christopher was less than the reasonably equivalent value of the transfer at issue.

The courts continue to interpret property valuation issues following the U.S. Supreme Court's decision in Associates Commercial Corp. v. Rash, 520 U.S. 953, 117 S.Ct. 1879, 138 L. Ed.2d 148 (1997). The Rash decision addressed a conflict among the circuits regarding the appropriate valuation of collateral for "cramdown" purposes in a Chapter 13. Pursuant to 11 U.S.C. §506(a), a lender's claim is secured only to the extent of the value of the collateral. In order to have a plan confirmed in which the debtor retains a vehicle over the secured creditor's objection, the debtor must invoke the cramdown power and must pay to that creditor the present value of the allowed secured claim over the life of the plan. The court held that the proper measure of value is the replacement value, not foreclosure value. The court noted that replacement value is fair market value, not necessarily the cost of a new replacement item.

In re Knowles, 253 B.R. 412 (E.D. Ky. 2000). Here, Judge Howard dealt with two issues: (1) how to calculate the replacement value in a "cramdown" under 11 U.S.C. §1325(a)(5)(B); and (2) whether a rental purchase agreement is a security interest. Toyota Motor Credit Corporation objected to the debtors’ Chapter 13 plan because of its contention that its collateral, a truck, was undervalued in the plan. The schedules valued the truck at $13,792.50 but listed Toyota’s claim as $22,153.88. Rentway objected to the treatment of its rental purchase agreements as security interests. The value of Rentway's collateral (furniture, a television and jewelry) was listed as $1,190 while the amount of its claim was listed as $9,578.65. Debtors amended their chapter 13 plan to increase the value of the truck to $17,812 apparently using some type of average valuation, but the value of Rentway's collateral remained the same.
Toyota maintained that, under Rash, the proper value is the NADA retail value. The Supreme Court also specifically prevented the use of any mechanical mid-point formula stating “whatever the attractiveness of a standard that picks the mid-point between foreclosure or replacement values, there is no warrant for it in the code.”

The debtor argued that In re Getz, 242 B.R. 916 (6th Cir. BAP 2000), held that averaging the NADA wholesale and retail values to determine replacement was proper. However, Judge Roberts held that Getz says that the use of that average as a starting point, with adjustments pursuant the evidence, was not inconsistent with Rash. This Court then held that it did not agree that the average of the wholesale and the retail values was an appropriate starting point and that Getz says that the trial court has the discretion to adopt a rule for replacement valuation. Judge Roberts declined to use the average of wholesale and retail values as a starting point. Instead, the court concluded that the starting point would be the NADA retail value, with appropriate adjustments to be made based on the evidence.

The court also held that the rental purchase agreements were not security agreements. Rentway maintained that the various rental purchase agreements were leases not security interests and therefore must be assumed or rejected by the debtors under 11 U.S.C. §365. In deciding the issue the court referred to KRS §§ 367.976 to 367.985 which defines the term “Rental-Purchase Agreement” and states that it should not be construed to be, nor be governed by . . . (f) a security interest as defined in KRS §355.1-201(37). Rentway contended that the debtors’ plan attempted to convert lease agreements into secured transactions and thereby allow them to keep over $12,000 worth of personal property for the payment of $1,190. The court found that the rental purchase agreements were neither true leases nor security instruments but they were “sufficiently executory to fall within §365.” The debtors, therefore, were required to either assume or reject leases in question.

In re Lynum, 246 B.R. 537 (Bankr. E.D.Ky., 2000). Here, Judge Howard dealt with the priority of liens. The debtor owed National City Bank $33,942.34, secured by the debtor’s boat pursuant to a note and security agreement that was executed on May 13, 1998. National City did not properly perfect its lien on the boat. The debtor then became indebted to M&T Financing on December 4, 1998, in the sum of $50,000.00. To secure this loan, the debtor gave M&T a security interest in the boat. M&T properly perfected its security interest. M&T moved for stay relief and abandonment. The trustee objected. He argued that, if he avoided NCB’s lien, he would be in a position superior to that of M&T, as a hypothetical judicial lien creditor. However, under Kentucky law, an unperfected security interest is subordinate to the rights of the subsequent lien creditor. If the trustee were to avoid the unperfected security interest, that lien would be preserved for the benefit of the estate and the trustee would be substituted in the position of the creditor holding the avoided lien.

However, under Kentucky law, conflicting security interests rank according to priority in time of filing or perfection. As a result, the fact that the trustee could avoid NCB’s lien and preserve it for the benefit of the estate does not mean he would prevail over M&T. M&T had the prior and superior lien on account of its properly perfected security interest, versus the trustee’s prior in time but unperfected lien. The court granted M&T’s motion for relief from stay.
In re Brumbaugh, 250 BR 605 (W.D. Ky. 2000). Here, Judge Cooper addressed the issue of whether a debtor's homestead exemption is impaired by a judgment lien filed upon the debtor's interest in real estate owned with her non-debtor husband as tenants by the entirety. The court held that the judgment lien did not impair the homestead exemption claimed by the debtor and as a matter of law the debtor was not entitled to avoid the judgment lien. Because Kentucky has opted out of the federal homestead exemptions set forth in 11 U.S.C. §522(b), the debtor claimed a homestead exemption in the amount of $4,500 pursuant to KRS §427.060. The debtor argued that the judgment creditor's lien impaired her homestead exemption, and as a matter of law the debtor was not entitled to avoid the judgment lien. Because Kentucky law permits the sale of one spouse's present possessory interest in the property, if the non-debtor spouse outlives the debtor spouse, then the holder of the right of survivorship takes nothing. Kentucky law does not permit the sale of one spouse's present possessory interest in the property.

Thacker v. United Companies Lending Corporation, 256 B.R. 724 (W.D. Ky. 2000). This case involved an improperly recorded mortgage and the Chapter 13 debtors' ability to avail themselves of the strong-arm powers of a bankruptcy trustee under 11 U.S.C. §544(a). In 1995, debtors borrowed $41,000 from the creditor, and secured the loan by granting a mortgage on their real property. The debtors signed the mortgage in the presence of a notary public and the mortgage was recorded. The debtors subsequently filed a Chapter 13 bankruptcy and sought to avoid the mortgage under §544(a). The mortgage failed to contain a description of the encumbered real property within the body of the document (it was attached instead), which the debtor claims was in violation of Kentucky's Conveyances and Encumbrances Statute (KRS, Chapter 382), Kentucky's Statute of Frauds (KRS 371.010) and Kentucky common law, all of which require mortgages to contain a written description of the encumbered property. The mortgage also placed the parties' signature before the description of the property, and the notary public's acknowledgement did not state who acknowledged or signed the instrument. The district court acknowledged the split of authority on the issue of whether chapter 13 debtors may avail themselves of the §544(a) strong-arm avoidance powers granted to trustees. The court found persuasive the line of cases which holds that the debtors indeed have standing to assert the §544(a) powers. 11 U.S.C. §544(a) permits a trustee to avoid any transfer of
property of the debtor or any obligation incurred by the debtor which is avoidable by a bona fide purchaser of real property. Thus, the question before the court was whether a bona fide purchaser would have had notice of the improperly executed mortgage. Citing KRS §382.270 and *State Street Bank and Trust Company v. Heck's, Inc.*, 963 S.W.2d 626 (Ky. 1998), the court concluded that the recordation of an unrecordable instrument does not constitute constructive notice, and therefore no notice existed to defeat a buyer’s bona fide purchaser status “... [N]o constructive or inquiry notice exists to defeat a buyer’s bona fide purchaser status.” The court acknowledged that the result compelled by this conclusion seemed to create an injustice but concluded that, because bankruptcy law requires that chapter 13 debtors be treated as bona fide purchasers, and because the creditors involved in the original transaction are in the best position to ensure compliance with the technical requirements of mortgages, the proper result was to permit the debtors to avoid the mortgage.

*In re Fears*, 258 B.R. 371 (W.D.Ky. 2001). In this group of consolidated cases, the bankruptcy court addressed the issue of whether formula-based collection costs added to unsecured student loan claims are allowable under the Bankruptcy Code. None of the parties disputed the fact that the principal and interest due on the loans was nondischargeable pursuant to 11 U.S.C. §523(a)(b), absent proof by a debtor that payment would cause an undo hardship. The court held that, pursuant to 11 U.S.C. §506, student loans are not oversecured claims, which may include fees and costs. They are unsecured claims and may not include the additional fees and costs. The district court reversed, holding that the Code’s definition of “claims” is broad enough to include the costs and fees. It concluded that the fact that §506(b) permits the charges to be included in a fully secured claim does not mean that an unsecured claim cannot include those charges.

**E. Reaffirmation**

*Pertuso v. Ford Motor Credit Co.*, 233 F.3d 417 (6th Cir. 2000). In this case, the debtors purchased a van on which they obtained financing through the defendant Ford Motor Credit Company. Debtors later filed a Chapter 7 bankruptcy petition, listed the van as a secured debt, and filed a statement of intent to reaffirm their debt to Ford in order to retain possession of the van. Ford then sent the plaintiffs a letter and proposed reaffirmation agreement. The debtors signed the reaffirmation agreement and remained current on their payments to Ford both before and after their discharge. Ford apparently failed to file the reaffirmation agreement with the court.

The debtors later filed a purported class action suit against Ford alleging violations of 11 U.S.C. § § 524(a)(2) (discharge injunction), 524(c) (failure to file with the court), and 362 (automatic stay). The U.S. District Court dismissed the case upon Ford’s motion, and the Sixth Circuit affirmed. The court rejected the debtors’ argument that §524 impliedly creates a private right of action for an asserted violation of the section. It also rejected their alternative argument that §524 is enforceable via 11 U.S.C. §105, which permits courts to “issue any order, process, or judgment that is necessary or permitted to carry out the provisions of this title.” The court analyzed the intent in the language and purpose of the statute and its legislative history, and concluded that no private right of action was authorized. The purpose of §524(a)(2) is to prohibit certain conduct. The appropriate remedy for a violation of the prohibited conduct lies in
contempt proceedings, not in a private lawsuit. Furthermore, the court found that §524(c) does not prohibit a creditor from seeking reaffirmation, but rather sets forth the conditions under which a reaffirmation agreement is enforceable. The violation of §524(c) merely renders the agreement unenforceable. Lastly, the court held that §362, which creates an automatic stay upon the debtor’s filing of a bankruptcy petition, is not automatically violated by the sending of a reaffirmation letter to a debtor. The court adopted the standards set forth in *In re Briggs*, 143 B.R. 438, 450-51 (Bankr. E.D. Mich. 1992), which permits a finding that a course of conduct violates §362(a)(6) if it “(1) could reasonably be expected to have a significant impact on the debtor’s determination as to whether to repay, and (2) is contrary to what a reasonable person would consider to be fair under the circumstances.”

*Cox v. Zale Delaware Inc.*, 239 F.3d 910 (7th Cir. 2000). The bankruptcy court held that a debtor seeking affirmative relief from a discharged debt due to the creditor’s failure to file a reaffirmation agreement may bring an action only as a civil contempt proceeding in the bankruptcy court that issued the discharge. In such a case, the procedure is to reopen the bankruptcy proceeding because the debtor is seeking to enforce the order of discharge issued in the previous bankruptcy proceeding.

In this case, Ralph Cox filed a voluntary petition for bankruptcy under Chapter 7. He signed an agreement reaffirming his $218.93 debt on a piece of jewelry, payable at the rate of $15.00 per month. This reaffirmation agreement was not filed with the bankruptcy court. He received a discharge. He later brought this suit on behalf of himself and others similarly situated, arguing that the reaffirmation agreement must be rescinded and he be allowed to recover the amounts that he and other members of the class had paid to Zale after discharge.

The district court reopened the case and then dismissed it, holding that §524(c) does not create a private right of action for violation of the requirement that a debt reaffirmation agreement be filed, relying on *Pertuso v. Ford Motor Credit Corp.*, 233 F.3d 417 (6th Cir. 2000). While the Seventh Circuit agreed with the district court’s result, it disagreed with the reliance on *Pertuso* because the private rights of action that the court is reluctant to imply into federal statutes are rights to obtain damages for statutory violations that are remediable by public agencies. In this case, Cox was not seeking damages, and §524(c) is enforceable only by private parties. As §524(c) makes an improper debt reaffirmation void, it gives the debtor a right to sue for rescission and a defense to any suit to enforce that agreement. The effect of rescinding a debt reaffirmation agreement is the same in either case: the debt is discharged to bankruptcy but the creditor is still vested with its security interest. In such an event, Cox would be worse off if he won than if he lost - - he could get his $219 back but Zale would get the ring back, together with the rental value of the ring during the period because Zale, by signing the reaffirmation agreement, agreed to forego repossession. The court found this to be a frivolous suit because the payments that Cox sought to recoup were made voluntarily; and a nuisance suit because its net expected value to Cox was negative.

F. Automatic Stay

*Aiello v. Providian Financial Corp.*, 239 F.3d 876 (7th Cir. 2001). In this case, the bankruptcy court held that an individual may not recover damages for a violation of the
automatic stay if those damages are purely emotional and not tied to any financial injury. Aiello filed a petition for Chapter 7 bankruptcy. One of her creditors, Providian, asked her to reaffirm her $1,000 credit card debt. The creditor threatened to charge her with fraud if she refused. She did refuse, but Providian did not charge her with fraud. She filed this class action suit to obtain redress on behalf of herself and other similarly situated victims of Providian’s alleged harassment. The court assumed that Providian willfully violated the stay.

The court noted that a creditor may ask a debtor to reaffirm the creditor’s debt so that it will not be discharged. The right to seek reaffirmation is an exception to the automatic stay. But, if in seeking reaffirmation the creditor resorts to extortionate conduct, the creditor has violated the automatic stay and brought the remedy provision, §362(h), into play.

The court stated, however, that this protection is financial in character and is not protection for peace of mind. If the creditor had intimidated the debtor in the present case into giving up her right of discharge, the bankruptcy court could have ordered under the authority of §362(h) monetary relief necessary to restore her to the financial position she would have occupied had the defendant not resorted to intimidation. The court noted that, if such financial injury were accompanied by emotional injury, the interest of judicial economy might weigh in favor of joining a claim for emotional injury, citing Fleet Mortgage Group, Inc. v. Kaneb, 196 F.3d 265 (1st Cir. 1999) as an action which “may have” presented such a situation. The court concluded that, in the absence of a financial injury, the debtor must resort to state tort claims.

_**U.S. Department of Health and Human Services v. James, 256 B.R. 479 (W.D. Ky. 2000)**_. This case addressed the issue of whether the filing of a bankruptcy petition allows a party to avoid the requisite administrative remedies provided for in Medicare matters. Here, the bankruptcy court ordered that the HHS’s exclusion of the debtor from participation in Medicare and Medicaid programs be set aside. HHS appealed this decision. The district court reversed. Dr. Gary D. James received four $10,000 Health Education Assistance Loans (“HEAL”) between 1980 and 1982. Dr. James did not repay these loans. The lenders therefore filed claims with HHS. The United States made the lenders whole and reassigned the HEAL loans to HHS. HHS unsuccessfully attempted to obtain repayment from Dr. James. HHS notified Dr. James that, based upon his failure to pay the loans or enter into a repayment agreement, he was excluded from participation in Medicare, Medicaid and all federal health care programs. Dr. James then filed a Chapter 11 petition. After a hearing, the bankruptcy court ordered the exclusion temporarily lifted in connection with a repayment plan that would require James to make payments to the United States in the amount $2,500 per month toward his HEAL debt. HHS appealed on the issue of whether the bankruptcy court had jurisdiction to review HHS’s authority.

The court found that neither the district court nor the bankruptcy court had jurisdiction because Dr. James must have exhausted his administrative remedies before obtaining judicial review. The court believed that anything less would circumvent the established procedures for determination of Medicare matters and administrative review of such determinations as set out in the Medicare program.

The court recognized that the issue is not well settled. Although the case law does not present a clear answer, the arguments for and against jurisdiction have been well developed and
the court believed that its holding comported with the tenor of the only cases remotely on point in the Sixth Circuit, citing *Lavapies v. Bolin*, 883 F.2d 465 (6th Cir. 1989); *In re: Clawson Medical Rehab. and Pain Care Center*, 12 B.R. 647 (E.D. Mich. 1981). The court also believed that the decision was consistent with the goals of the Medicare program.

G. Bad Faith Filing and Dismissal

*In Tamecki*, 229 F.3d 205 (3rd Cir. 2000). Here, the Third Circuit addressed bad faith filing. The debtor filed a Chapter 7 proceeding seeking discharge from approximately $35,000 in credit card debt owed to MBNA America. He had only one substantial asset, his share of a tenancy by the entirety in a home which he held with his estranged wife. They had over $100,000 equity in the home, and had been separated for approximately five years at the time the debtor filed his bankruptcy. A divorce proceeding was pending.

In his petition the debtor claimed an exemption under 11 U.S.C. § 552(b)(2)(B) for his share of the home equity. The trustee in bankruptcy challenged this election and sought dismissal of the debtor’s petition for lack of good faith under § 707(a) of the Code. According to the trustee, the debtor’s divorce was right around the corner and, therefore, the debtor would soon be entitled to his unencumbered share of the dissolved tenancy by the entirety, which would allow the debtor to pay off his debt and have money left over. Given these facts, the trustee reasoned that the debtor had acted in bad faith in filing his petition because he knew that he would soon be in a position to repay his debts. The bankruptcy court found that the debtor had failed to prove his good faith in filing for bankruptcy and dismissed the petition under §707(a).

§707(a) allows the bankruptcy court to dismiss a petition for cause if the petitioner fails to demonstrate good faith in filing. “At the very least, good faith requires a showing of honest intention.”

The court held that where the trustee has called into question a debtor’s good faith, and put on evidence sufficient to impugn that good faith, the burden then shifts to the debtor to prove his good faith. The debtor’s testimony confirmed the trustee’s belief that his divorce was “right around the corner.” The debtor did not submit any evidence of the good faith other than his testimony that he accrued his debt for subsistence purposes, he intended to repay the debt and that he would take his wife back “in a heartbeat.” The bankruptcy court discounted the self-serving testimony and relied upon the evidence that the debtor had acquired the large consumer debt just before filing for bankruptcy and during the pendency of his divorce. The court rejected the debtor’s claim that the trustee must prove extreme misconduct; that the inability to repay is not in and of itself evidence of bad faith, and that he did no more than avail himself of proper exemption under the code. The court felt that the reasonableness of his accrual of the debt and the timing of his filing, especially in relation to the unexplained circumstances relating to his divorce proceeding, were sufficiently questionable to warrant good faith scrutiny. There was a lengthy dissent.

H. Miscellaneous

*Wallace Hardware Company, Inc. v. Abrams*, 223 F.3d 382 (6th Cir. 2000). Here, the Sixth Circuit recently upheld a Tennessee choice of law provision in a guaranty agreement,
reversing the district court's application of Kentucky law. The Court of Appeals also considered various other issues, not analyzed here. Wallace Hardware entered into an agreement to provide hardware inventory to Tri-County Home Center and Tri-County executed a security agreement. The documents were signed on behalf of Tri-County by brothers Lonnie and Bill Abrams. The Abrams agreed to be liable jointly, severally and individually for payment of any and all goods and services furnished by Wallace Hardware. Additionally, a guaranty agreement was executed, although one of the Abrams brothers alleged his signature was forged. After bankruptcy proceedings which were resolved by settlement among the trustee and Wallace Hardware, Wallace Hardware brought an action against the Abrams in the U.S. District Court for the Eastern District of Kentucky. The Abrams sought an application of Kentucky law regarding the breach of guaranty claim, despite the fact that the guaranty clearly stated that it would be governed by Tennessee law. The guaranty failed to meet the requirements set forth in KRS 371.065(1) regarding the form of guaranties. The district court reviewed Kentucky's choice of law rules and concluded that the application of Kentucky law is appropriate whenever the state's interests predominate over all others. The district court found that Kentucky had a greater interest in the present case than did Tennessee. Wallace Hardware appealed.

The Sixth Circuit held that, in a standard commercial breach-of-contract case, the Kentucky courts would choose to adopt §187 of the Restatement (2nd) of Conflict of Laws. The Sixth Circuit extensively analyzes Kentucky case law dealing with conflict of laws provisions. The Court of Appeals held that the district court did not consider §187 of the Restatement and instead employed a purely interest-based approach. In doing so, the district court gave no weight to the parties' written agreement indicating that Tennessee law would control. Under §187, the parties' choice of law should be honored unless (1) "the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice"; or (2) "application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest." The Sixth Circuit found that the first prong was satisfied based on the fact that Wallace Hardware is located in Tennessee and that Tri-County elected to do business with and purchase goods from a Tennessee corporation. Second, the Sixth Circuit analyzed the fundamental policy prong under this guaranty. While the laws of the two states would reach different results, the court held that there must be a significant difference in the application of the laws of the two states. The court held that the purposes behind Kentucky's statute were largely served in this instance. In this case, the Abrams brothers could not have been uncertain and they do not claim any uncertainty as to the indebtedness they were agreeing to repay. The court further considered the fact that KRS §371.065 reflects only one of the policies at issue. Another policy to consider is that contract law upholds clearly ascertained and negotiated contract rights, as well as parties' freedom to contract for substantive rights.

*In re Schultz*, 254 B.R. 149 (6th Cir. BAP 2000). In this case, the bankruptcy court entered an order denying the debtor's general discharge on April 21, 2000. On May 8, 2000, debtor's counsel filed a motion for an extension of time to file an appeal of the bankruptcy court's order denying discharge. Here, the wife of debtor's counsel became seriously ill, and counsel testified that he was suddenly and unexpectedly preoccupied with her physical and psychological care. The bankruptcy court denied the motion, finding the debtor had not demonstrated the excusable neglect required to extend the time to file a notice of appeal pursuant
to Fed. R. Bankr. P. 8002(c)(2). On appeal the BAP held the bankruptcy court abused its discretion in determining the debtor’s failure to timely file a notice of appeal was not excusable neglect. The court distinguished this case from “law office upheaval” cases. The court acknowledged that the determination of what constitutes “excusable neglect” is an equitable one which must take into account all relevant circumstances surrounding the party’s omission. The court found that, because of the close familial relationship between a husband and wife and because of the severity of the illness at issue, the facts of this case are analogous to a situation in which the attorney is the one who is seriously ill. Accordingly, it reversed the bankruptcy court’s order denying the debtor’s motion for an extension of time to appeal.

_In re Bersaglia, 254 B.R. 376 (Bankr. E.D.Ky., 2000)._ Here, Judge Howard addressed the issue of whether workers compensation benefits could be classified as wages and, therefore, be given priority. The Kentucky Uninsured Employers Fund (the “UEF”) sought to have $4,000 of a total $12,000 claim designated a priority claim under 11 U.S.C. §507(a)(3). The UEF cited KRS § 342.175, which provides that “all right of compensation granted by this chapter shall have the same priority or priority for the whole thereof against the assets of the employer as is allowed by law for any unpaid wages for labor.” The court rejected the UEF’s position and held that worker’s compensation benefits did not constitute wages and thereby ordered that the claim of the UEF be allowed as an unsecured non-priority claim.

The UEF’s claim was based upon a worker’s compensation claim that it paid to an injured employee of the debtors under an agreed order between the UEF and the employee. In the agreed order of settlement, the UEF specifically reserves the right to seek recovery from City Enterprises and the Bersaglias for all amounts paid by it to the employee. UEF is responsible for the payment of compensation when the employer defaults in its obligations. In the event that the UEF pays, the employer is liable to the UEF for all amounts that were authorized to be paid. In enforcing these rights the Labor Cabinet is subrogated to all the rights of the person receiving such compensation from the fund. The UEF’s claim in bankruptcy, therefore, was in the nature of a reimbursement claim.

The UEF claimed that its debt should be given priority because under 11 U.S.C. §507(a), the bankruptcy code provides:

- (a) the following expenses and claims have priority in the following order. . . (3)
- third, allowed unsecured claims, but only to the extent of $4,300 for each individual corporation, as the case may be, earned within 90 days of the filing of the petition or the date of the cessation of the debtor’s business, whichever occurs first, for – (A) wages, salaries, or commissions, including vacation, severance and sick leave pay earned by an individual.”

The court held that, in employing §507(a)(3) priority, Congress used precise language and did not extend a priority to workers’ compensation benefits. Any attempt to do so by state statute would run afoul of the supremacy clause.

_In re Technologies International Holdings, Inc., 256 B.R. 476 (E.D. Ky. 2000)._ This case addressed two issues: (1) the liability of the debtor Technologies International Holdings ("TIH"), as guarantor on a note; (2) whether equitable considerations, including marshalling of
assets, required the claimant to seek satisfaction from the principal obligor on the note before turning to the guarantor. On June 1, 1998, TIH guaranteed the debt of Biosytems Technology Inc. ("BTI") in the principal sum of $200,000. On May 29, 1999, BTI refinanced the note which provided for a single advance of $203,912.28 with interest and was due four months later. TIH contended that the refinancing of the June note paid BTI’s indebtedness under the note in full as a matter of law and discharged TIH’s liability under the guaranty. Included in the guaranty, however, was a provision that TIH was liable as guarantor for any extensions, renewals or replacements of the note. TIH argued that this provision did not apply to the refinance because the terms of the second note were materially different from the terms of the first note. The major difference was to change from an open end credit arrangement to a four month term loan.

The notes and guaranty were executed in Virginia and, therefore Virginia law applied. The court cited *Gullette v. Federal Deposit Insurance Corporation*, 344 S.E. 2d 920 (Va. 1986), where the Virginia Supreme Court held that a novation is never presumed. The burden of proof is on the guarantor to establish by clear and satisfactory evidence that there existed on the part of all parties involved in the transaction a clear and definite intention to effect a novation to a previous note. Even though a second note may change some terms, the second note may still be a renewal of a previous note. In other words, a change in terms will not affect a novation. As a result TIH was liable under the guaranty.

The court also rejected TIH’s contention that the court should apply marshalling of assets or some other equitable theory to force the creditor to attempt to recover monies from BTI before proceeding against TIH. The court refused to apply the marshalling of assets or to force the creditor to collect from BTI first because the guaranty was an unconditional guaranty. The court recognized that its well settled that when a party signs an absolute guaranty the creditor is under no obligation to collect from the debtor before looking to the guarantor. TIH was liable on the guaranty.

*In re Treco*, 240 F.3d 148 (2d Cir. 2001). Here, the issue was whether a New York bank, under 11 U.S.C. §304(a), should be forced to turn over funds to a Bahamian bank undergoing bankruptcy proceedings in that country. For several years the Bank of New York ("BNY") acted as the Meridian International Bank Limited’s ("MIBL") correspondent bank in the United States, providing it and several of its subsidiaries account services, loans, and other financial accommodations. BNY and MIBL entered into an agreement under which MIBL pledged its accounts as security for all of MIBL’s liabilities to BNY. The next year, MIBL requested from BNY certain financial accommodations - - primarily in the form of overdrafts on its operating accounts - - in the amount of $15.15 million to be secured by new funds deposited at BNY by one of MIBL’s subsidiaries, Meridian Bank Tanzania, Limited ("Meridian Tanzania"). Meridian Tanzania and MIBL signed a second agreement pledging Meridian Tanzania accounts at BNY to BNY as security.

MIBL failed to repay the $15.15 million and BNY liquidated Meridian Tanzania’s pledged account in that amount. However, the Central Bank of Tanzania appointed a manager to operate Meridian Tanzania. The manager questioned the validity of the agreement and demanded the return of the $15.15 million that BNY had taken. The Supreme Court of the Bahamas then placed MIBL into involuntary liquidation.
The MIBL liquidators initiated a proceeding in the Bankruptcy Court for the Southern District of New York under 11 U.S.C. 304(a). Section 304(a) authorizes a foreign representative in a foreign bankruptcy proceeding to commence a case ancillary to that proceeding in a United States Bankruptcy Court to protect the administration of the foreign proceeding. That section, among other things, authorizes an injunction prohibiting actions against the debtor and permits the U.S. court to order the turnover of property to a foreign representative. BNY entered into a settlement agreement with Meridian Tanzania but the liquidators moved for partial summary judgment directing turnover of $600,000 remaining in MIBL's accounts at BNY and being held by BNY.

Section 304 of the Code was intended to deal with complex issues involving the legal effect the United States courts will give to foreign bankruptcy proceedings. The statute directs the courts to consider six factors before deferring to the foreign court and granting relief in support of foreign proceedings: (1) just treatment of all claims against or interests in the estate; (2) protection of U.S. claim holders against prejudice and inconvenience; (3) prevention of preferential or fraudulent dispositions of property; (4) distribution of proceeds of such estate substantially in accordance with the order prescribed by U.S. bankruptcy law; (5) comity and (6) if appropriate, the provision of an opportunity for fresh start for the individual in that the foreign proceeding concerns. The court is required to conduct a case by case balancing of these statutory factors.

The court believed that the first three factors did not present a bar to affording the relief sought by the liquidators. The court, therefore, mainly addressed the competing interests of comity and whether distribution of the proceeds of the estate would be substantially in accordance with the order prescribed by the U.S. bankruptcy law. While comity is a very important consideration, it does not automatically override other specified factors. The court's function under §304 is to determine whether comity should be extended to the foreign proceeding in light of the other factors. In this case, the court was dealing with an allegedly secured claim. Under Bahamian law the secured claim would be subordinate to all of the administrative expenses of the estate. This difference in prioritization under U.S. and Bahamian law was very significant because of the strong possibility that MIBL's estate would have little or no funds after payment of the administrative expenses. The comparison between the priority rules must consider the effect of the difference. Because administrative expenses would diminish BNY's claim significantly, the court concluded that turnover was not appropriate. The court also noted that the liquidators cited no cases in which a court had ordered the turn over of assets under §304 from a creditor with a secured claim. In fact, several bankruptcy courts have refused to grant relief under §304 where the priority of secured creditors was not recognized under the law of foreign jurisdiction. The court limited the ruling to a degree. Neither the bankruptcy court nor district court made a determination as to whether BNY's claim was, in fact, secured. Instead, the Second Circuit remanded the case for that determination.

III. LEGISLATIVE DEVELOPMENTS

Bankruptcy reform legislation has again passed in both the House of Representatives and the Senate, although in two different versions. The two versions passed each feature significant restrictions on consumers' ability to discharge or otherwise compromise debt. Each version also
contains less sweeping changes with respect to business bankruptcy. As of the date of this paper, each house of Congress has sent the version it passed to the other house. The competing versions are not formally in conference because there is no agreement regarding the make up of the conference committee. Proponents of the legislation believe that President Bush will be more receptive to the legislation than was his predecessor. However, the press of apparently higher priority legislative issues (i.e., tax and budget legislation) may make enactment of any bankruptcy legislation before the summer recess difficult.

A. Means Testing: Needs-Based Bankruptcy

Both the Senate and House bills amend Federal bankruptcy law setting forth new guidelines for dismissal or conversion of a Chapter 7 liquidation petition to one under Chapter 11 or Chapter 13. They also allow the bankruptcy panel trustee and any party in interest to move for such dismissal or conversion. Currently, a party in interest does not have this right. Significantly, the bills lower the "substantial abuse" standard for dismissal or conversion to one of simple abuse and replace the presumption in favor of granting relief with a presumption that abuse exists when the debtor's current monthly income exceeds a certain amount, as determined by a specified formula.

Under each bill, the presumption of abuse is strong and may only be rebutted by showing special circumstances that require additional expenses or adjustment of the current monthly income when there is no reasonable alternative. The bills also raise the bar for debtor's counsel. Should the court find that the Chapter 7 filing is in violation of certain bankruptcy rules, the debtor's attorneys will have to reimburse the trustee for legal fees incurred in pursuing the dismissal or conversion motion. Additionally, a Chapter 13 debtor's "disposable income" under each bill will be redefined to exclude domestic support obligations that first become payable after the date the petition is filed.

There are also revisions to procedural guidelines that will require written notice be given to the individual consumer debtor prior to filing for relief. This notice must advise of the types of credit counseling services available, the criminal penalties for fraudulent concealment of assets, and that creditor-supplied information may be examined by the Attorney General. (Sec. 104)

The bills require an individual debtor to obtain a briefing from an approved non-profit budget and credit counseling service prior to filing for bankruptcy relief, with some exceptions based upon availability of services in the district. A debtor cannot be discharged under Chapter 7 or 13 unless he has completed an approved course on personal financial management. The clerk in each district must maintain a list of credit counseling agencies and courses concerning personal financial management. The counseling services cannot inform credit reporting agencies of an individual debtor's use of personal financial management instruction. There are civil penalties for noncompliance. (Sec. 106)

2 The summarize of both the House and Senate bills is taken from summaries of the bills prepared by the Congressional Research Service ("CRS"). The Senate bill summary prepared by the CRS is current without amendments passed in the Senate. The author has incorporated some of the amendments thought to be of interest to the financial community.
B. **Enhanced Consumer Protection**

Subsection A (Penalties for Abusive Creditor Practices) of Title II of both the House and Senate bills provides for circumstances when the court may reduce (up to 20 percent) a claim wholly based on unsecured consumer debts when the debtor can show by clear and convincing evidence that the claim was filed by a creditor that unreasonably refused to negotiate a reasonable alternative repayment schedule proposed by the debtor’s approved credit counseling agency.

If a creditor willfully fails to credit payments received from a debtor (with a specified exception), and the failure causes material injury to the debtor, it is deemed a violation of discharge and operates as an injunction. (Sec. 202) Debt reaffirmation guidelines governing wholly unsecured consumer debts are modified to require specific detailed disclosures and explanations to the debtor for dischargeable debt agreements. Credit unions are exempt from these disclosures and explanations. Federal criminal law is amended and provides that U.S. attorneys and the Federal Bureau of Investigation are to enforce laws concerning: (1) abusive reaffirmations of debt; and (2) materially fraudulent statements in bankruptcy schedules that are intentionally false or misleading. The bills require bankruptcy courts to establish procedures to refer these cases to those agencies. (Sec. 203)

Subtitle B (Priority Child Support) of Title II of the Senate and House bills places certain unsecured claims for domestic support obligations in the first priority claim category, when the funds received by a governmental unit are applied in a prescribed order. The court cannot confirm a debt repayment plan under Chapters 11, 12, and 13 unless it has certification of the debtor's full payment of all adjudicated domestic support obligations which are due after the petition filing date. (Sec. 213) The bills except from the automatic stay certain choose-in-action that relate to domestic support obligation proceedings. (Sec. 214) The laws concerning nondischargeability of certain debts for alimony, maintenance and support are also amended. (Sec. 215) The bills would also make property, which is exempt from the estate, liable for a debt arising from domestic support obligations. (Sec. 216) A bona fide payment of a debt for a domestic support obligation cannot be avoided by the trustee. (Sec. 217) The trustee’s duties under Chapters 7, 11, 12, and 13 regarding a claim against an individual debtor for the collection of child support are set forth. (Sec. 219) Debts for certain qualified educational loans that would impose an undue hardship upon either the debtor or the debtor's dependent are dischargeable. (Sec. 220)

C. **Discouraging Bankruptcy Abuse**

Both the Senate and House bills provide for termination of the automatic stay 30 days after filing of a petition when the debtor has had a Chapter 7, 11, or 13 petition dismissed during the previous year, unless the subsequent filing is in good faith. (Sec. 302) If either of the bills are passed in their present form, courts will be required to grant two-year relief from the automatic stay when requested by a party in interest as to certain real property actions if there is a finding that filing the bankruptcy petition was part of a scheme to delay, hinder, and defraud creditors. (Sec. 303)

The bills also change a Chapter 7 debtor’s duty to take certain affirmative actions in order to retain possession of personal property. Instead, creditors will be able to take action under
nonbankruptcy law if the debtor fails to act within a certain time. There is an exception if the court determines, upon the trustee's motion, that the property is of consequential value or benefit to the estate. (Sec. 304) The bills provide for termination of the automatic stay as to the estate's property securing a claim or subject to an unexpired lease, when the debtor fails to complete an intended surrender of consumer debt collateral, or an intended property redemption or debt reaffirmation in order to retain such collateral, within a revised, accelerated time frame. This is subject to the court's determination, upon the trustee's motion, that the property is of consequential value or benefit to the estate. (Sec. 305)

Under either bill, the court will be required to confirm Chapter 13 plans when they provide that the holder of an allowed secured claim retains the attendant lien until payment or discharge of all debts. The bill additionally provides that, when a Chapter 13 proceeding is dismissed or converted without completing the plan, the holder retains the lien to the extent recognized by nonbankruptcy law. There are statutory guidelines setting forth circumstances in which cramdown under Section 506 cannot occur, and the creditor's entire claim will necessarily receive secured status. In the Senate, these circumstances include when the creditor has a purchase-money security interest in the debt; the underlying debt was incurred within three years prior to the filing of the petition; and the collateral for that debt is for a motor vehicle for the debtor's personal use (or if the collateral is anything else of value when the debt was incurred during the year preceding the filing). In the House, the guidelines are similar, with the exception that the underlying debt must have been incurred within the five years prior to the filing of the petition. (S. 420, Sec. 306, H.R. 333, Sec. 306)

In determining which state law governs the debtor's selection of exempt property, both bills hold that the debtor must be domiciled in the state for 730 days (an increase from the present 180 day requirement) and address circumstances in which the debtor has not been domiciled in a single state for that time period. (Sec. 307)

The House bill holds that the value of the homestead and burial plot exemptions are reduced to the extent it is attributable to any portion of property disposed of by the debtor within the seven-years prior to the filing date with the intent to obstruct or defraud a creditor; and to any portion of property which the debtor could not exempt. (Sec. 308). The Senate bill alters Section 308 by providing that a debtor may not exempt any amount of interest exceeding $125,000 in the aggregate in real or personal property that the debtor or his dependent uses as a residence; a cooperative that owns property the debtor or his dependent uses as a residence; or a burial plot for the debtor or his dependant. Excepted from the limitation is the principal residence of a family farmer (Sec. 420 Sec. 308)

The bills alter the provisions addressing conversion from Chapter 13 to another Chapter. They state that (1) the valuation of property and of allowed secured claims in a chapter 13 case shall not apply in a converted Chapter 7 case; and (2) the claim of any creditor holding security as of the date of the Chapter 13 petition shall be secured by that security unless the full claim amount (to be determined by nonbankruptcy law) has been paid in full as of the conversion date. When there is a prebankruptcy default, it shall be treated under nonbankruptcy law unless it is fully cured under the plan at conversion. (Sec. 309)

Both bills provide for a Chapter 7 debtor's assumption of unexpired leases on personal property and hold that, in a Chapter 11 case in which the debtor is an individual and a Chapter 13
case, if the lease is not assumed in the plan, it is rejected at the close of the confirmation hearing. Thus, the lease is free from the automatic stay. (Sec. 309)

The Senate bill provides for a cash payment plan for chapter 13 debtors in making payments to lessors of personal property and to creditors holding a claim secured by personal property. Debtors-in-possession will have to provide reasonable evidence of any requisite insurance coverage with respect to the use or ownership of the property. (Sec. 309)

The Senate bill lowers the threshold amount for a presumption of nondischargeability to $750 on both luxury goods and cash advances (which are extensions of consumer credit under an open end credit plan) when acquired within 90 days and 70 days, respectively. (S. 420, Sec. 310) The House bill makes the same adjustments as to time, but lowers the threshold for luxury goods to $250. The House’s threshold amount for cash advances remains at $750. (H.R. 333, Sec. 310)

The Senate bill precludes the automatic stay of any eviction, unlawful detainer action, or similar proceeding by a lessor against a debtor involving residential real property when the debtor resides as a tenant under a rental agreement, the debtor resides as a tenant under a rental agreement that has terminated, or eviction actions are based on endangerment to the property or person or the use of illegal drugs. This provision denies the automatic stay of any transfer that is not avoidable by the trustee. (H.R. 333, Sec. 311) In addition to some of the same circumstances, the Senate bill includes the situation in which the debtor has filed another bankruptcy proceeding in the year preceding the date the current petition was filed. The Senate bill also sets forth specific circumstances in which the automatic stay may not become effective. (S. 420, Sec. 311)

Both bills extend the period between Chapter 7 discharges to eight years, and between Chapter 13 discharges to five years. (Sec. 312)

Each of the Senate and House bills imposes strict deadlines and provides for automatic dismissal when Chapter 7 or 13 debtors fail to furnish mandatory information to timely file the required schedules. The court must dismiss within five days of any party-in-interest’s request based on the debtor’s failure to timely submit required documents. (Sec. 316)

According to the Senate bill, the Chapter 13 confirmation hearing must be held within 45 days of the first meeting of creditors. (Sec. 317)

A formula is provided in both bills to determine when a Chapter 13 plan is to be made over three or five years. (Sec. 318)

The bills each provide new guidelines for Chapter 11 business reorganization cases filed by an individual. The debtor must identify the estate’s property in bankruptcy and revise the contents, confirmation and modification of a reorganization plan. (Sec. 321)

The House bill prohibits debtors from exempting any interest, which exceeds the aggregate value of $100,000 and is acquired within the two years prior to filing the petition, in: (1) real or personal property used as a residence; (2) a cooperative that owns property used as a residence by the debtor or debtor's dependent; or (3) a burial plot for the debtor or debtor's dependent. (H.R. 333, Sec. 322)
Employee benefit plan participant contributions are exempted from property of the estate under both bills. (S. 420, Sec. 322 and H.R. Sec. 323)

Under each bill, the value of personal property securing an allowed claim is to be determined based on its replacement value, as of the date of the filing of the petition, without deduction for costs of sale or marketing. (S. 420, Sec. 326 and H.R. Sec. 327)


There are multiple new provisions under both the House and Senate bills concerning general and small business bankruptcy issues.

With respect to a trustee's authority to avoid a transfer of property, the length of time to perfect the transfer is increased from ten to thirty days under both bills. (Sec. 403) Guidelines for rejection and surrender of executory contracts and unexpired leases are revised under the bills. (Sec. 404)

Under both the Senate and House bills, acceptance or rejection of a Chapter 11 plan may be solicited from a holder of a claim or interest if: (1) the solicitation complies with applicable nonbankruptcy law; and (2) the solicitation was made prior to filing the petition and in compliance with applicable nonbankruptcy law. (Sec. 408) Both bills prohibit the trustee from avoiding a transfer if, in a case where the debts are not primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than $5,000. (Sec. 409) The extensions of time permitted for filing a Chapter 11 reorganization plan are limited under both bills. (Sec. 411)

Investment bankers for any outstanding security of the debtor may be treated as disinterested persons. (Sec. 414)

Both bills require the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States to propose amended Federal Rules of Bankruptcy Procedure and Official Bankruptcy Forms instructing Chapter 11 debtors to disclose information concerning the value, operations, and profitability of any closely held corporation, partnership, or other entity in which the debtor holds a substantial or controlling interest. (Sec. 419)

The Small Business Bankruptcy Provisions in both bills establish mandatory factors for the court to consider in determining whether the disclosure statement regarding a small business reorganization plan provides adequate information. Both bills define a small business debtor, generally, as a person (including a debtor affiliate) with not more than $3 million in aggregate non-contingent, liquidated secured and unsecured debts as of the date of the petition or the order for relief (excluding debts owed to one or more affiliates or insiders). (Sec. 432)

Under each of the Senate and House bills, there are revised rules concerning the ability of a secured single asset real estate interest creditor to get relief from the automatic stay when the debtor has commenced monthly payments to each of these creditors to allow the debtor, in the debtor's sole discretion, to make such payments from rents or other income generated before or after the filing of the petition by or from the property. These provisions require such payments in an amount equal to the interest on the value of the creditor's interest in the real estate,
determined at the then-applicable nondefault contract rate of interest. This is currently the fair market rate. (Sec. 444)

In the House bill, a small business bankruptcy reorganization plan must be confirmed within 175 days after the order for relief. There are provisions for the extension of time (H.R. 333, Sec. 438). The Senate bill provides that the plan must be confirmed with 45 days of the date of filing, with certain criteria specified for extensions (S. 420, Sec. 438)

Both of the bills allow, as an administrative expense, all monetary obligations due from a nonresidential real property lease previously assumed and subsequently rejected under the requirements governing executory contracts and unexpired leases for the two-year period following either the rejection date or date of actual turnover of the premises, whichever is later. (Sec. 445)

E. Ancillary and Other Cross-Border Cases

The Senate and House have both expanded the scope of bankruptcy law to incorporate the Model Law on Cross-Border Insolvency, and established a statutory mechanism for addressing cases involving cross-border insolvency and the cooperation among U.S. courts, trustees, debtors and their foreign counterparts. (Title VIII)

F. Protection of Family Farmers

Both Senate and House bills propose to reenact Chapter 12 (Adjustment of Debts of a Family Farmer with Regular Annual Income). However, the Senate includes more revisions of bankruptcy law with regard to same and incorporates provisions set forth to protect the family fisherman.

The House bill amends the Federal bankruptcy code to: (1) reenact Chapter 12, Adjustment of Debts of a Family Farmer with Regular Annual Income (thereby reinstating family farmer bankruptcy relief); and (2) cite circumstances under which the claim of a governmental unit that arises as a result of the disposition of a farm asset used in the debtor's farming operation shall be treated as an unsecured claim not entitled to priority.

The Senate bill provides for triennial adjustments of family farmers' debt limit. (Sec. 1002) Both the Senate and House bills address circumstances in which a governmental unit's claim, arising from the disposition of a farm asset used in the debtor's farming operation, shall be treated as an unsecured claim and is not entitled to priority. (Sec. 1003)

With respect to the maximum aggregate debts an individual or individual and spouse engaged in a farming operation may have to qualify as family farmers for debt adjustment purposes, the Senate bill increases the amount from $1.5 million to $3 million. The Senate bill also reduces, from 80 percent to 50 percent, the minimum percentage of aggregate, noncontingent, liquidated debts (with certain exclusions) arising out of the farming operation. (Sec. 1004)

The Senate bill repeals the requirement that the family farmer and spouse receive over 50 percent of income from farming operations in the year prior to the bankruptcy. Instead, it allows
the income requirement to be met during at least one of the three taxable years preceding the taxable year in which the petition is filed. (Sec. 1005)

Circumstances in which the court shall confirm a family farmer bankruptcy plan, notwithstanding the objection of the trustee or the holder of an allowed unsecured claim, are set forth in the Senate bill. This portion of the Senate bill prohibits post-confirmation modification of the plan which increases the payment amounts due before the modification. Further, unless the debtor proposes the modification, a modified plan may not require payments to unsecured creditors in any particular month greater than debtor's disposable income for that month based on an increase in debtor's disposable income or, if the modification takes place in the plan's last year, require any payments that would leave the debtor with insufficient funds after plan completion to carry on the farming operation. (Sec. 1006)

G. Health Care and Employee Benefits

Title XI of the House and Senate bills both address health care and employee benefits and provide guidelines for disposing of a health care businesses' patient records (not including a health maintenance organization) when it brings a proceeding for debtor relief and the trustee cannot pay for storage of patient records as required by law. Administrative expense claims are permitted for the costs of closing a health care business, including disposal of patient records and transfer of patients. (Sec. 1103) The legislation mandates that the court appoint an ombudsman to represent the interests of patients of a health care business within 30 days after filing under Chapters 7, 9, or 11 (Sec. 1104) and requires that the trustee use all reasonable and best efforts to transfer patients from the health care business being closed to an appropriate substitute. (Sec. 1105) The bills also preclude the debtor's continuation or reinstatement in Medicare or any other Federal health care program by denying the protection of the automatic stay. (Sec. 1106)

H. Miscellaneous

Both the Senate and House bills make technical corrections to Federal bankruptcy, judicial, and criminal law.

The Senate and House bills redefine single asset real estate to exclude family farms and repeal the $4 million ceiling for noncontingent, liquidated secured debts on such property. They also define the term "transfer" to include the creation of a lien, the retention of title as a security interest, foreclosure of the debtor's equity of redemption, and every mode of disposing of property or parting with an interest in property. (Sec. 1201)

Expenses incurred for an attorney or an accountant by an individual member of a creditors' and equity security holders' committee are excluded from compensable professional services by the Senate and House bills. (Sec. 1208)

The Senate and House bills revise preferences guidelines so that, if the trustee avoids a security interest given between 90 days and one year prior to the filing date by the debtor to a non-insider for the benefit of an insider creditor, then that security interest is considered avoided only as to the insider creditor. (Sec. 1213)
Pursuant to both Senate and House bills, the time within which a debtor may perfect a security interest created by the transfer and which the trustee may not avoid, will be extended from 20 to 30 days within the debtor's receipt of possession. (Sec. 1223)

Both bills set forth compensation guidelines for a trustee's services and expenses incurred when petitioning the court to convert or dismiss a chapter 7 case. (S. 240, Sec 1226 and H.R. 333, Sec. 1225)

Both the Senate and House bills modify the right of a seller of goods to reclaim goods from the debtor if they are received while the debtor is insolvent. The bills also limit the period of receipt to 45 days after the case begins, and limit the time when the seller may demand reclamation to 45 days after the debtor's receipt or within 20 days after the filing of the bankruptcy petition. (S. 240, Sec. 1229 and H.R. 333, Sec. 1228)

The Senate and House bills set forth provisions for expedited bankruptcy appeals to the Courts of Appeals. Any judgment, decision, order, or decree of a bankruptcy judge is deemed to be that of the appellate District Court, unless the District Court files its own decision within 30 days after the filing of the appeal. (S. 420, Sec. 1235 and H.R. 333, Sec. 1234)

Both Senate and the House bills provide that the Effective Date for each is 180 days after enactment. (S. 420, Sec. 1501 and H.R. 333, Sec. 1401)
CURRENT ISSUES BEFORE THE
KENTUCKY DEPARTMENT OF FINANCIAL INSTITUTIONS

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SECTION E
CURRENT ISSUES BEFORE THE
KENTUCKY DEPARTMENT OF FINANCIAL INSTITUTIONS

I. Establishment And Relocation Of Bank Branches Or Offices (808 KAR 1:150)

II. Examination Of Records – Promulgation Of Rules – Delegation Of State Treasurer’s Authority (KRS 393.280)

III. Unclaimed Property; Examination Of Holder Records (20 KAR 1:050)
IV. Unclaimed Property; Safe Deposit Boxes Or Other Safekeeping Repositories
(20 KAR 1:060)

V. Reports To Be Filed By Holders Of Unclaimed Property (20 KAR 1:080)
808 KAR 1:150. ESTABLISHMENT AND RELOCATION OF BANK BRANCHES OR OFFICES.
808 KAR 1:150. Establishment and relocation of bank branches or offices.

RELATES TO: KRS 287.102, 287.180, 287.185

STATUTORY AUTHORITY: KRS 287.180(2), 287.185

NECESSITY, FUNCTION, AND CONFORMITY: KRS 287.180(2) and 287.185 authorize the Department of Financial Institutions to designate those banks that do not have to apply for approval of the commissioner for permission to establish a branch or to relocate its principal office or branch. KRS 287.102 authorizes a qualified state bank to engage in any banking activity in which the bank could engage in other states if the bank meets specified conditions. Other states permit statewide branching as part of their authorized banking activities. This administrative regulation establishes the criteria for a bank to meet in order to be designated as not having to obtain commissioner approval to establish a branch, or relocate a principal office or branch.

Section 1. Permitted Activities Without Commissioner Approval. Any bank that meets the criteria set forth in Section 2 of this administrative regulation and provides the notices required in Section 3 of this administrative regulation may do any of the following in any county of the state, whether or not already located in the county, without commissioner approval:

(1) Establish a branch; or

(2) Relocate its main office or branch office.

Section 2. Criteria to Act Without Commissioner Approval. The following criteria shall be satisfied before a bank may undertake the activities described in Section 1 of this administrative regulation without commissioner approval:

(1) The bank shall have received its bank charter from the department at least three (3) years prior to undertaking the activities;

(2) The bank shall be well-capitalized.

(a) As defined by the Federal Deposit Insurance Corporation, if the bank is a nonmember bank; or

(b) As defined by the Federal Reserve Board of Governors, if the bank is a member bank;

(3) The bank shall have received a CAMEL composite rating of one (1) or two (2) on its most recent state or federal regulatory examination;

(4) The bank shall have received a management rating of one (1) or two (2) on its most recent state or federal regulatory examination;

(5) The bank shall not be a party to any formal or informal enforcement action initiated by a state or federal regulatory agency; and

(6) The bank's activity shall not cause the bank to exceed the fixed asset limitation established in KRS 287.100.

Section 3. Required Notices. A bank that desires to engage in the activities described in Section 1 of this administrative regulation without commissioner approval shall submit the following notices:

(1) A notice shall be sent to the department within thirty (30) days after the bank's board of directors approves the activity, which notice shall provide as follows:

(a) The address of the new location where the bank intends to establish or relocate its new branch or office;

(b) The expected date the new branch or office shall open; and

(c) A statement by the bank that it satisfies the criteria set forth in Section 2 of this administrative regulation signed by an authorized officer or agent of the bank.

(2) A notice shall be sent to any state bank with its main office located in the county where the new branch or office will be located within thirty (30) days after the bank's board of directors approve the activity, which notice shall provide as follows:

(a) The address of the new location where the bank intends to establish or relocate its new branch or office; and

(b) The expected date the new branch or office shall open.

(3) A notice shall be sent to the department within thirty (30) days after the bank has opened its branch or office at the new location advising the department of the opening.
Section 4. Effect of Subsequent Noncompliance with Criteria. If, subsequent to the establishment or relocation of an office or branch without commissioner approval, the bank no longer meets the requirements established in Section 2 of this administrative regulation, the bank shall thereafter be required to obtain commissioner approval prior to establishing or relocating any additional offices or branches until the bank again meets the criteria. The establishment or relocation already completed by the bank shall not be rendered ineffective. (27 Ky.R. 260; Am. 769; eff. 9-11-2000.)
EXAMINATION OF RECORDS – PROMULGATION OF RULES – DELEGATION OF STATE TREASURER’S AUTHORITY.
393.280 Examination of records — Promulgation of rules — Delegation of State Treasurer's authority.

(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.

Effective: July 15, 1998


Legislative Research Commission Note (7/15/94). This section was amended by 1994 Ky. Acts chs. 58 and 276. Where these Acts are not in conflict, they have been codified together. Where a conflict exists, Acts ch. 276, which was last enacted by the General Assembly, prevails under KRS 446.250.
UNCLAIMED PROPERTY; EXAMINATION OF HOLDER RECORDS.
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 administrative 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 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 immediately 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 examination 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. 1281; eff. 10-12-94.)
20 KAR 1:060. UNCLAIMED PROPERTY; SAFE DEPOSIT BOXES OR OTHER SAFEKEEPING REPOSITORIES.
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 administrative 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 depository;
(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 safekeeping 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.)
REPORTS TO BE FILED BY HOLDERS OF UNCLAIMED PROPERTY.
General Government Cabinet

20 KAR 1:080. Reports to be filed by holders of unclaimed property.

RELATES TO: KRS 393.110(1)

STATUTORY AUTHORITY: KRS 393.110(1), 393.280(4)

NECESSITY, FUNCTION, AND CONFORMITY: KRS 393.110(1) requires the holder of unclaimed property to submit annual reports to the State Treasurer concerning the property. This administrative regulation establishes the reporting requirements for a holder of unclaimed property.

Section 1. Reports Filed by a Holder of Unclaimed Property. A holder of unclaimed property shall annually file a completed Form 400, Unclaimed Property Report/Remit Form, with the main office of the State Treasurer no later than the close of business on November 1 of each year.

Section 2. Reports on Property Held in an Interest Bearing Account. If the holder of unclaimed property is required to place that property in an interest bearing account, the holder shall submit to the State Treasurer the following reports:

(1) Statements on the interest-bearing account holding unclaimed property. The statement shall:

(a) Be the kind normally issued on an interest-bearing account;

(b) Be filed:

1. With the main office of the State Treasurer; and

2. According to the holder's normal course of business no less than quarterly; and

(c) Include the value of the unclaimed property and the amount of the interest paid on the account.

(2) Reports on an amount paid out of an account holding unclaimed property. A holder of an account holding unclaimed property shall file a report within ten (10) business days of paying an amount out of the account. The report shall:

(a) Include:

1. The name, Social Security number, and the address of the property owner;

2. The amount paid;

3. The portion of the amount that represents interest paid and the portion that represents the original amount of unclaimed property;

4. The date the property was presumed abandoned;

5. Proof of payment;

6. An itemization of each fee or expense charged against the account; and

7. An affidavit indicating:

a. What specific proof was used in determining that the person that received the amount or payment was the rightful claimant; and

b. That the procedures for paying a claim for unclaimed property as established in 20 KAR 1:040 were followed; and

(b) Be filed at the main office of the State Treasurer.


(2) This material may be inspected, copied or obtained at the Kentucky State Treasurer, Capitol Annex, Room 183, Frankfort, Kentucky 40601, Monday through Friday, 8 a.m. to 4 p.m. (26 Ky.R. 491; Am. 989; eff. 11-15-99.)
LOAN WORKOUTS
(How to Limit Exposure for Lenders)

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LOAN WORKOUTS: HOW TO LIMIT EXPOSURE FOR LENDERS

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Note: Portions of this outline are drawn from materials that were prepared by the author in collaboration with
Susan S. Armstrong, Esq., Hon. Joan Lloyd Cooper and Lenna R. Macdonald, Esq. for a presentation to
the Louisville Bar Association on November 9, 1998, and the author thanks them for their contributions.

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LOAN WORKOUTS: HOW TO LIMIT EXPOSURE FOR LENDERS

I. PRE-DEFAULT ISSUES

A. Loan Document Provisions in Contemplation of Default (see Appendix A)

   [a] Covenants construed independently
   [b] Borrower had benefit of counsel
   [c] inconsistent provisions

2. Additional Deliveries
   [a] Power of attorney

3. Indemnification
   [a] Lender liable only for gross negligence and willful misconduct

4. Acceptance of Partial Performance not a Waiver

5. Claims and damages
   [a] no consequential damages
   [b] "timely" notice of claims or barred
   [c] automatic release of Lender upon payment

6. Governing Law; Consent to jurisdiction and venue
   [a] See Wallace Hardware Co. v. Abrams, 223 F.3d 382 (6th Cir. 2000) though Kentucky courts have been observed to be "egocentric" concerning choice of law questions, Kentucky would choose to adopt § 187 of the Restatement (Second) of Conflict of Laws; therefore, choice of Tennessee law by parties to guaranty is honored and guarantor is unable to interpose KRS § 371.065 as a defense

7. Disclosures
1. Waiver of Covenant Violations

2. Mechanics Lien Waivers

8. Waiver of Jury Trial

[a] Must be knowingly and voluntarily given, K.M.C. v. Irving Trust Company, 757 F.2d 752 (6th Cir. 1985)

[b] Enforceable in Ky. state court? see CR 38.01, but see CR 38.04

9. Arbitration

B. Pre-Default Extensions, Amendments, Waivers and Credit Enhancements

1. Waiver of Covenant Violations

[a] Failure of lender to formally waive may prejudice its ability later to claim entitlement to strict performance

2. Mechanics Lien Waivers

[a] Tile House, Inc. v. Cumberland Federal Savings Bank, 942 S.W.2d 904 (Ky. 1997) bank mortgagee’s knowledge of equitable lien (home purchaser’s contract), to which its mortgage in consequence was subordinate, resulted in the lien of the bank’s mortgage also being subordinate (to the extent of the amount secured by the equitable lien) to claims of mechanics lien holders who didn’t have knowledge of the equitable lien and whose claims were superior to the equitable lien, but which claims otherwise would have been subordinate to the lien of the bank’s mortgage.

[b] Metal Sales Mfg. Corp. v. Newton, 12 S.W.3d 691 (Ky. App. 1999) materialman’s lien is held to be created upon the delivery of labor or materials and perfected upon the filing of the lien statement, therefore, although the bank’s mortgage was filed prior to filing of materialman’s lien, the lien of the bank’s mortgage nevertheless was subordinate to the materialman’s lien to the extent of that portion of the indebtedness secured by the bank’s mortgage that was preexisting
debt being refinanced at the time the mortgage was given and so not "for value" under KRS 376.010(2). Even though the proceeds of the preexisting debt were used entirely for construction on the mortgaged premises, the operative inquiry is not the purpose for which the preexisting debt was incurred, but whether the mortgage was given "for value."

3. Effect of Modifications on Obligations of Guarantors

[a] Is contemporaneous consent from existing guarantors required or advisable?

[1] Ramsey v. First Nat. Bank and Trust Company of Corbin, 683 S.W.2d 947 (Ky. App. 1984) business partner and co-signer of note held to be a co-maker rather than an accommodation party, and so not entitled to discharge when other partner was released, under the "purposes and benefits" test.

Two primary factors are indicative of accommodation status: (1) no benefits from the proceeds of the instrument are received by the accommodation party, and (2) the signature is needed by the maker to acquire the loan. Id. at 954.

[2] KRS 355.3-605 provides that an accommodation party is not discharged if:

(a) The party asserting discharge consents to the event or conduct that is the basis of the discharge; or

(b) the instrument or a separate agreement of the party provides for waiver of discharge under this section either specifically or by general language indicating that parties waive defenses based on suretyship or impairment of collateral. (emphasis supplied)

[3] Kane v. Citizens Fidelity Bank and Trust Company, 668 S.W.2d 1984 (Ky. App. 1984) guarantors under continuing guaranty agreement who also cosigned the note at issue were not entitled to assert impairment of collateral defense when bank did not levy on assets or otherwise aggressively seek to
collect from the maker (guaranty agreement provided that it "is several and is independent of any other obligations or liabilities of guarantor on debtor's credits whether as co-maker, endorser, surety, or otherwise," id. at 566; see also Liberty National Bank and Trust Company v. Russ, 668 S.W.2d 567 (Ky. App. 1984))

[4] First Security Bank & Trust Company v. Robinson, 215 F.3d 1326 (6th Cir. 2000) guarantor not entitled to discharge when bank failed to perfect its security interest in collateral of borrower, where guaranty agreement provided bank may "impair, fail to realize upon or perfect Lender's security interest in the collateral." Id.

[b] Legal consideration for new guarantors

4. Real Estate Collateral

[a] Effect of not recording mortgage modification
   -- see KRS 382.520 re: extensions and renewals

[b] KRS 382.520; future advance and "dragnet" mortgage provisions:

   In re Polley, 219 B.R. 205 (Bankr. W.D. Ky. 1998) "artfully drafted" future advance clause in residential mortgage was effective to secure subsequent promissory notes evidencing business loans made to only one of the mortgagors and that made no reference to the mortgage, which provided:

   [T]his mortgage shall also secure any additional indebtedness made to the Bank by the mortgagors or any of them or whether made as surety, guarantor or otherwise and regardless of whether the same makes reference to this mortgage or is of the same type of class as the primary debt." Id. at 207.

   First Commonwealth Bank of Prestonburg v. West, 27 S.W.3d (Ky. App. 2000), future advance clause subjecting the interest of "the Mortgagor or the Borrower or any of them" was sufficient to encumber divorced spouse's interest in mortgaged property for indebtedness incurred by former husband prior to divorce even though she was not aware that he incurred the debt.

[c] Title policy endorsement versus attorneys' title opinion or new commitment or title report from underwriter
5. Taking additional collateral/other credit enhancements

[a] Preference Risks

[1] Federal Law - Under the Bankruptcy Code, the trustee [which can be either the duly appointed and acting Trustee or the Debtor-in-possession (DIP)] may seek to avoid transfers of property of the debtor to the creditor on account of an antecedent debt, made while the debtor is insolvent which occur within 90 days of bankruptcy (or 1 year in the case of an insider to the debtor) and result in the creditor receiving more on account of its claim than it would have on a Chapter 7 filed prior to the transfer. 11 U.S.C. § 547

[2] State Law - Under state law other creditors may, within 6 months of a transfer (See KRS 378.070), file a petition to avoid the transfer on the basis that it was made "in contemplation of insolvency and with design to prefer one or more creditors to the exclusion, in whole or in part, of others," KRS 378.060. See In re Rexplore Drilling, Inc., 971 F.2d 1219 (6th Cir. 1992), where the Court confirmed that the trustee may use either the federal or state avoidance actions and held that, under KRS 378.060 (a) "contemplation of insolvency" means whether a reasonable debtor should have known it was insolvent at the time of the transfer, and (b) a rebuttable presumption of a "design to prefer" is created where the debtor makes a transfer while insolvent.

[b] Fraudulent Conveyance Risks

[1] Federal Law - 11 U.S.C. § 548 - Under the Bankruptcy Code, the Trustee or DIP may seek to avoid transfers of property of the debtor where the debtor; (a) intends to hinder delay or defraud its creditors by the transfer; or (b) receives less than reasonably equivalent consideration in exchange for the transfer or obligation; and (i) was insolvent or became insolvent as a result of such transfer, or (ii) was or was about to engage in business or a transaction for which any property remaining with the debtor is an unreasonably small capital, or (iii) intended to incur or believed would incur debts beyond debtor's ability to pay as they mature.

[2] State Law - Any transfer made with the intent to delay, hinder
or defraud creditors... is void as against creditors, KRS 378.010. Further, any transfer made without valuable consideration shall be void as to existing creditors but not as to creditors whose claims are thereafter contracted, or as to purchasers with knowledge of the sale or charge. KRS 378.020. Note that insolvency is not a required element under KRS 378.020.

II. WORKOUT DUE DILIGENCE, OPTIONS AND ISSUES

A. Conflict Check

1. Waiver of Conflicts

B. Default/Demand Letter

1. Identify defaults
   [a] Payment versus non-payment
   [b] Ascertaining cure periods

2. Distinguishing default from acceleration

3. Default/Acceleration letter (see Appendix B)
   [a] Manner of giving notice
   [b] Conflicting addresses for notices
   [c] Notices to guarantors; inquiries from guarantors

C. Late charges and post-default interest increase
   [a] Traveler's Insurance Co. v. Corporex Properties, Inc., 798 F.Supp. 423 (E.D. Ky. 1992), "late charges specified in a contract are recoverable as liquidated damages because of the difficulty and impracticability of fixing the amount of actual damages for administrative expenses that will be sustained in the event of late payments," and "a 4% late fee is not unreasonable in commercial transactions," Id. at 428

   [b] Capitol Cadillac Olds, Inc. v. Roberts, 813 S.W.2d 287, 292 (Ky.

[a] Applicable to debts incurred primarily for personal, family or household purposes

E. **Set-offs**

1. In *Baker v. National City Bank of Cleveland*, 511 F.2d 1016 (6th Cir. 1975), the Sixth Circuit, applying Ohio law, held that setoff is not complete until three steps have been taken:

[a] the decision to exercise the right,
[b] some action which accomplishes the set-off and
[c] some record which evidences that the right of set-off has been exercised.

2. In *Ferguson Enterprises, Inc. v. Main Supply, Inc.*, 868 S.W. 2d 98 (Ky. App. 1993) the court, noting that the relationship between bank and depositor is that of debtor and creditor, adopted the Baker criteria in holding that, under KRS 355.4-303, a bank cannot set-off a customer’s account after accepting a garnishment order.

3. Banks may freeze bank accounts that are subject to a bank’s right of set-off. *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 116 S. Ct. 286, 133 L. Ed. 258 (1995). The Supreme Court held that the bank did not violate the automatic stay by placing an administrative hold on the debtor’s account while the bank sought judicial redress. The Court concluded that the administrative hold was neither a taking of possession of the depositor’s property nor the exercising of control over it, but merely a refusal to perform its promise to pay. *Id.* at 21, 116 S. Ct. at 290, 133 L. Ed. at 264.

4. "Special deposits" - see *Bank One, Pikeville v. Com., Natural Resources Cabinet*, 901 S.W.2d 52 (Ky. App. 1995) a bank may not setoff against a deposit made by depositor and accepted by bank for a special and particular purpose such as, in this case, certificates of deposit maintained for the benefit of the Natural Resources Cabinet pursuant to escrow agreement to which bank was a party.
F. Loan Document Audit

1. Promissory Note

[a] KRS 360.020(2) Requirement to apply partial payments first to interest then due

[1] Straub v. Chemical Bank, 608 S.W.2d 71 (Ky. App. 1980) Creditor receiving payments from debtor without any direction as to the application may apply them to any debt owed to the creditor by the debtor, including to an unsecured claim when the creditor also holds a secured claim, citing Wilkes v. Kitchen, 218 S.W. 718 (Ky. 1920); and, in any event, debtor has right to direct how payment shall be applied only where payment is voluntarily made, citing City of Olive Hill v. Gearhart, 157 S.W. 2d 481 (Ky. 1942).

[2] Ranier v. Mount Sterling National Bank, 812 S.W.2d 154 (Ky. 1991). In every contract there is an implied covenant of good faith and fair dealing, and where mortgage subordination agreement was silent concerning application of payments, bank was under equitable duty to apply those payments to its loan that was benefitted by the subordination, rather than to an unsecured loan it made to the borrower after the subordination agreement was entered into.

2. Loan Agreement

3. Security Agreement/Financing Statements

[a] Collateral descriptions don't match

[b] Proper places to file

[c] Financing Statement requirements

[1] Last name first for individuals

[d] Impact of Revised Article 9

4. Mortgage

[a] KRS 382.270: Mortgage not valid against purchaser for
valuable consideration without notice until acknowledged and lodged for record

[1] State Street Bank & Trust Company of Boston, Massachusetts v. Heck's Inc., 963 S.W. 2d 626 (Ky. 1998) prior recorded mortgage signed on Schedule C rather than signature page, though not valid as constructive notice under KRS 382.270, nevertheless created an equitable lien as of the date funds secured by it were advanced which had priority over lien on same property in favor of subsequent mortgage having actual and inquiry notice, at the time of its mortgage, of the earlier mortgage.

[2] Thacker v. United Companies Lending Corporation, 256 B.R. 723 (W.D. Ky. 2000) debtors in Chapter 13, relying on the strong-arm powers under 11 U.S.C. § 544(a), held entitled to set aside mortgage they had signed and which was recorded but which could not give constructive notice because the legal description of the property was attached as a schedule following the signatures of the mortgagors and not incorporated by reference, and the names of the debtor / mortgagors were not set forth in the acknowledgment (distinguishing State Street Bank, supra, where earlier mortgage also failed to provide constructive notice but later mortgagee, which was not entitled to bona fide purchaser status under bankruptcy law as in this case, had actual or inquiry notice.

[b] KRS 382.335: Requirement for "Scrivener"

c] KRS 382.385: "Line of Credit"/"Revolving Credit Plan"

d] KRS 382.520: "Revolving Credit Statute"

[1] Bank of Maysville v. Brock, 375 S.W. 2d 814 (Ky. 1964) ($10,000 repaid on original note of $50,000 and then reloaned remained secured by mortgage containing future advance clause covering indebtedness not exceeding $52,000 in the aggregate pursuant to KRS 382.520).

e] KRS 382.330: Requirement for date and maturity date of obligations secured.
Amount Requirement: Show amount of obligations secured [Pearce v. Hall, 75 Ky. (12 Bush) 209 (1876)]

Baird v. Read, 288 S.W. 1014 (Ky. 1926) (mortgage that does not recite the amount secured, even though recorded and even though amount is written into the mortgage after the recording of same, is not effective for constructive notice).

In re Taylor, 18 B.R. 128 (Bkrtcy. W.D. Ky. 1982) (Mortgage complying in all respects with the recording statutes except for the omission of the maturity date of the secured obligation, but which disclosed the amount of the monthly payments, held sufficient to perfect the mortgage lien since the document was recorded "however improper in form" id. at 129).

Blieden v. Citizens Fidelity Bank and Trust Company, 49 B.R. 386 (Bkrtcy. W.D. Ky. 1985) (Although the mortgage erroneously stated that it secured one note in the amount of $86,600 rather than eleven notes totaling that amount, the mortgage nevertheless satisfied requirements of KRS 382.330, purporting to distinguish Trio Realty Company v. Queenan on the basis that the Queenan mortgage was patently defective because of omission of the amount secured by that mortgage).


[1] Baird v. Read, 288 S.W. 1014 (Ky. 1926) (mortgage that does not recite the amount secured, even though recorded and even though amount is written into the mortgage after the recording of same, is not effective for constructive notice).

--- distinguish re-recording

[g] KRS 382.340: Recording requirements for mortgage executed by "public utility corporation"

[h] KRS 382.380: Requirement for filing "statement of amount and maturity" in the case of mortgage granted to a trustee to secure bonds to be issued later

[i] KRS 382.430: Requirement for county, state and post office
address of mortgagee

[j] KRS 376.050: Required recital in mortgage securing loan made "for the purpose of erecting, improving or adding to a building"

[k] KRS 382.140: Requirement for notary seal affixed to documents executed outside of Kentucky to be recorded in Kentucky

[l] KRS 411.195 Enforceability of written agreement to pay attorney fees in event of default

[1] Farmers Bank & Trust Company v. Brazell, 902 S.W. 2d 830 (Ky. App. 1995) (KRS 411.195 permits recovery of attorneys' fees only from those who are parties to the writing, and so former joint tenant in the alternative of certificate of deposit who did not sign notes that permitted recovery of attorneys' fees and who contested bank's right to liquidate same upon death of other joint tenant was not liable for attorneys' fees to bank).

[m] KRS 423.160: Short forms of acknowledgment

5. Guaranty

[a] K.R.S.371.065 A guaranty not written upon or that does not expressly refer to the instrument guaranteed is not enforceable unless it states the maximum aggregate liability of the guarantor and a termination date after which no newly created obligations will be subject to the guaranty


[b] Payment or "Absolute" Guaranty vs. Collection Guaranty.

[1] Under a guaranty of payment, sometimes referred to as an "absolute" guaranty, the guarantor is liable immediately upon
default of the borrower, whereas under a guaranty of collection, the guarantor promises to pay only after the creditor has attempted unsuccessfully to collect from the principal debtor including liquidation of collateral. See KRS 355.3-419 for conditions concerning the guaranteed indebtedness to be fulfilled in order to enforce a collection guaranty of a (negotiable) instrument.


[1] Reg. B prohibits a bank from automatically requiring spouses to sign guaranties except in limited circumstances:

(a) where the spouse jointly applies for the credit or

(b) where the spouse is an owner or active in the business or

(c) where the spouse independently offers to sign the guaranty.

[2] A bank can always require the applicant to provide additional credit support wherein the spouse can independently offer to sign the guaranty.

6. Pledge Agreements

[a] Revised Article 8 and 9

[1] May need to examine partnership agreements, etc. to determine whether perfection was attained

[2] Uncertificated securities/account control agreements

7. Lien priority confirmation

[a] UCC searches

[b] Title policy endorsements

[c] Organizational status / confirming borrower’s identity
G. File Correspondence and "Lender Conduct" Audit

1. Lender Liability issues

[a] Overview: claims by borrower that lender is liable based on theories that may include fraud, duress, fiduciary responsibilities, breach of duty of good faith and fair dealing, interference with contractual or business relationships, interference with corporate governance, joint venture, alter ego theories, negligence and, in the bankruptcy setting, equitable subordination, (11 U.S.C. §510(c)), fraudulent conveyance (11 U.S.C. §544 and 548), and preference recoveries.

[b] What is "Good Faith and Fair Dealing?"

[1] §205, Restatement (Second) of Contracts

Every contract imposes upon each party a duty of good faith and fair dealing in its performance and in its enforcement. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness or reasonableness.

[2] K.R.S. 355.1-203 Creates an obligation of good faith in the performance or enforcement of every contract within the UCC.


[4] Lender Insecurity Clauses. A term providing that one (1) party or his successor in interest may accelerate payment or performance or require collateral or additional collateral "at will" or "when he deems himself insecure" or in words of similar import shall be construed to mean that he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against whom the power has been exercised. KRS 355.1-208.
[5] K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) bank breached the covenant of good faith and fair dealing by not giving borrower any notice prior to refusing to advance funds to pay borrower’s suppliers.

[6] Lillard v. Farm Credit Services of Mid-America, ACA, 831 S.W.2d 626 (Ky. App. 1991) mortgagee’s premature termination of mortgagor’s application for credit was not valid business decision, and therefore questions of whether termination was arbitrary and whether mortgagee acted in good faith were questions for jury.

[7] Gross v. Citizens Fidelity Bank—Winchester, 867 S.W.2d 212 (Ky. App. 1993) court affirms jury verdict in favor of bank that set off, under clause allowing it to do so if it believed it "will have difficulty collecting" the amount owed, when plaintiff was indicted for drug and currency violations.

[8] Pearman v. West Point Nat’l Bank, 887 S.W.2d 366 (Ky. App. 1994) foreclosing lender breached duty of good faith and fair dealing and so was not entitled to a deficiency as a result of its contracting, prior to its deficiency judgment being entered, with third party to sell mortgaged property and, in fact, selling property for an amount after the foreclosure sufficient to pay the borrower’s indebtedness in full, citing Ranier v. Mount Sterling National Bank, supra.

[9] Christie v. First American Bank, 908 S.W.2d 679 (Ky. App. 1995), the duty of good faith and fair dealing does not extend to a pure demand note since it would "prevent lenders from enforcing their legal rights." id. at 680. The "holder of a demand note may demand payment at anytime with or without any reason for so doing", id. at 680.


F3d 308 (6th Cir. 1997) in context of suit by insured against insurer for wrongful failure to defend under the policy, court states that "a party’s acting according to the express terms of a contract cannot be considered a breach of the duties of good faith and fair dealing," id. at 313.

[12] Forsythe v. BancBoston Mortgage Corporation, 135 F.3d 1069 (6th Cir. 1997) court found that lender did not breach duty of good faith and fair dealing in obtaining a release from the borrower resolving a foreclosure action by the lender; court refused to impose fiduciary duty on lender as holder of mortgage escrow funds, citing Steelvest, Inc. v. Scansteel Serv. Ctr., Inc., 807 S.W.2d 476 (1991).

[13] Star Bank, Kenton County, Inc. v. Parnell (992 S.W. 2d 189) (Ky. App. 1998). Court reverses a jury verdict that bank acted in bad faith in threatening, three years prior to actually declaring a default, but at a time when the borrower’s financial statements disclosed it to be insolvent, to call the loan based on a "deem itself insecure" provision unless the borrower granted additional collateral. Citing Fort Knox National Bank v. Gustafson, Ky., 385 S.W. 2d 196 (1964), court held that good faith under KRS 355.1-201(19) ("honesty in fact in the conduct or transaction concerned") is a subjective determination, and also that a bank’s negligence, unless contrived, should not be considered in determining good faith.

[14] Ousley v. First Commonwealth Bank of Prestonburg, S.W.3d 45 (Ky. App. 1999) principles of good faith and fair dealing require a bank to furnish a former customer’s records to that customer if the bank still has the records and the customer will reimburse the bank for the cost of obtaining the records.


d What to do with potentially damaging correspondence


e Interviews with relationship managers and other bank personnel
H. Other Situational Considerations

1. Structure and posture of credit

[a] Is additional credit support available?

[1] Preference issues - In a workout, taking additional collateral from whatever source available is usually advisable notwithstanding exposure to a preferential transfer action

[2] Bankruptcy is not required for creditors to attack the transfer of new or additional collateral. Creditors can sue in state court within 6 months of the transfer relying on state statutes. (See KRS 378.060 and 378070).

[b] Line of Credit or Revolving Credit versus Term Loan

[1] See K.M.C. v. Irving Trust, 757 F.2d 272, supra, lender must give some prior notice of refusal to make further advances under "-0- balance" funding arrangement

2. Estate as Debtor

[a] KRS Chapter 396

[1] Proof of claim is barred if not presented within 6 months of appointment of personal representative or 2 years from death if no representative appointed, KRS 396.011

[2] Matured claims are not preferred over unmatured claims, KRS 369.095(2), 396.115

[b] Bankruptcy proceedings are not applicable to an Estate.

3. Non-Profit corporation as debtor

[a] Complications caused by lender membership on board of directors, etc.
[b] No involuntary bankruptcy - An involuntary bankruptcy petition may not be filed against a corporation that is not a moneyed business, or commercial corporation. See 11 U.S.C. § 303(a).

4. Special problems of Bank as Trustee

[a] Fiduciary standard applicable

[b] Bank trustee as "deep-pocket" target of bondholders

5. Lender's status as it affects enforceability of loan documents

[a] The failure of a financial institution subject to the franchise tax imposed by KRS 136.505 to pay that tax or file the required return bars it from maintaining an action or enforcing debt obligations until the return is filed and any tax is paid, KRS 136.570

6. Problems presented by competing and "subordinate" lenders


[b] Equitable Subordination in Bankruptcy - Generally, equitable subordination of non-insider claims and liens arises only in cases of the most serious misconduct if not actual fraud, overreaching or spoilation of the detriment of others. (See In re Tinsley and Groom, 49 B.R. 85, 90 (Bankr. W.D. Ky. 1984) where the Court stated that "equitable subordination is a harsh remedy that is not to be lightly invoked.") (See also Baker & Getty Financial Services, Inc., 974 F.2d 712, 718 (6th Cir. 1992) where the Sixth Circuit set forth the prevailing standard for equitable subordination including (1) the claimant must have engaged in some type of inequitable conduct; (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.)

7. Environmental Risks

[a] The 1992 EPA Lender Liability Rule ("EPA Rule") which interpreted the "secured creditor exemption" under CERCLA [see 42. U.S.C. § 9601(20)(E)] in a manner generally helpful for lenders, but which subsequently was vacated by the D.C. Circuit, was substantially codified by the 1996 Asset Conservation, Lender Liability, and
Deposit Insurance Protection Act, see Fed. Reg. 36424 (July 7, 1997)

[1] 1996 codification added protections for trustees not addressed by EPA Rule, but didn't include "bright line" rules that are contained in EPA Rule for disposing of property after lender takes title

[2] U.S. v. Pesses, No. 90-0564, 1998 U.S. Dist. Lexis 7902 (W.D. Pa. May 6, 1998), reportedly the first decision holding a lender exempt from liability under the 1996 codification, holds that lender that re-leased and attempted unsuccessfully to sell a site mortgaged to it under public finance arrangement that was contaminated by hazardous waste and low level radiation, met the burden of satisfying the secured creditor exemption, including by making commercially reasonable efforts as soon as practicable to divest itself of the property

[b] U.S. v. Best Foods, 118 S. Ct. 1876 (1998) vacates and remands U.S. v. Cordova, 113 F. 3d 572 (6th Cir. 1997), but adopts its holding that parent corporation is derivately liable as an "owner" under CERCLA for the environmental liabilities of its subsidiary only if the "corporate veil" may be pierced based on traditional corporate law principles [add 6th Circuit / Ohio case]

[c] State law considerations

8. Same-class debt rule re: "dragnet" clauses

[a] In general, "broad, boilerplate future advance clauses in adhesion contacts are not enforceable as to future transactions which are of a different type or class than the original secured transaction", Dalton v. First National Bank of Grayson, 712 S.W.2d 954, 957 (Ky. App. 1986) (in this case, security interest in mobile home of individual held not to also secure overdraft).

[b] Revised Article 9 addresses issue favorably to lenders

9. Co-Lenders; participants

[a] Typically materially increases time and expense unless "lead banks" have clear discretion under the loan documents to control the workout

[b] Risk that lenders with smaller exposures will seek to force a purchase
of their interest by the lead by refusing to cooperate

[c] "Lender liability" can be incurred by lenders with smaller exposures as a result of the actions of the lead bank

10. Election of remedies

[a] Multi-state collateral

[1] one form of action jurisdictions (e.g., California – seek local counsel)

I. Workout; or self-help and judicial remedies?

1. Is a "take-out" possible?

2. Greater risks now presented by loan workout than previously

3. What did the document and file audits disclose?

4. Nature of Borrower's business and the Collateral

[a] (e.g. construction versus commodity)

5. Profile of Borrower/Collateral in the community

[a] Public relations considerations

6. Quality of Borrower's management

[a] Integrity

[b] Expertise

[c] Posture: Adversarial or Constructive


7. Quality of financial information and reporting
8. Possibility of additional collateral/guarantors
   [a] Preference risk
   [b] Fraudulent conveyance issues

9. Is additional funding critical to successful workout?

10. Risk of further losses

11. Advisability of engaging a "crisis manager" to help assess likelihood of a recovery
   [a] Control risks, including equitable subordination risks in bankruptcy
   [b] Invitation to Borrower to engage crisis manager (see Appendix C)

III. IMPLEMENTATION OF WORKOUT

A. Manner of corresponding with Client

1. When communicating in-house, oral communication may be preferable, subject to reporting constraints

B. Manner of corresponding with Debtor

1. Importance of paper trail


C. Pre-Workout Letter (see Appendix D)

1. Appendix D is intended to be a "shield", and not a "sword", for the lender
   [a] Should substantially help protect against allegations of oral commitments to modify the loan documents, advance additional funds or forebear from exercising remedies
   [b] Document in Forms Appendix does not contain acknowledgment of defaults or that borrower has no defenses or counterclaims (see Forbearance Agreement)
D. Forbearance Agreement

1. Is normally the document desired by the lender to govern the lender/borrower relationship when quick action by the borrower is necessary to avoid self help, state court remedies or bankruptcy proceeding

2. Customary components

   [a] Borrower’s acknowledgment that defaults have occurred and that the loans are due and payable

   [b] Borrower’s statement that it has no defenses or counterclaims

   [c] Confirmation of amounts owed

   [d] Agreement by lender to forbear, normally for some (typically short) specified interval, conditioned on performance by borrower of its agreed undertakings during the forbearance period

   [e] Stipulations of borrower’s undertakings during the forbearance period - - unique to each credit’s facts and circumstances

      [1] Opportunity for lender to “cure” documentation defects

   [f] Identify events of default operative during forbearance period that would entitle lender no longer to forbear

   [g] Various waivers and releases by borrower, e.g.

      [1] Agreement not to contest lender’s motion for relief from automatic stay

      [2] Release of any claims vs. lender

      [3] Agreement to pay lender’s fees and expenses

E. Mutual Release

1. See Forsythe v. BancBostom Mortgage Corporation, 135 F.3d 1069 (6th Cir. 1997), supra
[LOAN DOCUMENT PROVISIONS IN CONTEMPLATION OF DEFAULT]

Construction of Provisions. Each covenant by the Borrower contained in this Agreement and the other Loan Documents shall be construed without reference to any other such covenant, and any determination of whether Borrower is in compliance with any such covenant shall be made without reference to whether any Borrower is in compliance with any other such covenant. Borrower and Lender each acknowledge that they have consulted with or had ample opportunity to consult with their respective legal counsel in negotiating the provisions of the Loan Documents, and agree that no presumption in favor of either party should be applied in construing the provisions of the Loan Documents, regardless of which party or legal counsel for such party prepared the Loan Documents. In the event of any conflict between or among the provisions as contained in one Loan Document and other provisions contained in the same or one or more other Loan Documents, Lender shall be entitled to resolve the conflict by selecting which provision shall be applicable unless such selection is manifestly unreasonable.

Additional Deliveries. Borrower shall deliver or cause to be delivered to Lender from time to time hereafter, promptly upon request of Lender, such additional documents, instruments and information as Lender may request in order to insure the binding effect in accordance with the terms thereof of any Loan Document, or to effect the intent of this Agreement or to establish the security for the benefit of Lender contemplated by this Agreement and the other Loan Documents, and Borrower hereby appoints Lender as Borrower's attorney-in-fact, which is coupled with an interest and irrevocable until all of the Obligations are paid and discharged to the satisfaction of Lender, to do all acts and things that Lender may deem necessary or appropriate in furtherance of any of such purposes.

Indemnification. Borrowers hereby jointly and severally indemnify and hold Lender harmless from and against any and all costs, claims, losses, damages or expenses, including reasonable attorneys' fees, incurred by Lender as a result, in whole or in part, of Lender's entering into this Agreement and the other Loan Documents, or otherwise incurred by Lender in connection with or arising out of this Agreement and the other Loan Documents unless resulting from the gross negligence or malicious conduct of Lender.

Acceptance of Partial Performance not a Waiver. Without limitation of any other provision contained in the Loan Documents concerning construction and enforceability of waivers, any acceptance by Lender of any payments of principal, interest, late charges or any other sums due under the Notes or other Loan Documents, or of tender of performance by Borrower of non-monetary obligations of Borrower under the Loan Documents, shall not constitute a waiver by Lender of any breach by Borrower of the provisions of the Note or Loan Document in respect of which such payment was made or performance was tendered unless such waiver by Lender is made expressly in writing.
Claims and Damages. In no event shall Lender ever be liable to the Borrower for consequential damages resulting from, arising out of or in connection with the Loan or any of the Loan Documents, whatever the nature of a breach by the Lender in the obligations of the Lender hereunder. No action shall be commenced by the Borrower for any claim against the Lender under the terms of this Agreement unless a notice specifically setting forth the claim of the Borrower shall have been given to the Lender within fifteen (15) days after the occurrence of the event which the Borrower alleges gave rise to such claim, and failure to give such notice shall constitute a waiver of any such claim. Upon full payment and satisfaction of the Obligations, Lender thereupon automatically shall be fully, finally and forever released and discharged from any further claim, liability or obligation in connection with the Loan and with this Agreement, except any obligation to release Collateral of record from any lien or claim by Lender.

Governing Law: Consent to Jurisdiction and Venue. This Agreement shall be construed, enforced and otherwise governed in all respects by the laws of the Commonwealth of Kentucky. Borrower hereby consents to the jurisdiction of any state or federal court located within the County of [Jefferson, Commonwealth of Kentucky] and, without limitation of the foregoing, irrevocably agrees that, subject to the Lender's sole and absolute election, any case or proceeding relating to Title XI of the United States Code and any actions relating to the Obligations shall be litigated in such courts, and Borrower waives any objection which Borrower may have based on improper venue or forum non conveniens to the conduct of any proceeding in any of such courts. Nothing contained in this paragraph shall affect the right of the Lender to bring any action or proceeding against Borrower or the property of Borrower in the courts of any other jurisdiction.

Disclosures. Lender is authorized by Borrower to disclose the contents of the Loan Documents and its files concerning same to prospective purchasers thereof, and Borrower further agrees that Lender shall incur no liability to Borrower as a result of Lender discussing the business affairs of Borrower with any Person guaranteeing or pledging Collateral for any part of the Obligations, including but not limited to notifying such Person of the occurrence of a Default Condition or Event of Default, although Lender shall be under no obligation whatsoever to do so.

WAIVER OF JURY TRIAL. THE LENDER AND BORROWER ACKNOWLEDGE THAT THE TIME AND EXPENSE REQUIRED FOR TRIAL BY JURY EXCEED THE TIME AND EXPENSE REQUIRED FOR A BENCH TRIAL AND HEREBY KNOWINGLY VOLUNTARILY WAIVE, TO THE FULLEST EXTENT PERMITTED BY LAW, AND AFTER HAVING CONSULTED OR HAVING HAD AMPLE OPPORTUNITY TO CONSULT THEIR RESPECTIVE LEGAL COUNSEL CONCERNING THE CONSEQUENCES OF SUCH WAIVER, TRIAL BY JURY IN ANY ACTION OR OTHER PROCEEDING (WHETHER CONTRACT, TORT OR OTHERWISE) BROUGHT TO ENFORCE OR DEFEND AGAINST COLLECTION OF OR OTHERWISE IN CONNECTION WITH THIS AGREEMENT OR THE OTHER LOAN DOCUMENTS.

Arbitration. Lender and Borrower agree that upon the written demand of either party, whether made before or after the institution of any legal proceedings, but prior to the rendering of any judgment in that proceeding, all disputes, claims and controversies between them, whether
individual, joint, or class in nature, arising from this Note, any Related Document or otherwise, including without limitation contract disputes and tort claims, shall be resolved by binding arbitration pursuant to the Commercial Rules of the American Arbitration Association ("AAA"). Any arbitration proceeding held pursuant to this arbitration provision shall be conducted in the city nearest the Borrower's address having an AAA regional office, or any other place selected by mutual agreement of the parties. No act to take or dispose of any Collateral shall constitute a waiver of this arbitration agreement or be prohibited by this arbitration agreement. This arbitration provision shall not limit the right of either party during any dispute, claim or controversy to seek, use and employ ancillary, or preliminary rights and/or remedies, judicial or otherwise, for the purpose of realizing upon, preserving, protecting, foreclosing upon or proceeding under forcible entry and detainer for possession of, any real or personal property, and any such action shall not be deemed an election for remedies. Such remedies include, without limitation, obtaining injunctive relief or a temporary restraining order, invoking a power of sale under any deed of trust or mortgage, obtaining a writ of attachment or imposition of a receivership, or exercising any rights relating to personal property, including exercising the right of set-off, or taking or disposing of such property with or without judicial process pursuant to the Uniform Commercial Code. Any disputes, claims or controversies concerning the lawfulness or reasonableness of an act, or exercise of any right or remedy concerning any Collateral, including any claim to rescind, reform, or otherwise modify any agreement relating to the Collateral, shall also be arbitrated; provided, however that no arbitrator shall have the right or the power to enjoin or restrain any act of either party. Judgment upon any award rendered by any arbitrator may be entered in any court having jurisdiction. The statute of limitations, estoppel, waiver, laches and similar doctrines which would otherwise be applicable in an action brought by a party shall be applicable in any arbitration proceeding, and the commencement of an arbitration proceeding shall be deemed the commencement of any action for these purposes. The Federal Arbitration Act (Title 9 of the United States Code) shall apply to the construction, interpretation, and enforcement of this arbitration provision.
FORM FOR COMMERCIAL DEMAND / CURE LETTERS
BUSINESS PURPOSE LOANS.

[LETTERHEAD]

[DATE]

[NAME OF CORPORATION]  
[ADDRESS]  
[ADDRESS]  
Attention: [OFFICER]

[GUARANTOR]  
[ADDRESS]  
[ADDRESS]  
Attention: [OFFICER]

Re: Promissory Note (Note No. __________) (the "Note"), dated __________ in the original principal amount of __________ executed and delivered by __________________________, a ______ corporation ("_____") (n/k/a __________) (the "Bank").

Dear [ADDRESSEES]:

Reference is hereby made to the above-referenced Note which is secured, inter, alia, by a (1) a __________________________ (the "_____") (n/k/a __________), dated __________, executed and delivered by __________________________ in favor of the Bank guaranteeing, among other things, the payment of the obligations owed under the Note, (2) a Mortgage, dated __________, executed and delivered by __________________________ (______) and recorded against real property located in __________________________ (the "Property") with the ______ County Clerk’s Office in Mortgage Book _____, Page _____ (collectively, ______ and ____ sometimes hereinafter referred to as the "Obligors"; collectively, the Note, the Mortgage, the Guaranty, and all other documents evidencing or security the obligations under the Note sometimes hereinafter referred to as the "Loan Documents").
The indebtedness on the Note as of the date of this letter includes the following amounts, exclusive of attorney’s fees and costs:

<table>
<thead>
<tr>
<th>Note No.</th>
<th>Principal</th>
<th>Interest</th>
<th>Late Charges</th>
<th>Per Diem</th>
<th>Total</th>
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NOTICE IS HEREBY GIVEN THAT THE OBLIGORS CONTINUE TO BE IN DEFAULT UNDER THE TERMS OF THE NOTE AND THE LOAN DOCUMENTS FOR FAILURE TO MAKE PAYMENTS ON THE NOTE AS REQUIRED UNDER THE LOAN DOCUMENTS.

[IF CURE PERIOD REQUIRED USE THE FOLLOWING LANGUAGE:]

AS OF THE DATE HEREOF, _________________________________ AND __/100 DOLLARS ($_____), REPRESENTING THE _______________ AND _______________ PAYMENTS EACH IN THE AMOUNT OF _________________________________ AND __/100 DOLLARS ($_____), IS DUE AND PAYABLE. OBLIGORS MUST BRING THE OBLIGATIONS UNDER THE NOTE CURRENT BY _______________,[INSERT CURE PERIOD REQUIRED NO. OF DAYS, I.E. 30] DAYS FROM THE DATE THEREOF, AT WHICH TIME _________________________________ AND __/100 DOLLARS ($_____) (WHICH INCLUDES THE REGULARLY SCHEDULED ___________ PAYMENT) MUST BE PAID TO THE HOLDER BY CASH, CERTIFIED CHECK OR MONEY ORDER, IN ORDER TO CURE THE DEFAULTS UNDER THE TERMS OF THE NOTE.]

[IF CURE PERIOD IS NOT REQUIRED USE THE FOLLOWING LANGUAGE:]

The obligations owed under the Note are hereby accelerated, and demand is hereby made for the immediate payment in full of all amounts outstanding under the Note (plus any applicable interest which accrues on or before the date of payment) at or before 12 noon on _______________ at the office of the Bank, _______________________________, Kentucky, Attn: [ACCOUNT OFFICER], [TITLE].

If such payment in full in accordance with the preceding sentence is not made such failure may result, without further notice by the holder hereof, in the enforcement by the holder of its rights and remedies under the Note. These remedies include, without limitation, the right to foreclose the Mortgage recorded against the Property, and to bring a suit against those liable for repayment of the
obligations due and owing under the Note. The Bank reserves the right to exercise or to refrain from the exercise, in such order as the Bank elects, any one or more of the remedies available to the Bank pursuant to the Note and other Loan Documents or otherwise at law or in equity, and nothing contained in this letter or any action or inaction on the part of the Bank shall constitute a waiver of any rights of the Bank to pursue such rights and remedies.

Acceptance by the Bank of any partial payment made prior to ______________ shall not be deemed to be a waiver of the default, or of any of the rights or remedies available to the Bank in connection with the Note or any of the Loan Documents.

Please be advised that the Bank, as of ______________, has elected to apply the interest rate provided in the Note to be applicable upon acceleration of the amounts due and payable under the Note. Specifically, the Note provides in part:

[INSERT DEFAULT RATE OF INTEREST LANGUAGE FROM NOTE].

Obligors are hereby advised that negotiations, if any, between the Obligors and the Bank shall not constitute a waiver of the Bank’s right to exercise its rights and remedies under the Note and the Loan Documents or otherwise at law or in equity, including, but not limited to, those described in this letter. Any such waiver shall not be effective unless set forth in writing, duly executed by an authorized representative of the Bank. Obligors shall not be entitled to rely upon any verbal statements made or purported to be made by or on behalf of the Bank in connection with any alleged agreement by the Bank to refrain from exercising any of its rights under the Note and other Loan Documents or otherwise at law or in equity.

[INCLUDE OTHER DISCLOSURE REQUIREMENTS OUTLINED IN EITHER NOTE, MORTGAGE OR OTHER LOAN DOCUMENT.]

By copy hereof, the Bank hereby advises __________, as the Guarantor, obligated to pay all or any portion of the indebtedness evidenced by the Note of the herein described default, and this letter constitutes formal notice to and demand upon such Guarantor to cure such default as herein specified.
Feel free to contact me (___/___ - ___) if you have any questions with regard to the above.

Sincerely,

(________________________)

By:
Name:
Title:

cc: [ ]
INVITATION TO BORROWER TO ENGAGE A CRISIS MANAGER

We believe the Company needs to hire what is commonly referred to in the financial services industry in these circumstances as a "crisis manager." This person would be someone you hire who has experience in evaluating companies having financial problems, evaluating their business plan and analyzing present and projected future cash flows, has contacts with and extensive knowledge of alternative financing sources, and so forth. However, you and the other members of the management team would continue to control all aspects of management unless, as the Bank has often found to be the case, you elect to involve this person in management.

Accompanying this letter is a list of such "crisis managers," any one of which the Bank believes would be effective in this role. It is, of course, your choice, but it is the Bank’s desire that interviews be set up with prospective crisis managers immediately.
AGREEMENT CONCERNING DISCUSSIONS AND NEGOTIATIONS
PERTAINING TO LOANS
(Form)

THIS AGREEMENT CONCERNING DISCUSSIONS AND NEGOTIATIONS PERTAINING TO LOANS (the "Agreement") is made and entered into effective as of ____________ by and among [i] __________________________, a Kentucky corporation ("Borrower"), [ii] EDWARD A. JONES, individually ("Mr. E. Jones"), [iii] ROBERT T. JONES, individually ("Mr. R. Jones"), and [iv] __________________________, a national banking association ("Lender").

RECITALS

A. Borrower is indebted to Lender for the principal of, interest on and late charges due in connection with the "$1,000,000 Loan" and the "$500,000 Loan" (collectively, the "Loans"), all as more particularly described in a certain Loan Agreement dated as of January 30, 2000 to which Borrower and Lender are parties (the "Loan Agreement").

B. Mr. E. Jones and Mr. R. Jones (referred to collectively hereinafter as the "Guarantors") have jointly and severally, absolutely and unconditionally guaranteed payment of the Loans pursuant to the two (2) Guaranty Agreements executed and delivered by each of them, respectively, for the benefit of Lender, both dated as of January 30, 2000 (collectively, the "Guaranties").

C. Borrower is in material default of the Loans, and Lender pursuant to and in accordance with the provisions of the documents governing those Loans has accelerated the payment thereof, as set forth in a letter from Lender to Borrower dated as of March 28, 2000 (the "March 28 Letter").

D. Borrower and Guarantors (referred to collectively hereinafter as the "Obligors") have requested that Lender enter into discussions and negotiations concerning the operations, financial condition, business and affairs of the Obligors, which discussions and negotiations might involve the execution and delivery of a forbearance agreement or other agreements to which Obligors and Lender would be parties, and Obligors and Lender desire that all discussions and negotiations and any other communications between and among them be governed by the provisions of this Agreement.

NOW, THEREFORE, in consideration of the premises, for other valuable consideration, the receipt of which is hereby acknowledged, and intending to be legally bound, it is hereby agreed as follows:

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1. **Incorporation of Recitals.** The recitals to this Agreement are hereby incorporated by reference as though fully set forth at this point and each of the Obligors and Lender acknowledge those recitals to be true and correct.

2. **No Obligation to Negotiate or Agree.** Neither Lender nor any Obligor shall be deemed to have waived any rights or to have incurred any obligations as a result of any discussions or negotiations between or among Lender and any of the Obligors. Either the Lender or any of the Obligors may elect at any time in the exercise of their sole and absolute discretion to terminate any discussions or negotiations among them at any time and for any reason without liability to any other party to this Agreement as a result of such election. Without limitation of the foregoing, the acceleration of the maturity of the Loans and the ability of Lender to pursue its remedies against Borrower, Guarantors and/or any collateral for any of the Loans shall not be affected in any way except, if the same should eventuate, pursuant to a Modification Agreement as hereinafter defined.

3. **Reservation of Rights and Remedies.** Lender reserves all of its rights and remedies under the Loan Agreement, the Guaranties and any and all other agreements evidencing, securing, guaranteeing or otherwise pertaining to any of the Loans (collectively, the "Loan Documents"). No course of conduct by the Lender in meeting with any of the Obligors shall constitute a waiver by Lender of, or an agreement by Lender to forbear now or hereafter from the exercise of, any of the rights and remedies available to Lender under any of the Loan Documents, at law or in equity. Lender may pursue any of such rights and remedies at any time, irrespective of and without regard to the existence or continuation of any discussions and negotiations between or among Lender and any of the Obligors or their counsel.

4. **No Modification Except by Written Agreement.** The Loan Documents shall remain unchanged and in full force and effect unless and until one or more written agreements expressly modifying the Loan Documents is entered into among Lender and each Obligor that is a party to any such written agreements. Notwithstanding that the Lender and one or more of the Obligors may reach an oral understanding on one or more issues that Lender and one or more of the Obligors are trying to resolve, neither Lender nor any Obligor shall be bound by any oral agreement, and no rights or liabilities, either express or implied, shall arise on the part of Lender or any Obligor, or any third party, unless and until the oral understanding pertaining to any given issue has been reduced to a written agreement that has been signed by each party that would incur rights or obligations in connection with the oral understanding. Furthermore, no such written agreement (each a "Modification Agreement") shall be effective against Lender unless it is signed by either Lawrence A. Doe, Vice President of Lender, or John Currency, Senior Vice President of Lender, and no Modification Agreement shall be effective against Borrower unless signed by Mr. E. Jones, who is the President of Borrower (Messrs. Doe, Currency and E. Jones in such capacity each being a "Designated Representative").

5. **Reliance on Negotiations not Warranted.** As set forth above, either Lender or any Obligor may discontinue negotiations at any time and no oral agreement shall be binding unless and until reduced to a definitive written agreement and signed by the applicable Designated
Representative of Lender and Borrower and any other party that would incur any rights or obligations thereunder. Accordingly, neither Lender nor Obligors shall be liable to the other for any loss incurred as a result of pursuing or consummating or not pursuing or consummating alternative opportunities available to them including, in the case of Borrower, refinancings, sales, leases, investments by additional stockholders, or entering into additional contracts or pursuing other business opportunities or negotiations, nor shall Lender be liable on the account of any decrease in value in any of the collateral heretofore granted or that hereafter may be granted to Lender as security for any of the Loans, nor shall the obligations of any of the Obligors to pay additional interest or late charges that accrue on any of the Loans be discharged or otherwise impaired in any manner as a result of any negotiations and discussions between and among the Lender and the Obligors.

6. Other Stipulations. This Agreement constitutes the final, complete and exclusive agreement of the Lender and the Obligors with regard to its subject matter, may not be modified in any respect except pursuant to a writing signed by Lender and each Obligor that is party to such modification (and then only if the writing is signed by the Designated Representative in the case of Lender and Borrower), and shall be governed in all respects by the law of the Commonwealth of Kentucky. Lender and Obligors each represent to the other that they have obtained advice from independent legal counsel for each with regard to and prior to signing this Agreement.

IN WITNESS WHEREOF, this Agreement has been executed by each of the parties to it on the dates set forth in the notarial certificates below, but shall be deemed effective as of the date first set forth above.

[add provision for signatures of parties to Agreement]
EMPLOYMENT LAW ISSUES OF CONCERN
TO FINANCIAL INSTITUTIONS

Susan C. Sears
Frost Brown Todd LLC
Lexington, Kentucky
EMPLOYMENT LAW ISSUES OF CONCERN TO FINANCIAL INSTITUTIONS

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INTRODUCTION

The employment litigation explosion of the last decade has made it imperative that employers treat employment issues as a serious part of every business enterprise. Employers are learning that prevention is key – and the cost of prevention is minimal when compared to the cost of defense. Prevention means considering every aspect of the employment experience ("from the cradle to the grave" or "hiring through separation/termination") as the veritable powder keg it can prove to be in a courtroom. Prevention begins with seeking sound advice from professionals trained in the area of human resources and/or employment law. Prevention means adopting sound policies that incorporate neutral, work-related criteria – and which are uniformly applied to similarly situated employees across-the-board. Prevention means documentation of those uniformly applied policies. Prevention means training, training and more training – for all employees, but particularly supervisors and executives.

The materials that follow are intended to provide an overview of the most common employment issues that arise in every workplace, regardless of size. While financial institutions have employment issues that are unique, e.g., training employees with respect to obligations under banking regulations, or certain governmental reporting requirements – the vast majority of employment issues faced by a financial institution will be those "generic" employment issues which all businesses encounter with increasing frequency.
HIRING ISSUES

I. HIRING - OVERVIEW OF GENERAL LEGAL PRINCIPLES

Employers today must balance the goal of hiring a productive work force with the legal limitations placed upon the pre-employment process, while addressing concerns with respect to substance abuse, dishonesty, poor attendance, poor training and high turnover. Employers also face increasing legal risks based upon claims of negligent hiring in the event that they have not undertaken a diligent review of relevant employment factors.

II. GENERAL PRINCIPLES FOR ESTABLISHING SELECTION CRITERIA

A. Define the Job

B. Establish Essential Job Functions

C. Establish qualifications, such as job-related education/licensure, job-related work experience, and demonstrated ability to perform particular aspects of the job.

D. Caution: Absolute requirements (such as test scores and diploma requirements) may be suspect if they screen out minorities and/or women on a disproportionate basis or if they discriminatorily screen out otherwise qualified individuals with disabilities. Track any such requirements to establish lack of "disparate impact." Any absolute requirements must be logically tied to the job duties of the open position such that business reasons exist for imposing the requirements.

III. RECRUITING

A. Job Advertisements -- Be careful about what you include as a description of a job and the criteria which you use to eliminate a job candidate. One court ruled that a rejected applicant had stated a claim in an age discrimination case based on a "sloppy" want ad. The company defended the claim by stating that the applicant was unqualified, listing several job requirements that the applicant had no experience in. The want ad listed in the newspaper did not list those same criteria.

B. Word of Mouth Recruiting -- Word of mouth recruiting is not per se discriminatory under Title VII. But it may violate Title VII under the disparate treatment and impact theories. In one case, reliance on referrals from the union as the sole method of hiring violated Title VII since the employer knew that the union didn't admit minorities. EEOC v. Costello, 67 FEP Cases 626 (D.Mass 1994).
C. Nepotism Policies -- Pro nepotism policies have the same problem as word of mouth recruiting.

D. Recruiting Agents -- A common practice among employers is the utilization of third-party recruiters, such as private employment agencies, to obtain employment candidates. An employer may be held liable under agency principles for any discriminatory recruiting and referral practices engaged in by employment agencies. Therefore, inform employment agencies in writing of your expectation that they comply with requirements of the ADA and Title VII. Include in any contract with a recruiter that the agency will conduct its activities in compliance with the ADA and other nondiscrimination requirements.

E. Recruiting Practices and the National Labor Relations Act -- It is permissible for a company to seek to maintain or achieve nonunion status. However, the National Labor Relations Board and reviewing courts have consistently found pre-employment inquiries about an applicant's prior or current union affiliation or sentiments to constitute illegal "interrogation" in violation of Section 8(a)(1) of the Act.

IV. THE EMPLOYMENT APPLICATION

A. Overview -- Most organizations have standard blank forms that they utilize month after month, year after year. Seldom do they update these forms until a problem arises. Because there are quite a few rapidly changing obligations and prohibitions (especially as a result of the ADA and FMLA), employers should have application forms reviewed by legal counsel on a regular basis.

B. Discrimination -- The EEOC and Kentucky Human Rights Commission (KHRC) expect employers to be able to demonstrate that each of the questions it requires applicants to answer is related to any jobs for which the applicant could reasonably be applying. Even questions that are not discriminatory on their face may indirectly cause discrimination. For example, requesting information about graduation dates combined with selection of those early in their careers could lead to a pattern of hiring people in their thirties. Such a practice could lead to an age discrimination claim.

C. Applicant Tracking Information -- Can you demonstrate what jobs were applied for? What jobs was a particular applicant not considered for and when? Whether the claimant was even considered an applicant? What is your process for rejecting a potential applicant?
D. At-Will Employment -- Define the employment applied for as "at-will" in the application.

1. To make the statement less intimidating, consider including the employee's at-will rights too. An example of such a statement is:

"I understand and agree that my employment with the company is at-will, meaning that I may resign at any time and my employment may be terminated by the company for any reason and at any time without previous notice."

2. The at-will statement should be legible and in a place on the application where the applicant is likely to notice it. The end of the application directly above the signature line is an appropriate place.

E. Past Employment -- There should be enough space for the applicant to provide complete information about past employment history. Ask for positions and allow enough room for multiple positions held with each employer. The fact that an employee has been promoted or transferred within a company is valuable information.

1. Also request salary information. Allow the applicant to provide starting and ending salary amounts.

2. Request applicants to supply you with reasons for leaving each previous job.

3. Also include:
   a. A statement certifying that the applicant was truthful in completing the application.
   b. A release form authorizing you to verify education and experience and to check credit information.
   c. A reminder that the applicant will be required to provide information for compliance with the Immigration Reform and Control Act.
   d. A statement that employment may depend upon the results of physical examinations, drug tests or other types of pre-employment tests.
   e. Consider the pros and cons of insisting on a release of information by previous employers.
4. Because you will be keeping the applications on file, be cautious of what you write. In fact, you should refrain from writing on the employment application at all.

V. PRE-EMPLOYMENT TESTING AND INQUIRIES

A. EEOC Uniform Guidelines on Employee Selection Procedures

Under federal regulations, a selection criterion that disproportionately screens out minorities or females is illegal unless it has been validated. The easiest way to avoid issues is to demonstrate that the selection procedure does not produce a "disparate impact."

B. Drug/Alcohol Testing

1. Constitutional protections. Generally, private employers are not subject to constitutional prohibitions that might prohibit drug/alcohol testing.

2. Collective bargaining. Drug testing of applicants is normally not a mandatory subject of bargaining for a unionized employer.

3. Americans with Disabilities Act. Under the ADA, employers may engage in pre-employment testing for the illegal use of drugs. Moreover, individuals who are currently engaged in the illegal use of drugs are not protected under the ADA. Alcohol, however, is not an illegal drug and testing for alcohol is considered a "medical examination" for purposes of the ADA, and therefore can only be tested for post-offer.

4. The most important protections concerning drug and alcohol testing have to do with the process. If someone is rejected because they "flunked," be sure you can demonstrate you were right and that you did not talk about it.

C. Polygraph Examinations

1. Employee Polygraph Protection Act of 1988. The Employee Polygraph Protection Act significantly curtails an employer's ability to require polygraph testing of job applicants or current employees.

   a. Prohibitions. Employers may not require or request that an employee or applicant take a test.

   b. Exceptions. The Act permits polygraph testing of job applicants by the pharmaceutical industry and employers that provide security systems. A polygraph examination
may only be required of current employees when an employer reasonably suspects that the employee was involved in a workplace theft or other misappropriation of property. In other words, the results of the examination can be used as justification for adverse employment action, but additional supporting evidence is required.

D. Psychological/Honesty Tests

1. Overview. Restrictions on employers' use of polygraphs have led many employers to try alternative forms of testing in employee selection procedures, including psychological and honesty tests. Tests that have a disproportionate impact on members of protected groups, or which are applied in a disparate or discriminatory manner, may violate Title VII and state anti-discrimination laws.

2. Disability discrimination. Psychological/honesty testing also raise issues under the ADA. Psychological tests may, for example, be viewed as medical examinations for purposes of the ADA. Any employer who relies on honesty or psychological testing, especially those pre-marketed by large companies, should obtain written assurances and/or indemnifications from the test manufacturers that provide protection to the employer in the event that the tests are later challenged under either the ADA, the Uniform Selection Guidelines or other discrimination laws.

E. HIV Testing

1. Overview. HIV testing is not a recommended course of action for the vast majority of employers.

2. Disability discrimination. Individuals with AIDS are considered as having a disability under the ADA and many state employment discrimination laws. Accordingly, to the extent that the purpose of a test is to screen out individuals with AIDS from employment, significant employment discrimination issues are raised. In addition, in Kentucky, disclosure of HIV-related test results is prohibited except in limited circumstances.

F. The ADA is the source of most of the "non-obvious" restrictions on pre-employment inquiries.

1. Pre-employment Examination and Inquiries Regarding Disability: Prohibited except for pre-employment inquiries into the ability of an applicant to perform job-related functions. Employers may ask an applicant if he/she can perform a particular task essential to the job applied for, or whether the applicant can
meet the attendance expectations for a position. However, an employer may not ask about the nature or extent of a disability or how often the applicant would require leave for treatment necessitated by the disability. An employer also may not inquire into an applicant's workers' compensation history.

2. Physical agility tests are not medical examinations and so may be given at any point in the application process. However, such tests must be given to all similarly situated applicants regardless of disability. On October 10, 1995 the EEOC issued its final enforcement guidance regarding pre-employment inquiries. The revised guidance is less restrictive and permits "limited questions" about reasonable accommodation in pre-employment interviews if:

   a. an obvious disability reasonably causes the interviewer to believe the applicant needs accommodation;
   b. the applicant voluntarily discloses a hidden disability reasonably causing inquiry about accommodation needs; or
   c. the applicant voluntarily discloses the need for accommodation.

3. Post-Offer Medical Examinations:

   Permitted if:
   
   a. all entering employees are examined;
   b. medical information is collected and maintained on separate forms and in separate medical files and is treated as a confidential medical record; and
   c. medical information is used only in a manner that is consistent with the ADA.

Under EEOC rules the medical examinations themselves do not have to be job related and consistent with business necessity. However, if certain criteria are used to screen out an employee or employees with disabilities as a result of such an examination or inquiry, the exclusionary criteria must be job related and consistent with business necessity and performance of the essential job functions cannot be accomplished with reasonable accommodation as required by the ADA.
VI. INTERVIEWING

A. Overview -- Pre-employment interviews are perhaps the most important part of the pre-employment process. Everyone who interviews should be trained, not only of the various legal pitfalls which could result from an inappropriate interview, but also about how to ask the right questions to avoid hiring the problem employee.

B. Educate supervisors about what not to ask.

Examples:

1. When did you graduate from high school?
2. "Family planning" and dependent care questions (no one will believe you ask them of men, too);
3. Workers compensation claims experience questions;
4. Whether the applicant has a specific disability;
5. Whether the applicant needs leave for treatment, when he first became disabled and the like, even if the applicant volunteers he has a disability -- remember, the new guidelines permit inquiries about reasonable accommodation, not the disability or its nature or extent.

C. In addition, educate supervisors about what they can -- and should -- ask, especially to help identify "high risk" employees. Examples:

1. Relationships with supervisors and co-workers.
   a. Tell me about your best boss, your worst boss.
   b. Describe the worst disagreement/conflict that you had with a supervisor/co-worker. How was it resolved?
   c. If the conflict was not resolved to your satisfaction, what do you think the company should have done?
2. How would you describe your relationship with your last supervisor? With previous supervisors?
   a. Describe how you got along with co-workers in your last job?
   b. Have co-workers ever hampered your productivity? How did you handle it?
3. Connections outside the workplace.
   a. What volunteer activities outside work have you participated in that would enhance your candidacy for this job?

   a. What did you accomplish in your last job that you are most proud of?
   b. What was the greatest challenge you faced in your last job and how did you handle it?
   c. What was the greatest disappointment you had in your last job? How did it affect your productivity?

5. Job changes.
   a. Why did you leave your last job? Previous jobs?
   b. If you left voluntarily, what could the company have done to keep you?

D. Employer may ask about an applicant's ability to perform both essential and marginal job functions. Employer may also:
   1. Ask the applicant if he can perform a specific function (i.e., can you lift 50 pounds, can you drive a truck?);
   2. Ask an applicant to describe or demonstrate how he can perform the function. This request must be made of all applicants unless the applicant has an obvious disability which may prevent the performance of a particular function.

E. Credit Checks/Background Checks
   1. Denying an applicant employment because of a poor credit rating has a disparate impact on minority groups and has been found unlawful unless a business necessity can be shown.
   2. Pre-employment inquiries
      a. Prohibited inquiries include: assets, liabilities, charge accounts, bank accounts, credit ratings, past wage garnishments, home ownership, and car ownership.
      b. To determine whether an applicant is a stable resident of the area without asking about home ownership, an employer may inquire about how long the applicant has
lived in the area. If car travel is necessary, the employer should ask whether the applicant has the use of a reliable car.

3. Fair Credit Reporting Act amended September 30, 1997

F. Covenants Not to Compete -- If employers don't ask the right questions, the employer may have hired an employee who will be limited in her ability to perform her job because of a covenant not to compete that she signed at a previous position. It is important to ask applicants about these types of covenants in industries and companies which utilize this device.

VII. THE EMPLOYMENT OFFER

A. Employment Offer Letter

The law does not require an employment offer letter and, if poorly written, an offer letter can do more harm than good. Here are some ideas to consider:

1. Quote salary as being paid "at an annual rate of _______ for employment at-will for an indefinite term" to avoid the argument that employment was for at least a one-year term.

2. Avoid mention of future deadlines or milestones, such as, "Your first performance appraisal will be on 6-15-01." This could be construed to imply a contract for a fixed period.

3. Include an "at-will" statement in the offer letter.

4. Avoid terms such as "permanent," "career" or "family." They may imply unending employment.

5. Keep the letter as brief as possible.

6. Expressions of hope and optimism ("We look forward to many contributions and our mutual success") are generally not the stuff of which contracts are made, and can create an argument of an implied contract of employment.

VIII. CONSEQUENCES OF POOR OR ILLEGAL HIRING PRACTICES

A. Negligent Hiring

1. Overview. An employer may reduce potential liability to a third party by conducting thorough pre-employment background investigations and screening out applicants with a history of certain
problems. These investigations, by their very nature, raise issues of discrimination and the prospective employee's right to privacy. On the other hand, to the extent no investigation is undertaken, an employer may be liable for negligently hiring a person who is incompetent or unfit.

2. Definition of negligent hiring. A cause of action for negligent hiring arises when an employer knew or should have known by conducting a reasonable pre-employment investigation that an employee was not competent to perform the required job or was otherwise deficient in a respect that could reasonably be foreseen to cause harm to others.

3. Background checks. The tort of negligent hiring imposes a general duty on the employer to conduct a reasonable background check of a potential employee to ensure that the employee is fit for the position.

a. In California, a jury awarded $5.5 million when it determined an employment agency failed to do a background check on a paroled murderer. Holway v. Snelling Temporaries, Calif Super Ct., (1992). The court ruled that the temporary agency should have noticed the 5.5 year gap in his resume, and his listing of two prison addresses as his references.

b. A Florida jury determined that a Gainesville carpet cleaning franchise should pay a $1 million judgment in a negligent hiring action brought by the parents of two students killed by an employee who had been previously arrested on weapons, drug and violence charges. McKishnie v. Rainbow International Carpet Drying & Cleaning Co., Fla Cir. Ct., (1994).

Summary for Financial Institutions

The costs of hiring the wrong worker can be enormous. The increased investments in training and expectations of productivity are among the direct costs, not to mention the fact that the job just does not get done – when the “wrong” worker is hired. In the worst case, indirect costs include litigation that can range from negligent hiring allegations (“with a reasonable investigation, the bank would have known that Ms. X, the most recent safe deposit box attendant, has a history of dishonesty) to wrongful termination claims by employees who quit one job to take another that turns out to be a bad “fit.”

The above materials and suggestions with regard to the hiring process for the most part apply to all employers. However, there are several particular hiring issues
financial institutions should pay closer attention to, for obvious reasons. For example, if your organization makes use of the psychological/honesty tests referred to above, determine the source of the tests your organization administers as part of the hiring process and whether or not the test manufacturer(s) has provided written assurance of protection and/or indemnity in an instance of a challenge to the test. As you review the above materials, pay close attention to those that may pertain to your business, and follow up appropriately.
AT-WILL EMPLOYMENT
DO THE EXCEPTIONS SWALLOW THE WHOLE?

This section focuses on the long-standing Kentucky employment at will doctrine, and some of its exceptions. As early as 1896, Kentucky's high court has recognized that an employment relationship between two parties that is for an "indefinite" period of time is employment "at will" - or employment that can be terminated at any time by either the employee or the employer. Louisville and N.R.Co. v. Offutt, 36 S.W. 181 (1986). See also, Edwards v. Kentucky Utilities Co., 150 S.W.2d 916 (1941). That is, neither the employee nor the employer is entitled to have expectations of a future employment relationship: the employee has no obligation to remain employed; the employer has no obligation to retain the employee.

What is clear is that Kentucky's employment at will doctrine has increasingly become limited due to the exceptions -- contractual, statutory and common law in nature -- that often apply to defeat a defense to an employee's challenge of discharge that the employment was "at will." The question that is increasingly asked from the perspective of employers is whether or not the "exceptions" to at-will employment have almost completely "swallowed" the concept. Clearly, with the employment litigation explosion of the last decade, that is not an unreasonable question. However, to the extent the question is valid and serves to encourage employers to (1) be clear about the terms of an employment relationship, and (2) to make personnel decisions on the basis of neutral performance-based reasons, the net result over time may turn out to benefit both employers and employees in the long run.

Contractual Exceptions of Employment at Will

It has long been held that where employment is for a definite period of time, an employee cannot be discharged without "good cause". See, Otis & Co. v. Power, 1 Ky. Opinions 312 (Ky. App. 1866). In the absence of a written contract of employment, the difficulty becomes proving that the parties intended the employment to last for a definite period of time. As with any agreement not evidenced by a writing, courts will look at all the facts and circumstances to attempt to discern the parties' intentions.

In earlier Kentucky cases, it was not uncommon for the courts to accept proof of compensation paid on an annual basis as evidence of the parties' intentions to enter into a one year contract. For example, in Stewart Dry Goods v. Hutchinson, 198 S.W. 17 (Ky. 1917), Hutchinson was employed by Stewarts at a stated annual salary. In that case, the court held that where Hutchinson had continued to work for the same salary into the second year, i.e., after the original contract year had expired, that circumstance was evidence of the parties' intentions to continue his employment for another year. Likewise, in Putnam v. Producers' Livestock Marketing Assoc., Ky. App., 75 S.W.2d 1075 (1934), the court held that a one-year contract had been formed based upon evidence that included, among other things, a per annum salary. Other facts and
circumstances the court noted were the fact that the company had paid Putnam's moving expenses, as well as other representations made by the employer both at the time of hiring and throughout the employment relationship.

Kentucky courts’ manner of dealing with claims of (unwritten) employment contracts can be seen in cases as recently as 1980. In *Humana v. Fairchild*, Ky. App., 603 S.W.2d 918 (1980), a terminated hospital administrator presented evidence of an "offer letter" stating an annual salary, various representations of the employer upon which Fairchild had relied and proof relating to the type of job Fairchild would perform (management) to argue that there existed a contract of employment between the parties. The Court held the extrinsic evidence to be sufficient to support a finding of an agreement between the parties of one year of employment. See also, *Hammond v. Heritage Communications, Inc.*, Ky. App., 756 S.W.2d 152 (1988) (oral assurances from manager that employee would not be fired if her picture appeared in Playboy magazine sufficient to raise an inference that oral contract existed and at-will employment status had been modified.)

**Implied Employment Contracts**

Without question, the most often cited Kentucky case on employment contract law is *Shah v. American Synthetic Rubber Corp.*, Ky., 655 S.W.2d 489 (1983). The issue in *Shah* was whether the parties intended an employment contract such that American Synthetic (ASRC) could fire Shah at will. Shah contended that ASRC fired him without cause in violation of an implied contract, where after a 90 day probation period, he could be fired only "for cause" in accordance with policies and procedures established by ASRC for employees who were similarly situated. ASRC argued that Shah was an at-will employee who could be terminated with or without cause. The trial court sustained Defendant ASRC's motion for summary judgment finding that Shah’s employment was "not for a definite period and was terminable at will by either party." The Kentucky Court of Appeals affirmed, relying on *Edwards v. Kentucky Utilities Co.*, 150 S.W.2d 916 (1941), *supra*.

The Kentucky Supreme Court first clarified that Shah was seeking relief for the alleged breach of an employment contract the terms of which included more than employment for an indefinite period of time. Shah’s claim was that his implied contract with ASRC included a term under which he could only be terminated for work-connected, “just cause”. In its opinion reversing the Court of Appeals, the Supreme Court set forth the factors to be considered in determining the precise nature of the (implied) contract between Shah and ASRC. A court should review the totality of the circumstances of each particular case, including: (1) the understanding of the parties based upon their written or oral negotiations and/or agreements; (2) the usage of business; (3) the situation and objectives of the parties; (4) the nature of the employment and (5) all other circumstances surrounding the transaction. Because of the case by case analysis a court must undertake (much of which gave rise to a factual dispute between the parties), it was inappropriate to grant summary judgment for the defendant.
Of significance to post-Shah Kentucky cases was the Court’s holding in Shah that “parties may enter into a contract of employment terminable only pursuant to its express terms – as “for cause” – by clearly stating their intention to do so, even though no other consideration than services to be performed or promised is expected by the employer, or performed or promised by the employee.” A particular importance of the Shah ruling is that, when it is claimed that an employment contract arises from something other than an unambiguous piece of writing and there is conflicting evidence, summary judgment is inappropriate – as the conflict in evidence regarding the parties’ intentions will be a question for the fact-finder at trial. See also, Audiovox Corp. v. Moody, Ky. App., 737 S.W.2d 468 (1987).

Do Employee Handbooks or Manuals Create Contractual Obligations?

In Nork v. Fetter Printing Co., Ky. App., 738 S.W.2d 824 (1987), the issue was whether or not an employer’s policy and procedure manual or handbook created an implied contract of employment. Employers often cite this case for the proposition that implied contracts of employment are not created by provisions contained in such a manual, and indeed, in Nork, the Court held this to be the case. A careful review of the opinion reveals, however, that as an “absolute,” such a proposition may be too strong a statement. In Nork, the Court reviewed the policy manuals at issue and determined that those particular manuals did not satisfy the requirement set forth in Shah, i.e., did not evidence clear statement of intention to create a contract of employment terminable only pursuant to its express terms. Again, following Shah, while some manuals will contain “strong enough” (disclaimer) language to support summary judgment, others will not – and the Shah factors must be applied to determine the parties’ intentions.

Does Nork apply to all employee manuals? While there is disagreement as to the reach of the Nork case, there are some who argue that it does not stand for the proposition that provisions within employee manuals, per se, will never constitute contractual terms which are enforceable. It has been argued that employee manuals that set out definite, unambiguous terms with respect to employees’ rights, and contain no at-will disclaimer language may very well contain terms which can be enforced by a court as terms of an employment contract. While there is no case law that specifically addresses the question, what is clear – is that the factors set forth in Shah should control. Some of the questions that might be critical in determining whether representations in an employee manual create contractual expectations include the following:

- What was the understanding of the parties as to the meaning of the personnel manual?
- What, if anything, was said when the manual was distributed to employees?
- Were there oral promises or disclaimers?

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1 The following questions were authored by Steven D. Downey, Esq., who practices in Bowling Green, Kentucky. The questions are contained in materials created by Mr. Downey in connection with his article, “Breach of Employment Contract Actions” which appeared in the seminar materials distributed to attendees at the 6th Biennial Employment Law Institute, June 1998, a University of Kentucky College of Law Continuing Legal Education program.
Have other employees been able to rely upon the terms of the manual in the past to enforce a right which they believe they held based upon the language of the provision at issue?

What is the testimony of management representatives of the business as to the meaning of the employee manual?

What is the stated purpose of the manual?

What do the plaintiff and other employees say was said to them by management about the manual?

Was there talk of unionization in the business at the time the manual was created?

Were employees disgruntled because they felt they had no job security at the time the manual was created?

Did the employer offer the personnel manual in an area of low unemployment to try to “keep employees” by offering “job security”?

Has the manual been changed and did it contain a disclaimer in the past which has been deleted?

Did the employer ever tell the discharged (or disciplined) employee that he or she could look to the manual to determine what their rights were?

Statutory Exceptions to the Employment at Will Doctrine

The employment at will doctrine has also been limited by specific local, state and federal statutes prohibiting the discharge of employees for illegitimate reasons. The primary examples of such statutes are found in the various anti-discrimination laws. So prevalent are these exceptions that it makes sense to think of “at-will” employment, in the first instance, as the ability of an employer to terminate a worker “for just about any reason except an impermissible one.” These laws, which have become familiar to most, include inter alia:

Title VII (federal Civil Rights Act of 1964, and amendments of 1991) and its state counterpart (KRS Chapter 344)

Prohibits discrimination on the basis of race, gender, religion, ethnic and national origin. The state statute also prohibits discrimination on the basis of marital or familial status. Both statutes also prohibit retaliation by any person against an employee who has opposed a discriminatory practice, or participated in an investigation or other proceeding under either statute.

Age Discrimination in Employment Act (ADEA) and its state counterpart (KRS Chapter 344)

These acts prohibit discrimination against workers who are covered under the acts, i.e., over 40 years of age. The statutes similarly protect against retaliation.
Americans with Disabilities Act (ADA) and KRS Chapter 344 (as related to disability)

Provides protection against discriminatory practices based upon an individual’s disabling physical or mental condition and/or retaliation under the Act.

Family Medical Leave Act

Federal statute that provides certain job protections for workers who fall within the scope of the act due to their own, or a family member's, illness that necessitates an absence of three days or longer (up to twelve weeks annually) from work for medical reasons.

Workers Compensation Retaliation Act (KRS Chapter 342)

Prohibits retaliation against employees who have exercised their rights under Kentucky's workers compensation statutes.

KRS 336.130

Provides protection from retaliation for employees who have participated in activities related to organized labor.

Occupational Safety and Health Act (OSHA) and state counterpart, KRS Chapter 338

These statutes, which extensively regulate health and safety within the work environment, also provide protection against an employee’s exercise of rights under these laws. This includes, among other things, the reporting of alleged OSHA violations, and participation in OSHA investigations.

Fair Labor Standards Act and state counterpart (KRS Chapter 337)

These laws govern wage and hour issues, and contain anti-retaliation provisions prohibiting discrimination against an employee who exercises any right pursuant to federal or state wage and hour statutes.

Other Statutes

The above statutes are just some examples of laws that provide protection for employees from Kentucky’s employment at will doctrine by way of federal or state statute. The list is not exhaustive. For example, Lexington/Fayette County and Louisville enacted “fairness ordinances” which prohibit discrimination on the basis of sexual orientation and gender identity. While legislature has whittled away considerably
at employment-at-will by enacting State statutes governing the employment relationship in Kentucky, the courts have been less enthusiastic with regard to "common law" exceptions.

Common Law Exceptions to Employment at Will

Absent contractual or explicit statutory protection, in Kentucky there exists a cause of action for the tort of "wrongful discharge against public policy". The established public policy exceptions to at-will employment are articulated in the well known case of Grzyb v. Evans, Ky., 700 S.W.2d 399 (1985). Grzyb provides for only two situations where a discharge is so contrary to public policy that it is actionable absent explicit legislative or constitutional pronouncements prohibiting the discharge. The first situation is where an employee suffers an adverse employment action because he or she refuses or fails to violate the law in the course of employment, and the second is where the reason for the discharge was the employee's exercise of a right conferred by well-established legislative enactment. Id. at 402.

The first public policy exception, an employee's failure or refusal to violate the law, is easily imaginable. An example would be where an employer attempts to insist that the company bookkeeper-employee sign and file false tax returns on behalf of the business. Should the bookkeeper fail or refuse to violate the law, and suffer termination (or any adverse employment action) for failing or refusing to violate the law, Grzyb protection would be triggered. The second Grzyb exception would apply in a circumstance where a worker suffers an adverse employment action such as termination or discipline because the worker exercised his or her right to vote, for example.

However, "If plaintiff's discharge does not meet these criteria, it is not a basis for a wrongful discharge claim, no matter how 'morally indefensible' the employer's reasons." Stewart v. The Pantry, Inc., 715 F.Supp. 1361, 1364 (W.D.Ky. 1988). Thus, where a plaintiff has no statutory protection and further, fails to allege facts to which one of Kentucky's two "public policy" exceptions apply, a complaint must be dismissed as a matter of law. Id. at p. 401.

The Kentucky Supreme Court has made clear its intent to refuse to expand an at-will employee's claims for wrongful discharge beyond the above two well-defined situations, both implicating conduct that is contrary to public policy. In Boykins v Housing Authority of Louisville, Ky., 842 S.W.2d 527, 529 (1992), the high court stated: "In Firestone Textile Company v. Meadows, Ky., 666 S.W.2d 730 (1983), we embraced Brockmeyer v. Dun & Bradstreet, 113 Wis.2d 561, 333 N.W.2d 834 (1983), to establish the clear limitations on any judicial exceptions to the employment-at-will doctrine." Emphasis in original.

Because of the restrictive language in Firestone and Boykins, supra, conventional wisdom would dictate that it is fairly difficult for a plaintiff to make out a case of wrongful discharge against public policy, absent contractual, statutory or clear "Grzyb"
protection. The fact that the Kentucky legislature has enacted explicit legislation to prohibit various types of "retaliatory" termination also provides persuasive reasoning against any judicially-created expansion of the tort of wrongful discharge. Finding the doctrine of separation of powers relevant, the Kentucky Supreme Court has indicated its unwillingness to extend the tort of wrongful discharge beyond the explicit language in statutes such as these because "[s]uch matters are for legislative determination, and are not proper subjects for judicial policymaking." *Nelson Steel Corporation v. McDaniel*, Ky., 898 S.W.2d 66, 69-70 (1995). In making this point, the Court was mindful of the powers of the General Assembly, as well as the Court's own limitations. It stated: "we recognize that the regulatory power of the state empowers the General Assembly to place statutory limits on the employer/employee terminable-at-will relationship when necessary consistent with public purpose." Id.

In addition, the requirement that the public policy must be found in "explicit legislative statements" has been interpreted by courts in the strictest sense. See *Boykins v. Housing Authority of Louisville*, Ky., 842 S.W.2d 527, 528 (1992). For example, KRS 61.102(1) demonstrates Kentucky’s General Assembly intent to provide state employees (not private employees) with "Whistle-Blower" protection. Moreover, subsequent case law interpreting the statute has complied with the Court's directive to narrowly construe the statute. KRS 61.102(1), in pertinent part, it prohibits a state employer from acting to "... subject to reprisal ... or discriminate against any [state] employee who in good faith reports, discloses, divulges or otherwise brings to the attention ... of any appropriate body or authority ... any facts or information relative to an actual or suspected violation of any law, statute ..."

In *Boykins*, the Supreme Court rejected Plaintiff's retaliatory discharge claim and affirmed the Court of Appeals' finding that the legislature had not established a policy on retaliatory discharge. However, the Supreme Court did not do this without first analyzing whether the Kentucky state workers' whistleblower statute, KRS 61.101, et seq., was applicable to the facts. In *Boykins*, an employee of the Housing Authority filed a negligence action against her employer pertaining to an injury her nephew received on the property of the Housing Authority. Plaintiff was later discharged and sued, arguing her discharge was in retaliation for her negligence action. Interpreting the "Whistle Blower" statute narrowly, the Court held the employee was not protected because the negligence action was unrelated to her employment. The Court found no merit to the employee's argument that the statute applied because she raised public safety and health issues (or issues of general "public interest.") The Supreme Court further states, "The narrowly drafted purpose of KRS 61.102 reveals no legislative intent to encompass the action of filing suit the circumstances presented...."

Perhaps even more instructive is *Davis v. Powell's Valley Water District*, Ky. App., 920 S.W.2d 75 (1995). In *Davis*, the Court of Appeals takes a consistently restrictive view of the state workers' whistleblower statute, KRS 61.101, et seq. In *Davis*, plaintiffs asserted retaliatory termination because they discovered and published information they believed indicated the defendant and some of its employees allegedly participated in certain illegal activities. The trial court directed verdict for the defense,
finding that the statute did not apply since the defendant was not a political subdivision of the state and therefore, the statute did not apply.² The Court of Appeals reversed the trial court, focusing on the explicit language of the statute that applies only to employees of the Commonwealth of Kentucky or political subdivisions. It determined the statute afforded protection to the plaintiffs – but only after and because it determined the Water District to be a “political subdivision” of the state. The clear implication is that where a defendant in a particular case cannot be considered a political subdivision of the state or any way connected to the state, but is strictly a private business, there is no whistleblower protection in Kentucky.

² For purposes of applying KRS 61.102(1), “employer” is defined as: “[t]he Commonwealth of Kentucky, or any of its political subdivisions. Employer also includes any person authorized to act on behalf of the Commonwealth, or any of its political subdivisions, with respect to formulation of policy or supervision, in a managerial capacity, of subordinate employees[.]” Id. at 76.
SEXUAL HARASSMENT
AN UPDATE SINCE THE US SCT 1998 DECISIONS

In 1998, the U.S. Supreme Court handed down seminal decisions interpreting the law in sexual harassment cases. Faragher v. City of Boca Raton, 77 FEP Cas. (BNA) 14, U.S. Sup. Ct. No. 97-282 (1998) and Burlington Industries, Inc. v. Ellerth, 77 FEP Cas. (BNA) 1, U.S. Sup. Ct. No. 97-569 (1998). In those cases, the court established a new standard for hostile-environment harassment committed by a supervisor. When not accompanied by a tangible job detriment, an employer will be liable for supervisory hostile environment unless it pleads and proves a two-pronged affirmative defense that: (a) the employer exercised reasonable care to prevent and correct promptly any sexually harassing behavior, and (b) the plaintiff-employee unreasonably failed to take advantage of any preventive or corrective opportunities provided by the employer or to avoid harm otherwise.

However, when a supervisor's harassment can be demonstrated and culminates in a tangible employment action, no affirmative defense is available. A tangible employment action constitutes a significant change in employment status, such as hiring, firing, failure to promote, reassignment with significantly different responsibilities, etc.

The Court did not alter the "knew or should have known" standard of liability for non-supervisory hostile-environment harassment (peer to peer harassment).

The interpretation of Faragher and Burlington Industries by the lower courts is of great interest (and concern) to employers. In the case, Williams v. General Motors Corporation, No. 97-3351 (6th Cir. 1999), the Sixth Circuit Court of Appeals applied the Faragher and Burlington Industries standards.

The 6th Circuit reversed the summary judgment granted by the federal district court on following facts. Ms. Williams was a 30-year employee at the Warren, Ohio plant. She worked third shift in the tool crib. She alleged hostile environment based on the following:

Co-worker "Harassment"

1. Giovannoe, a co-worker, used the "F" word constantly.

2. In June, 1995 Giovannoe used the phrase "Hey slut."

3. In September, 1995 Giovannoe said he was "sick and tired of these f--king women;" she and Giovannoe threw boxes at one another.
Supervisor “Harassment”

1. In July, 1995 Ryan, her supervisor, looking at her breasts said “You can rub up against me anytime” and “You would kill me, Marilyn. I don’t know if I can handle it, but I’d die with a smile on my face.”

2. In July, 1995 Williams was bending over. Ryan, behind her, said “Back up; just back up.”

3. In July, 1995 Williams was writing the phrase “Hancock Furniture Company.” Ryan put his arm around her back, leaned his face against hers and said “you left the dick out of the hand.”

General “Harassment”

1. Williams was forced to take third shift although Giovannoe had originally agreed to take it.

2. In September, 1995 Williams discovered a box of tool crib release forms glued to the top of her desk.

3. Williams was denied overtime.

4. Williams alone did not have a key to the office.

5. Williams alone was denied a break.

6. Williams was not allowed to sit at the table by the crib window, but in the back.

7. A motorized cart once sat on a skid and blocked other carts.

8. A female co-worker locked the crib with Williams inside.

9. Twice materials were stacked in front of the alternate exit.

Lessons to Learn from the Williams case:

- After Faragher and Williams it is no longer enough for an employer to take corrective action. Employers have an affirmative duty to prevent sexual harassment by supervisors (emphasis mine). Once an employee has established active discrimination involving “no tangible employment action,” an employer can escape liability only if it took reasonable care to prevent and correct any sexually harassing behavior and the employee failed to use remedial measures to alleviate the situation.
The Sixth Circuit rejected the trial court’s “dis-aggregation” of plaintiff’s claims into four separate categories of (1) foul language; (ii) annoying treatment by co-workers; (iii) perceived inequities of treatment; and (iv) sex-based remarks. The dis-aggregation divorced the incidents from their context and deprived them of their full force.

The supervisor “status” of the perpetrator matters for purposes of liability. It does not matter for purposes of determining whether a hostile-environment exists. The totality-of-the-circumstances test mandates that courts consider harassment by all perpetrators combined.

The supervisor’s conduct was not “merely crude, offensive, and humiliating, but also contained an element of physical invasion.”

Giavonnoe’s remarks were not merely “foul language in the workplace” but could be viewed as “humiliating and fundamentally offensive to any woman in that work environment, and they go to the core of Williams’s entitlement to a workplace free of discriminatory animus.”

The pranks are not merely oafish behavior but could be viewed as work-sabotaging behavior that creates a hostile work environment.

At oral argument, Williams’ attorney asked the court whether the conduct alleged in this case would be tolerated in our courthouses. The court’s answer? “We believe it would not, and we reject the view that the standard for sexual harassment varies depending on the work environment.” [Does the Court also reject Judge Scalia’s “societal context” view?]

Conduct need not be overtly sexual to be “based on sex.” The myriad instances where Williams was ostracized, combined with gender-specific epithets, create a inference – to be tried to a jury – that gender was a substantial motivating factor for co-workers’ behavior.

The district court misconstrued the requirements of the subjective test when it viewed as significant Williams’s testimony that Ryan never threatened her and she never felt physically threatened. She was aware of the policy against harassment, but never complained about Ryan. She never told Ryan to stop and stated she thought he was joking.

The Court says the district court turned the subjective test on its head substituting Ryan’s intention for Williams’s perception. That Williams thought Ryan meant to joke does not mean she perceived his comments as jokes. Humor is not a defense.

The “subjective offense” component of a prima facie case does not require that a plaintiff report a hostile work environment. “A plaintiff can be subjected to sexual harassment...and yet, for a number of valid reasons, not report the harassment. Williams’s reluctance to report the incidents is entirely
understandable considering that one of the alleged aggressors was her supervisor and she wanted to get along at work.” [The failure to complain may be relevant to the affirmative defense.]

- To show unreasonable interference with work performance, the plaintiff need not prove a decline in productivity or that her work was actually affected. “The employee need only show that the harassment made it more difficult to do the job.”

Lessons from EEOC Guidance about Vicarious Employer Liability (1999)

1. **Definition of Supervisor**

   An individual qualifies as an employee’s supervisor if the individual has authority to undertake or recommend tangible employment decisions affecting the employee or the individual has authority to direct the employee’s daily work activities. As long as the individual’s recommendation is given substantial weight by the final decision-makers, that individual meets the definition of supervisor. An employer may be subject to vicarious liability for harassment by a supervisor who does not have actual authority over the employee where the employee reasonably believed that the harasser had such power.

2. **Corrective Action May Not Be Enough**

   Unlawful harassment may occur despite the exercise of requisite legal care by the employer and employee. In these circumstances, the employer will be liable. The affirmative defense may be useful in limiting damages.

3. **Policy Is Not Enough**

   If an employer has an adequate policy and complaint procedure and properly responded to a complaint, but management ignored previous complaints by other employees about the same harasser, then the employer has not exercised reasonable care.

4. **Implement A General Civility Code**

   Encourage employees to report “harassment before it becomes severe or pervasive.” The employer must make clear to employees that it will stop harassment before it rises to the level of a violation of law.
5. **Do Not Be Picky**

A complaint procedure should not be rigid. A complainant should not be forced to adhere to a particular format or commit to writing before a complaint is taken seriously or is investigated.

6. **Give Away The Store**

The EEOC recommends that employers' policies contain information about the time frames for filing charges with the EEOC.

7. **“No” Means “Yes”**

An employee may report alleged harassment to a supervisor, but ask him/her to take no action. Inaction by a supervisor in such circumstances may lead to employer liability.

8. **Bend Over Backwards**

Intermediate measures may be necessary before the investigation is over, such as scheduling changes to avoid contact between accuser and accused or transfer of alleged harasser or placing alleged harasser on paid leave. The complainant should not be involuntarily transferred or otherwise burdened.

9. **Do Something**

If no determination can be made because the evidence is inconclusive, the employer should still undertake further preventive measures, such as training and monitoring.

10. **Spill The Beans**

Management should inform both parties about corrective action taken.

11. **Go Looking For Trouble**

Due care requires management to correct unwelcome harassment regardless of whether an employee files an internal complaint.

12. **Organize Your Skeleton Closet**

The EEOC advises employers to keep records of all harassment complaints.
13. It's Always Your Problem

An employee who fails to complain does not carry the burden of proving the reasonableness of that decision. The burden lies with the employer to prove that the employee’s failure to complaint was unreasonable. The employee might have reason to believe that the complaint mechanism entailed a risk of retaliation or that it was not effective.

EDUCATE YOUR MANAGERS ON THE SEXUAL-HARASSMENT MYTHS

Myth No. 1

It’s the company’s problem.

Reality Check

You may be disciplined or terminated for inappropriate behavior even if it does not meet all the legal criteria of sexual harassment.

You may be sued individually.

You may not be “taken care of” by the company.

You may be personally liable for punitive damages even when the company is not.

Myth No. 2

I can assume people are not offended if they do not express offense.

Reality Check

Plaintiffs/victims offer a hundred credible reasons/excuses for not speaking up, including fear, futility, ignorance of process.

Myth No. 3

We’re okay because we have a written policy against harassment and a complaint procedure.

Reality Check

A policy and complaint procedure are no guarantee against liability. They are only as effective as their implementation and they depend upon employees’ perceptions of the company’s seriousness about these issues.
Myth No. 4

As long as everyone is okay with the speech/conduct, we are safe.

Reality Check

The fact that suggestive speech or conduct may be welcome is no excuse.

“Welcome” trash talk and conduct are extremely dangerous for many reasons.

Welcome can and does change to unwelcome.

Not all recipients will find the offending conduct welcome.

Not all offenders are equal. What may be okay between coworkers/friends can become offensive from manager or coworker/non-friend.

The sleaze factor in a work environment is critical.

Myth No. 5

We cannot control people’s “free speech,” their falling in love, their private affairs, etc.

Reality Check

If you cannot control your employees in the work environment, stop being a manage.

You can and should regulate speech in the work environment. Personal business stops being personal when it begins to adversely affect the work environment. The company should have a rule that supervisors should have no intimate relationship (sexual or otherwise) with subordinates. Period.

Myth No. 6

If I cut my employees some slack and make them like me, they’ll return the favor and no one will turn on me.

Reality Check

Yes, they will. Managers who are fair, consistent and play by the rules are far less likely to be sued or to lose suits than those who wing it or rely on employees’ personal loyalty. Effective management is not the same as a popularity contest.
Myth No. 7

Using my personal standards of business etiquette, I can decide what is and is not offensive. If I'm not offended, it’s permissible.

Reality Check

Your opinion is almost irrelevant. What the plaintiff and jury think matters.

Myth No. 8

Touching and joking is necessary for good morale.

Reality Check

No. Effective, professional management and good profits are necessary for good morale.

Myth No. 9

If it’s true or I heard it on TV or radio, it’s okay to talk about it.

Reality Check

“Truth” or rehashed trash is no defense. Many true things are best left unsaid.

Many things that are considered appropriate and funny on TV/radio are inappropriate and risky in the workplace [or will sound horrible when repeated in a courtroom].

Myth No. 10

I can act at work they way I act everywhere else.

Reality Check

Not even close. Arrogance or clueless-ness (or both) is a huge problem in these cases. The office is not your home, your car, your favorite bar or pick-up joint. You have no right to say whatever pops into your head. You have no right to litter the company’s work environment with trash talk or conduct (or to allow it to be littered by others).

Myth No. 11

It’s got to be really bad before we lose.
Reality Check

Juries do not distinguish between unlawful harassment and bad taste. They will punish you for breaches of etiquette, not just for sexual blackmail or egregious conduct.

Myth No. 12

If I'm careful to whom I talk and where, no one will ever know.

Reality Check

All workplace communications are subject to discovery, including conversations, e-mail, voicemail, marginalia, interoffice memos, notes, planners, calendars, etc. Even communications away from work, but involving or relating to employees, are subject to discovery and may be used against you and the company.

Myth No. 13

I will get a fair shake in the courtroom from a jury of my peers once they hear the "true version" of events.

Reality Check

Forget about it. You are Goliath. No one likes him. Moreover, the picture presented in the courtroom will bear little resemblance to the actual facts. You can't recreate past context. People do lie and lie effectively.

Myth No. 14

People can't sue if they give as good as they get.

Reality Check

Yes they can and do. A victim's questionable behavior may not be admitted into evidence, may be denied or may be rationalized away. Your mission is to nip the bad seed in the bud, not water it.

Myth No. 15

We only have to be careful around females.
Reality Check

This law protects everyone. Males and females can be the victims of opposite and same-sex harassment. If it’s sexually explicit or suggestive in nature, whatever the source, whoever the target, whatever the context, knock it off.

Myth No. 16

We can wait until someone complains.

Reality Check

Absolutely not. We need to be proactive and err on the side of preventing harassment. In some circumstances, we may be liable for harassment even if we did not know about it.

Myth No. 17

If the “victim” asks me not to report or act on the problem, I’m okay doing nothing.

Reality Check

Wrong. All too often the victim’s request is later denied or reinterpreted. The victim’s wish is not controlling. The company has obligations to investigate and correct independent of his or her wish. It is not the “victim’s” prerogative to make that call.

Myth No. 18

If employees can’t stand the heat, they should get out of the kitchen. Majority rules.

Reality Check

Law and company policies rule. The majority may have to defer to a more sensitive minority.

Myth No. 19

I can fire people at will, so I’ll just unload my sensitive types.
Reality Check

While most employers do maintain “employment-at-will,” you, as a good manager, will want to have a good and legitimate reason for termination. You cannot fire or punish people for complaining about harassment or for supporting such complaints.

Myth No. 20

I can wear my “friend” or “regular person” hat along with my management hat.

Reality Check

Nope. The management hat trumps.

Myth No. 21

After I get the complaint or notice of a problem, it’s best just to let it ride for a while and see how it shakes out.

Reality Check

Report it immediately to the appropriate person. Get it up the line - NOW!

EDUCATE YOUR WORKFORCE ON SOME BASIC DO’S AND DON’TS

DO:

Keep your hands to yourself.

Keep your mouth totally clean; avoid crude language, gestures and objects.

DO NOT:

Do not date or request dates from subordinates, direct or indirect [if you feel the flicker of mutual desire, ask for a company-blessed solution]

Do not “come on” to subordinates.

Do not “carouse” with subordinates.

No relating of dreams, sexual exploits, fantasies, etc.
No retelling of smutty TV or radio humor.

No comments on body, weight, physical attributes, sexual habits or liaisons, intimate topics, etc.

Do not use e-mail, voicemail or other Company information processing or storage resources for suggestive jokes, comments, etc. No use of sexually explicit internet sites.

No suggestive magazines or objects in the workplace.

No sexual gag gifts, cards, etc.

No suggestive graffiti or posters or pictures.

No "hazing" or teasing of employees especially when it relates to sex, age, race, national origin, disability, religion, sexual orientation.

No gender-biased remarks (this applies to all protected statuses).

No use of supervisory authority to gain sexual advantage.

Do not wait for a complaint.

No delay in reporting any complaint or suspected problem.

Do not be bullied by or partial to either alleged victim or accused harasser.

Do not bring your private life into the workplace.

Keep company posters up at all times (anti-harassment policy, HOTLINE, open door).

Impose the above rules on subordinates.
1999 – THE YEAR OF THE ADA
(AMERICANS WITH DISABILITIES ACT)

A. WHO IS DISABLED?

The Supreme Court ruled that individuals must be viewed in their corrected or medicated state in determining whether they are disabled. The three decisions were a clear victory for employers: *Sutton v. United Air Lines, Inc.*, 527 U.S. 471, 119 S.Ct. 2139, 9 AD Cas. (BNA) 673 (1999); *Murphy v. UPS, Inc.*, 527 U.S. ___ (1999) and *Albertsons, Inc. v. Kirkingburg*, 527 U.S. ___ (1999).

*Sutton* -- Plaintiffs were twin sisters; each has severe myopia [uncorrected 20/200 (R) 20/400 (L); corrected 20/20]. Without corrective lenses, the sisters could not drive, watch TV or shop.

In 1992, they applied to United as commercial airline pilots. They did not meet the airline’s minimum vision requirement of 20/100 or better.

The sisters filed a charge alleging disability discrimination, pursuing a theory of actual disability and a “regarded as” theory. The trial court dismissed. The trial court viewed them in their “corrected” state. In addition, the trial court said the airline did not view plaintiffs as generally foreclosed from piloting, just from the particular job of global airline pilot. The Tenth Circuit affirmed (contra the First, Second, Third, Fifth and Seventh and the EEOC’s Interpretive Guidance).

The Supreme Court held that the EEOC’s Interpretive Guidance is an impermissible interpretation of the EEOC. If a person is taking measures to correct for the impairment, the effects of those measures - positive and negative - must be taken into account when deciding “substantial limitation.” The Court cites three bases for its rationale: (i) a disability is an impairment that currently “substantially limits,” not one that could or might; (ii) the inquiry is individualized; are the major life activities of such individual limited; and (iii) Congress could not have meant to protect as disabled the 43,000,000 Americans with impairments (which, if uncorrected, would be disabling). Therefore, the Court found that the sisters were not disabled.

In addition, the Court held that the airline did not regard them as disabled. An employer can “regard” in two ways: (i) it may mistakenly believe a person has an impairment that substantially limits; or (ii) it may mistakenly believe that an actual, non-limiting impairment does, in fact, substantially limit. Here the sisters argued the second “mistake,” i.e., that the airline mistakenly believed that the actual myopia substantially limited them in the major life activity of working. The Court rejected that
argument holding that the particular job of global pilot is not a broad class of jobs.

**Murphy** -- Murphy was a UPS mechanic hired in August, 1994. His position required him to drive commercial motor vehicles. He was diagnosed with high blood pressure at age 10. With medication, he functioned normally. Driving was conceded to be an essential job function. A DOT regulation required that drivers not have a "current clinical diagnosis of high blood pressure likely to interfere with their ability to operate a commercial vehicle safely." At hire, Murphy was erroneously certified and began work. In September, the error was discovered and he was retested. In October, UPS fired him because his blood pressure was too high. Sutton determined the result of Murphy's claim. Murphy in his medicated state was not disabled. UPS did not view Murphy as precluded from a broad class of jobs and did not fire him because of an unsubstantiated fear that he would suffer a heart attack or stroke while driving. Rather, it fired him because his blood pressure exceeded the DOT's requirements for drivers of commercial vehicles.

**Albertsons, Inc.** -- Kirkingburg was offered a job as a truck driver at an Albertson's warehouse. Before actually starting work, he took a vision test to see if he met DOT requirements for commercial vehicle drivers. Although he did not, he was improperly certified and began work in August, 1990. In December, 1991 he took a LOA because of a job injury. On return to work he took a physical exam where it was determined his eyesight failed DOT standards. He applied for a waiver, but was fired. He received the waiver in early 1993 but was not rehired. The Ninth Circuit reversed the trial court's granting of summary judgment to Albertsons.

The Supreme Court cited three "missteps" by the Ninth Circuit: (i) while Kirkingburg sees using only one eye and most people use two, "difference" is not tantamount to a "substantial limitation;" (ii) the Ninth Circuit improperly disregarded Kirkingburg's ability to compensate/mitigate the impairment; his brain developed subconscious mechanisms to cope; and (iii) the Ninth Circuit ignored its obligation to determine the existence of a disability on a case-by-case basis; monocularity differs in its impact on individuals.

Kirkingburg's obtaining a waiver made no difference since the waiver program was experimental and did not purport to modify the substantive content of the general regulations.

Employers can expect plaintiffs' lawyers to come up with ways to circumvent the effect of those decisions. Anticipated circumventions include greater use of the other definitions of disabled: having a "history of disability" and being "regarded as disabled."
Employers can also anticipate the argument that the medication itself has a disabling effect. See, e.g., McAlindin v. County of San Diego, No 97-56787 (9th Cir. 9/16/99). McAlindin suffered from anxiety and panic disorders and had trouble sleeping. He undertook the corrective measure of psychotherapy and medication. The medication made him impotent. The Court held that sex, sleeping and interacting with others are major life activities and that McAlindin was substantially limited in sex and sleeping.

See also EEOC v. R.J. Gallagher Co., 181 F.3d 645, 9 AD 917 (5th Cir. 1997). Boyle was a 20-year employee of Gallagher. He rose from salesman to President. He performed well. In late 1993 he was diagnosed with blood cancer. He underwent a month of chemotherapy, but stayed in touch with work and made decisions and assignments. He was pronounced in remission and released to work. The Company chairman demanded what amounted to a guarantee that Boyle could serve as President. The Chairman suggested retirement citing Boyle’s affluence. He then demoted Boyle to Vice President of Sales and reduced his salary by 50%. Boyle declined the opportunity. (Boyle died in January, 1995.)

The Court found the blood cancer was an impairment and that working is a major life activity. The issue was the effect of the treatment (continuing chemotherapy). The Court held that Boyle, in remission, was not disabled. His need to return to the hospital for six monthly treatments (3-5 days each) did not suffice, especially given the flexibility executives enjoy.

However, the Court reversed summary judgment to the employer on the “record of” and “regarded as” definitions. A record of a cancer diagnosis is not enough; plaintiff must show a record of an impairment that substantially limits. The Court cited Boyle’s 30-day hospitalization, limited vision, etc. The employer’s offering a reduced position does not preclude trial on the regarded as theory since it arguably led to constructive discharge.

Other “Regarded” Cases

- Ross v. Campbell Soup Company, 237 F. 3d 701 (6th Cir. 2001). The Sixth Circuit reversed summary judgment for employer finding that the federal district court had “too easily dismissed” as direct evidence that the employer regarded the plaintiff as disabled a note written by plaintiff’s supervisor referring to the plaintiff as “the back case.”

- Heyman v. Queens Village Committee for Mental Health for Jamaica Community Adolescent Program, Inc., 1999 U.S. App. LEXIS 30720 (2d Cir. 11/30/99). The employer fired an employee with lymphoma and moved for summary judgment on the theory that the employee was not actually disabled. The Court denied the motion allowing the plaintiff’s “regarded as” claim to proceed.

- Deane v. Pocono Medical Center, 142 F.3d 138 (3d Cir. 1998) (en banc). Plaintiffs pursuing a regarded as theory (but who are not actually disabled) only have to prove
that they can perform the essential functions of the job to gain the protection of the Act.

- **Spades v. City of Walnut Ridge, Arkansas, 186 F.3d 897, 9 Am. Dis. Cas. (BNA) 1015 (8th Cir. 1999).** Police officer Sam Spades attempted suicide with a handgun, but survived. He received counseling and medication for depression. He asked to return to work, but was fired because of the City's fear of increased liability. When he sued for disability discrimination, the Court held that since the depression was corrected with medication, he was not disabled. The Court rejected Spades' "regarded as" theory without any helpful discussion.

**B. REASONABLE ACCOMMODATION**

- **Vollmert v. Wisconsin of Transportation, 197 F.3d 293, 9 Am. Dis. Cas. (BNA) 1704 (7th Cir. 1999).** A learning disabled employee failed to learn a new computer system and was transferred to a dead-end job. Plaintiff's expert testified that plaintiff was capable of learning the new system with proper training. The Court reversed summary judgment for the employer on the basis of the testimony. The Court rejected the argument that the opinion was conclusory, holding that the expert's opinion was based on his review of the employee's education, employment history and performance on an aptitude test.

- Two years earlier in **Weigel v. Target Stores, 122 F.3d 461 (7th Cir. 1997),** the same Court rejected as conclusory an expert's opinion that an employee with depression could do her job.

- **Belk v. Southwestern Bell Telephone Company, 194 F.3d 946, 9 Am. Dis. Cas. (BNA) 1621 (8th Cir. 1999).** Plaintiff, a polio victim, requested his employer to modify a physical performance test for a telephone cable repair position. The employer refused and plaintiff sued. The trial court rejected the defense request for a jury instruction that job-related tests are acceptable. The jury returned a verdict for plaintiff. The Court of Appeals reversed and ordered a new trial because the employer was deprived of its business necessary defense.

- **Smith v. Midland Brake, Inc., 180 F.3d 1154, 9 Am. Dis. Cas. (BNA) 738 (10th Cir. 1999) (en banc).** Reassignment is not just the opportunity to apply for a job with other applicants. When a disabled employee cannot perform his current job, the employer must reassign the employee if there is an available position he can do. The arguably creates a preference for the disabled employee.

- **Weiler v. Household Fin. Corp., 101 F.3d 519 (7th Cir. 1996).** Request for a transfer to a different supervisor is per se unreasonable.

- **Kennedy v. Dresser Rand Co., 193 F.3d 120, 9 Am. Dis. Cas. (BNA) 1335 (2d Cir. 1999).** Requesting a change in supervisors as an accommodation is not per se unreasonable but the plaintiff must overcome a presumption of unreasonableness.
• *Cannice v. Norwest Bank Iowa N.A.*, 189 F.3d 723, 9 Am. Dis. Cas. (BNA) 1103 (8th Cir. 1999). Plaintiff suffered from depression that was aggravated by several work events. However, maintaining an aggravation-free work environment is not a reasonable accommodation.

1. **EEOC Interpretive Guidance on Reasonable Accommodation**

   a) What information can you get on the employee's disability and need for accommodation?

   An employer may ask an individual to provide "reasonable documentation" regarding the alleged disability and limitations when the disability and/or need for accommodation is not obvious. The employer may require that the documentation be provided by "an appropriate health care or rehabilitation professional." What is "reasonable documentation?" Only that information needed to establish the person has a disability and that the disability necessitates a reasonable accommodation (not complete medical records, usually).

   An individual may be required to be examined by the employer's doctor only if he has not provided adequate information from his own and only after the inadequacy has been explained, but not cured.

   b) The interactive process.

   A worker's "notice" to the employer that he needs an accommodation need not mention the ADA or use the words "reasonable accommodation." Requests may be oral and casual. The request may come from someone other than the disabled individual. A disabled employee is not precluded from requesting a reasonable accommodation because he failed to request one at the time of application or hire.

   Employers should respond to such requests "expeditiously." Unnecessary delays violate the Act. The interactive process, or dialogue between the employer and employee is an absolute imperative.

C. **DIRECT THREAT**

• *Rizzo v. Children's World Learning Centers*, 173 F.3d 254, 9 Am. Dis. Cas. (BNA) 436 rehearing en banc granted 8/27/99, 1999 U.S. App. LEXIS 21402, 9 Am. Dis. Cas. (BNA) 1407, 187 F.3d 680 (5th Cir. 1999). Rizzo was a hearing-impaired school van driver. A parent complained her child was unable to get Rizzo's attention and expressed fear that Rizzo could not hear a choking child. The Board removed Rizzo from driving so that Rizzo's hours as an aide were reduced. After the Court noted that choking children probably do not make sounds, the Board contended that Rizzo could not distinguish spoken words and specific sounds ("pain" was "chain," etc.). The parties stipulated Rizzo was disabled. The ability to discriminate spoken words
was a safety requirement that tends to screen out a class of individuals with hearing disabilities. In such a case the defendant bears the burden to prove the employee poses a direct threat (otherwise, the burden of proof is on the plaintiff to show she can perform safely and is not a direct threat). The Board did not meet its burden. Rizzo had an excellent safety record; mirrors allowed her to see the children; and who can distinguish words in a van full of little kids?

D. BENEFITS


- **Kimber v. Thiokol Corporation**, 196 F.3d 1092 (10th Cir. 1999). A plaintiff was receiving benefits under his employer’s long-term disability plan. After two years, the employer stopped payments when it learned that the disability condition was actually a mental impairment (diabetes related). Plaintiff argued that to provide unequal benefits for different disabilities is discriminatory. However, the employer obtained summary judgment.

E. SOCIAL SECURITY

- **Cleveland v. Policy Mgt. Systems Corp.**, 119 S.Ct. 1597, 9 Am. Dis. Cas. (BNA) 491 (1991). Application for social security disability is not an automatic bar to an ADA suit, nor does it create a strong presumption against the plaintiff’s success under the ADA.

Inconsistency in theory of claims under ADA and SSA is of sort normally tolerated by legal system. Claimant’s sworn assertion in application to SSA that she is “unable to work” appears to negate an essential element of ADA case if she does not offer a sufficient explanation.

The Court noted the statute’s differences including the SSA’s lack of a “reasonable accommodation” provision (i.e., an ADA suit claiming plaintiff can do job with reasonable accommodation may be consistent with SS claim that she could not perform her job without it). Moreover, conditions change and a statement made to SS at time of application may not reflect the actual capability of the employee at the time of a relevant employment decision.

F. ARBITRATION

- **Bratten v. SSI Services, Inc.**, 185 F.3d 625, 9 Am. Dis. Cas. (BNA) 1045 (6th Cir. 1999) (Jones, Nelson, Norris). A union member filed his disability claim in federal court and the employer argued that he was bound to take his claim to arbitration under the CBA. The Sixth Circuit held for the union member because the waiver of the right to litigation, as opposed to arbitration, was not clear and unmistakable. To
 waive the right to litigate a statutory claim, a CBA must specifically refer to the statute in question.

G. PRIVACY

- **Cossette v. Minnesota Powers Light**, 188 F.3d 964, 9 Am. Dis. Cas. (BNA) 1086 (8th Cir. 1999). Plaintiff complained that the employer disclosed her past back injury and lifting restrictions to a prospective employer. The ADA protects plaintiff from such unauthorized disclosure regardless of whether she is "disabled" under the ADA.

- **Scott v. Leavenworth School Dist.**, (D. Kansas 2000). Defendant may not use ADA’s confidentiality provisions to decline to produce coworkers’ medical information in discovery to Plaintiff.

H. HARASSMENT

- **Farley v. Nationwide Insurance** (11th Cir. 12/14/99). Jury verdict of $414,603 affirmed; $300,000 was for emotional pain. Plaintiff’s wife and doctors testified that his mental condition worsened because of colleagues’ jokes and calling him “one of the crazies.” One supervisor posted a cartoon labeling the employee as “Just Plain Nuts.”

I. STRAY REMARKS

- **Hopkins v. Electronic Data Systems Corporation**, 196 F.3d 655, 9 Am. Dis. Cas. (BNA) 1724 (6th Cir. 1999). Plaintiff was terminated for cost-cutting reasons from a department to which he earlier had volunteered to go. Plaintiff claimed discrimination in part because a co-employee (later his supervisor) allegedly called him “the mentally ill guy on Prozac that’s going to shoot the place up.” The court held that this remark, if made, was too vague to constitute direct evidence of discrimination, especially where a non-disabled employee was fired under similar circumstances and the cost-cutting defense was not shown to be pretextual.

J. VERDICTS

- **EEOC v. Chuck E. Cheese**, No. 98c-698x (W.D. Wis. 11/5/99). Chuck E. Cheese’s regional manager fired David Perkl, a janitor, in 1997 for stated financial reasons. The regional manager allegedly said the restaurant chain did not hire “those kind of people.” Perkl cannot speak. He communicates with pictures and signs. He works with the help of a full-time job coach. The jury awarded Perkl $13 million in punitive, $100,000 in backpay and $700,000 in compensation. It was the largest verdict in an EEOC prosecuted ADA case.

against metal desks to unnerve him. The jury returned a verdict of $4.4 million dollars.


K. IMMUNITY

- *Board of Trustees of the University of Alabama, et al. v. Garrett*, 121 S. Ct. 955; 2001 LEXIS 1700 (2001). The Americans with Disabilities Act does not apply to any state or state agency as Congress exceeded the scope of its authority and invalidly abrogated the States Eleventh Amendment immunity in enacting the ADA. [Note: States and state agencies may still be liable under state disability laws similar to the ADA.]
WAGE AND HOUR LAWS

Now more than 60 years old, the Fair Labor Standards Act ("FLSA") remains probably the second most frequently violated law in the United States (after the speed limit). This is so principally because the exemptions from overtime compensation are complicated and poorly understood by both employers and employees, the salary basis test for exempt workers is often ignored, and workers are often "permitted" to work a flexible schedule other than the one that the employer intends to pay.

The materials that follow are designed to serve as a continuing reference tool for the H.R. professional or supervisor who wants to avoid being "burned" by wage-hour liability. A thorough understanding of these materials can help managers resolve the case studies that are offered at the end of the materials.

OVERVIEW

History and Purpose

The FLSA was enacted by Congress in 1938 in response to the Great Depression. Congress wanted to ensure that workers would be paid a minimum wage for their work. Congress also wanted to maximize the number of available jobs by requiring employers to pay a premium for working fewer employees lots of hours instead of more employees only 40 hours each week. As a result, the FLSA contains a number of regulations designed to assure both a minimum wage and compensation for overtime hours worked. The FLSA also contains regulations aimed at curbing abuses in child labor.

Minimum Wage

The current minimum wage for covered employees is $5.15 per hour. There are no increases scheduled at this time. Legislation has been introduced that would increase the minimum wage by $1.00/hour.

Maximum Hours

After an employee has worked 40 hours in one seven-day work week, any hours worked over 40 must be compensated at one and one-half times the regular rate. The work week must be fixed and defined, as discussed below. An employer has no requirement to pay overtime compensation for hours in excess of eight per day, or for work on Saturdays, Sundays, holidays, or regular days of rest.
Child Labor Provisions

The FLSA restricts employment to persons 16 years of age and older. However, younger children may be employed in certain circumstances. For example, children 14 and 15 years of age may be employed in certain occupations other than mining, manufacturing or processing.

Work hours for 14- and 15-year old children are limited to 3 hours per day and 18 hours per week when school is in session, and all hours worked must be outside of school hours. When school is not in session, work hours are limited to 8 hours per day and 40 hours per week. Work must be limited to the hours between 7:00 a.m. and 7:00 p.m. (9:00 p.m. from June 1 through Labor Day).

Special rules apply to agriculture, and younger children may be employed to do agricultural work under certain circumstances. For example, children under 14 years of age may be employed on farms owned or operated by the child’s parent or a person standing in the place of the parent. However, those children may not be employed or permitted to work in agricultural occupations that have been declared hazardous for children under 16 years of age. Those occupations include operation of certain machines, work with certain animals, and work from a ladder or scaffold.

The FLSA also prevents persons under the age of 18 from working in particularly hazardous industries. Restricted industries include manufacturing and storing of explosives, logging and sawmilling, roofing, excavation, demolition, meat packing, mining, work involving certain power-driven machines, and work involving exposure to radioactive substances.

Employees vs. Independent Contractors

The FLSA defines an employee as any person “suffered or permitted to work” by an employer and not excluded from the definition by any other section of the FLSA. The definition is very broad and does not require a contract of employment.

Independent contractors, however, are not employees within the meaning of the FLSA. One way to determine whether a person is an employee or an independent contractor is to consider the “economic reality test.” The economic reality test is used to determine whether an individual is economically dependent on the business or, as a matter of economic fact, is in business for himself or herself. Some of those factors to consider include:

- The degree of control exerted by the alleged employer over the worker;
- The worker’s opportunity for profit or loss;
- The degree of skill required to perform the work;
• The permanency of the relationship between the individual and the organization;

• The worker’s investment in the business; and

• The extent to which the work is an integral part of the alleged employee’s business, or the extent to which the alleged employee is economically dependent on a particular business.

The greater the degree of control and supervision that the business exercises over the worker or the work performed, and the greater the economic dependence of the worker on the business, the greater the likelihood that the worker is an employee rather than an independent contractor.

EXEMPT EMPLOYEES – NO OVERTIME PAY REQUIRED FOR “WHITE COLLAR” EMPLOYEES

The Duties Test

The FLSA permits an employer to exempt individuals who are bona fide administrative, professional, executive or management employees from the payment of overtime compensation. These are known as the “white collar” exemptions. It is important to remember that an employee’s exempt status cannot be conferred by paying a salary of particular level, and is determine not by the title of the position, but by the nature of the duties actually performed. Exempt status depends largely on a case-by-case analysis of these duties in the case of a particular employee. The employer bears the burden of proving the exemption.

Although in the case of each exemption a “long test” exists, since most employers pay exempt employees at least $250/week, the “short tests” summarized below most frequently apply.

Administrative Employees

• A bona fide “administrative” employee is one who is paid a salary of at least $250/week and who meets the following requirements:

• Office or nonmanual work directly related to management policies or general business operations of his or her employer or the employer’s customers; or

• Functions in the administration of a school system, or educational establishment; and
• He or she customarily and regularly exercises discretion and independent judgment.

Some examples of exempt administrative employees include executive and administrative assistants, personnel directors, credit managers, investment consultants, management consultants, school principals and vice-principals and heads of school departments.

Professionals

• A bona fide professional is an employee who is paid a salary of at least $250/week and who meets the following requirements:

• His or her primary duty consists of the performance of:

• Work requiring knowledge of an advanced type in a field of science or learning acquired by a prolonged course of specialized intellectual instruction and study; or

• Work that is original and creative in character in a recognized field of artistic endeavor, the result of which depends primarily on the invention, imagination or talent of the employee; or

• Teaching, tutoring, instructing or lectures as a recognized or certified teacher; and

• His or her work requires the consistent exercise of discretion and judgment in its performance.

Some examples of exempt professionals include doctors, nurses, engineers, lawyers and teachers.

Executive/Managerial Employees

• A bona fide executive or managerial employee is an employee who is paid a salary of at least $250/week and who meets the following requirements:

• His or her primary duty consists of the management of the enterprise in which he or she is employed or of a customarily recognized department or subdivision of the enterprise; and
• He or she customarily and regularly directs the work of two or more other employees.

Some relevant considerations in determining whether an employee is an exempt executive or management employee are: 1) time spent on “management” duties; 2) relative importance of management duties; 3) how often the employee exercises discretionary powers; 4) how closely the employee is supervised; and 5) relationship between the employee’s salary and that of others performing nonexempt work.

Computer-Related Occupations

In response to the growing number of employees holding computer-related positions, the FLSA and its related regulations were amended to permit these professionals to be exempt from overtime requirements in certain circumstances. The exemption extends to highly skilled computer programmers, systems analysis, and software engineers. The exemption does not extend to trainees, beginning programmers, or employees involved in operating computers or in manufacturing, repairing or maintaining computers.

An exempt employee in a computer-related occupation must meet the following requirements:

• His or her primary job duties must include:
  - The application of systems analysis techniques and procedures, to include consultations with users in order to determine hardware, software or system functional specifications; or
  - The design, development, documentation, analysis, creation, testing, or modification of computer systems or programs based on and related to user specifications; or
  - The design, documentation, testing, creation, or modification of computer programs related to machine operating systems; or

A combination of the above duties; and

• He or she is compensated on a salary or fee basis of $170 per week, or if compensated on an hourly basis, he or she must be paid in excess of $27.63 per hour.

The Salary Test

Salary Basis

In order to qualify under the white-collar exemptions for executive, professional, and administrative employees, such employees must be paid on a salary basis. As discussed below, professional and administrative employees may also be paid on a fee
basis. A private sector employee is paid on a salary basis if he regularly receives each pay period, on a weekly or less frequent basis, a pre-determined amount constituting all or part of his compensation. This pre-determined amount may not be subject to reduction because of variations in the quality or quantity of the work performed. Subject to the exceptions noted below, the employee must receive his full salary for any week in which he performs any work, without regard to the number of days or hours worked. However, an employee need not be paid for any workweek in which he performs no work.

Permissible Deductions from an Employee’s Salary

Deductions from an employee’s salary may be made for absences of a day or more for personal reasons other than sickness or accident. In addition, deductions from an employee’s salary may be made for absences of a day or more as a result of sickness or disability, provided that such deductions are made pursuant to a bona fide plan, policy, or practice of providing compensation for loss of salary caused by sickness and disability. Deductions also may be made for absences covered by the Family and Medical Leave Act.

Subject to Deduction

An employee’s salaried status – and thus the employee’s exempt status – will be lost if the employee is covered by a policy that permits disciplinary or other deductions in pay “as a practical matter.” The “as a practical matter” standard is met if there is either an actual practice of making such deductions or an employment policy that creates a “significant likelihood” of such deductions.

Window of Correction

The regulations interpreting the FLSA provide for a “window of correction” with regard to the salary basis test for exempt white-collar employees – “where a deduction not permitted by these interpretations is inadvertent, or is made for reasons other than lack of work, the exemption will not be considered to have been lost if the employer reimburses the employee for such deductions and promises to comply in the future.”

Fee Basis

Professional and administrative employees remain exempt under the Act if they are compensated on a fee basis rather than a salary basis. Compensation on a fee basis is characterized by the payment of an agreed sum for a single job regardless of the time required for its completion. A fee payment is adequate to satisfy the professional employee exemption if it is at a rate that would amount to at least $250 if 40 hours were worked. Similarly, a fee payment is adequate to satisfy the administrative employee exemption if it is at a rate that would amount to at least $250 if 40 hours were worked.
CALCULATING OVERTIME

The Workweek

The FLSA's overtime payment requirements are based on the concept of a workweek. An employee's workweek is a fixed and regularly occurring period of 168 hours – seven consecutive 24-hour periods. It need not coincide with the calendar week but may begin on any day and at any hour of the day.

Each workweek is treated as a separate and independent period. There is generally no carryover of time worked from one workweek to another. For example, even if an employee works 60 hours in one week and only 5 hours in the second week of a pay period, the employer must pay the employee for 20 hours of overtime earned during the first week.

The FLSA allows employers to change a workweek from one period of seven consecutive days to another period of seven consecutive days, provided that the change is intended to be permanent and is not designed to evade the purposes of the Act.

Exception to the General Workweek Rule for Hospitals. Section 7(j) of the FLSA allows an "employer engaged in the operation of a hospital or an establishment which is an institution primarily engaged in the care of the sick, the aged, or the mentally ill or defective who reside on the premises" to calculate overtime compensation owed by using a work period of 14 consecutive days, instead of the workweek of seven consecutive days, if the following conditions are met:

- Prior to the performance of the work, the employer and the employee reached an agreement or understanding that overtime would be calculated in this way; and
- The employee receives compensation at a rate not less than time and one-half his regular rate for all hours worked in excess of (i) eight hours in any workday and (ii) 80 hours in the established fourteen-day work period.

Regular Rate of Pay Defined

As discussed above, the FLSA requires that overtime be compensated at a rate not less than one and one-half times the regular rate at which the employee is actually employed. Of course, the regular rate at which the employee is employed may in no event be less than the statutory minimum.

The regular rate is the hourly rate actually paid the employee for the normal, nonovertime workweek for which he is employed. If an employee is employed solely on the basis of a single hourly rate, that hourly rate is his regular rate. He must be paid
one and one-half times that hourly rate for all hours worked in excess of 40 in a given workweek.

Not Included In “Regular Rate”

The regular rate includes all remuneration for employment paid to, or on behalf of the employee, with the exception of the following.

- Sums paid as gifts, the amounts of which are not measured by or dependent upon hours worked, production, or efficiency;

- Payments made for occasional periods when no work is performed due to vacation, holiday, illness, or other similar cause; reasonable payments for traveling expenses; and other payments to an employee which are not made as compensation for the hours of employment;

- Sums paid in recognition of services performed during a given period of time if: (i) such sums are paid and determined at the sole discretion of the employer at or near the end of the period and not pursuant to any prior contract; or (ii) such sums are made pursuant to a bona fide profit sharing plan; or (iii) the payments are talent fees;

- Contributions irrevocably made by an employer to a trustee or third person pursuant to a bona fide plan for providing old age, retirement, life, accident, or health insurance, or similar benefits for employees;

- Extra compensation provided by a premium rate for certain hours worked by the employee in any day or workweek because such hours are in excess of eight in a day or in excess of the maximum workweek;

- Extra compensation provided by a premium rate paid for work by the employee on Saturdays, Sundays, or holidays, provided that such premium rate is not less than one and one-half times the rate that the employer has established, in good faith, for like work performed in non-overtime hours on other days; and

- Extra compensation provided by a premium rate paid to the employee, pursuant to an applicable employment agreement or collective bargaining agreement, for work outside of the hours established in good faith by the agreement.

Most Common Violations of “Regular Rate” Compensation
Some employers do not realize everything that is included in an employee’s regular rate, upon which the employee’s rate of compensation for overtime work is determined.

**Shift Premiums**

Shift premiums are included in an employee’s regular rate. For example, if an employee receives a 10% shift premium for working on the second shift, his regular rate is his hourly rate plus the shift premium. For his overtime work, of course, he must be paid time and one-half of his regular rate.

**Awards and Prizes**

The value of prizes won by employees for quality, quantity, or efficiency in the performance of their customary tasks during regular working hours must be included in their regular rate calculations. An employer generally must allocate the prize over the period in which it is earned. If merchandise is awarded, the employer must allocate the cost of the merchandise.

**Bonuses and Incentive Payments**

Bonuses and incentive payments that are dependent on the quality, quantity, or efficiency of production or hours worked generally must be included in the regular rate. Examples of such bonuses include: lump sum bonuses paid pursuant to a labor contract, production or work incentive bonuses, bonuses that are based on a percentage of sales, cost-of-living bonuses, and attendance bonuses. There is an exception, however, for discretionary bonuses. If both the fact that payment is to be made and the amount of the bonus are determined by the employer, in its sole discretion, at or near the end of the period the bonus covers, and the payment is not made pursuant to any prior agreement or promise that would lead the employee to expect the payments regularly, the amount of the bonus is excluded from the regular rate calculation.

**CALCULATING HOURS WORKED**

**Preparation To Work**

In response to confusion generated by early court decisions about whether employers had to pay for incidental job-related activities, Congress clarified the law in 1947 to exclude the following from the minimum wage and overtime requirements of the FLSA:

- Time spent by an employee traveling to and from the actual place of performance of the principal activities, unless payment for such activities is required by a contract or by custom or practice;
• Time spent by an employee on tasks that are performed before or after the principal activities in a workday, unless payment for such activities is required by a contract or by custom or practice.

These exclusions apply only to those periods of time just before or just after the "workday." The FLSA continues to cover, for example, travel that occurs during normally scheduled work hours.

On-Call Time And Waiting Time

Employees must be compensated for time spent “on-call” unless the employee can use the time effectively for his or her own purposes. If the employee remains on the employer’s premises or so near that he or she cannot use the time freely, then he or she must be compensated for the time. However, if the employee can come and go, the time generally may be excluded from working time.

The same is true for time spent by an employee waiting to perform work. The inquiry turns on the question of whether the time spent is primarily for the benefit of the employer. Unless the employee is completely relieved from duty and allowed to leave for a specified period of time, and the period of time is long enough to give the employee discretion as to how to use the time, the employee must be compensated for the time spent waiting. If the employee is “engaged to be waiting,” as opposed to “waiting to be engaged,” the time is compensable.

Employers can reduce the likelihood that on-call time will be treated as compensable by following this eight-part test:

• Send on-call employees off the premises;
• Make sure that the employees have a reasonable amount of time to respond to calls;
• Schedule and publicize on-call periods;
• Make sure that callbacks are infrequent;
• If possible, do not require called-in employees to wear uniforms;
• Encourage employees to spend on-call time pursuing personal activities;
• Carefully choose when to discipline employees for on-call policy infractions;
• Provide a written on-call policy to employees.
Seminars And Training

An employee must be compensated for time spent attending seminars and training programs, *unless*:

- The event occurs outside of the employee’s regular working hours;
- Attendance is truly voluntary;
- The program is not directly related to the employee’s job; *and*
- The employee does not perform any productive work while attending the event.

Attendance is not voluntary if the employee is led to believe he or she will be disadvantaged in any way by non-attendance.

Travel Time

An employee must be compensated for travel:

- That is considered “all in the day’s work”; *or*
- From home to work when the employee is on special assignment in another city; *or*
- During normal working hours in conjunction with an overnight trip.

In addition, employees must be compensated for work actually performed while traveling.

Rest And Meal Periods

Rest periods are counted as working time unless they are more than 20 minutes long. The FLSA does not require rest breaks; however, if they are provided, employees must be paid for that time.

Meal breaks are counted as working time *unless*:

- They are more than 30 minutes long;
- Employees are relieved of all duties, including answering the phone and waiting on customers; *and*
- Employees are free to leave their stations.
In order to avoid an overtime situation with an employee who frequently eats meals at his or her work station, an employer may wish to require employees to leave their work stations during meal breaks.

**Time “Suffered” To Work**

An employee who voluntarily works overtime still must be paid for that time, even if the employee works overtime without being requested to do so and without permission to do so. An employee’s “voluntary” overtime, including time “made up” at the employee’s request, constitutes compensable time because the employee is being “suffered or permitted to work” for the benefit of the employer. If the employer knows or has reason to know that the employee is working overtime hours, and does nothing to prevent the employee’s conduct, the employer is responsible for the payment of overtime. A policy specifically disallowing unauthorized overtime may not be sufficient. The employer must be vigilant in ensuring that the policy is followed.

This rule is equally applicable to work performed at home. Moreover, employers are responsible for accurately recording and paying both minimum wage and overtime for employees who work from home.

Employers should make sure that all time worked is reported by the employee and paid. Even if an employee agrees that time will be unpaid, that promise is not binding on the employee. Steps employers can take to reduce the risk of FLSA violations include:

- Don’t allow employees to catch up over their lunch hours without writing the time down, even if the employee wants to;
- Compensate an employee who works overtime without permission, even if your policy requires advance approval;
- Develop a means for monitoring time worked at home;
- Do not permit informal “comp” time practices;
- Pay seminar or training time if the employee is required to attend or does work while attending.

**Compensatory Time Off – “Comp Time”**

Meeting overtime obligations by permitting time off instead of pay is risky and complicated. It is only effective if the pay period is longer than one week; the time off must be granted during the same pay period in which the overtime hours are worked. An example of permissible comp time occurs where Joe works 42 hours in week one of a two-week pay period, and he works only 37 hours in week two. It’s the employer’s responsibility to assure – and be able to prove – that Joe does not work more hours than permitted.
ENFORCEMENT

The FLSA is enforced by the U.S. Department of Labor, Wage & Hour and Public Contracts Division. A comprehensive wage and hour audit by the Department of Labor may be triggered by the complaints of just one employee. Either the DOL or an employee may bring a lawsuit against the employer for unpaid minimum wages, unpaid overtime compensation and liquidated damages, and an employee's lawsuit may be brought on behalf of other employees similarly situated.

The statute of limitations for actions for unpaid minimum wages, unpaid overtime compensation and liquidated damages under the FLSA is two years from the time the cause of action accrues. As a result, wage and hour audits by the Department typically cover a two-year period. However, the statute of limitations for willful violations is three years, and thus, some audits may cover three years. In the course of its investigation, the Department of Labor is authorized to enter the business premises to inspect records and interview employees. The Department may subpoena records, if necessary.

Failure to comply with the FLSA can be extremely costly. Violations of the wage and hour provisions may require the employer to pay employees an amount equal to the underpayment, plus an equal amount in liquidated damages. In addition, employers may be required to pay reasonable attorneys' fees and costs. The FLSA also contains an anti-retaliation provision. In one recent case discussed below, an allegation of retaliation for complaining about overtime pay problems resulted in a jury verdict of over $13 million for six employees.

The FLSA also provides that in the case of a willful violation, the Department may impose a fine of up to $10,000, imprisonment up to six months, or both. Any person who repeatedly or willfully violates the wage and hour provisions of the FLSA is subject to a penalty of up to $1,000 per violation. Violations of the child labor provisions may result in a penalty of $10,000 for each employee who was the subject of such a violation.
THE TERMINATION PROCESS

Terminating an employee is one of the worse aspects of an employer's responsibilities. An employer faces a number of potential pitfalls during the termination process. Especially with the growing number of lawsuits by former employees, employer must be mindful of the legal risks associated with terminating an employee. For instance, has the employee's employment history been documented to explain the justification for the termination? Has the employee received prior disciplinary actions? Have the employee's performance deficiencies been documented and noted to the employee? Has the employer over-documented the employee's deficiencies or documented the wrong deficiencies? Has the employee complained to management about discriminatory behavior in the workplace, which could lead to a retaliatory discharge claim? Is the employee a member of a protected class? These questions are considerations that the employer must evaluate and take into account when making the decision to terminate an employee.

Courts recently have been provided with ample opportunities to interpret and expand the laws governing the employee-employer relationship. Now more than ever, employers are exposed to great legal risks when terminating an employee. As a result, the employer needs to carefully consider the legal risks involved in the termination process more so than any other decision an employer makes. However, these risks do not begin when the employee is terminated. The risks began at the creation of the employment relationship and continue throughout the employee's tenure. How the employer structures the relationship (i.e., is the employment relationship at-will or governed by contract?) determines the manner of terminating an employee. The amount
and number of evaluations and disciplinary actions also impact the termination process and the employer's success if the employee sues for wrongful termination. In general, smart documentation throughout the employment relationship helps to protect the employer in employment-related issues.

**DOCUMENTATION DURING THE EMPLOYMENT RELATIONSHIP**

In addition to the structure of the employment relationship, the employer's actions throughout the employment relationship impact the employer's ability to terminate an employee. Documentation through performance evaluations and disciplinary reviews creates the record of the employment relationship which may be necessary to defend a lawsuit. Poor performance evaluations and numerous disciplinary actions serve as the evidence to explain the employer's rationale for discharging the employee. A sympathetic plaintiff is one who can argue that he was unaware of his performance problems and was provided good evaluations while employed. Consistent documentation of personnel issues through counseling and performance reviews provides the employer with useful evidence when defending against a wrongful termination claim.

Routinely and accurately evaluating your employee allows both the employer and employee to gauge the employee's performance and address problem areas at the initial stages. In addition, during evaluations of its employees, an employer must be alert to its manner and presentation of the review. A pattern of giving unrealistically low ratings may later be used as evidence of supervisory bias. Moreover, an employer is placed in a difficult position when it terminates an employee who received unrealistically high ratings. The best advice for the employer is to accurately reflect the employee's performance during the review. Sugar coating results only lead to future problems for
employers. Above all, communicate regularly and communicate honestly. Then, write down these communications.

Finally, evidence that an employer promptly took corrective action to address claims of harassment or other problems in the workplace has always been important in defending harassment lawsuits. However, especially with the Supreme Court's recent decision in *Faragher v. City of Boca Raton*, 118 S.Ct. 2275 (1998), and *Burlington Industries v. Ellerth*, 118 S.Ct. 2257 (1998) an employer's prompt remedial measures is essential to defend effectively a lawsuit brought by an employee alleging harassment. By providing an affirmative defense in hostile work environment lawsuit for supervisory harassment, the Supreme Court's message is that employers who take corrective measures to remedy workplace harassment are in a better defensive position if a lawsuit arises. Accordingly, taking prompt corrective actions when allegations of harassment arise and documenting the actions as record for potential lawsuits are additional safeguards to prevent future problems when deciding to terminate an employee.

Consistently performing evaluations of employees, documenting poor performance or behavior problems and efficiently addressing problems in the workplace leads to better employment relationship and places the employer in a better position when deciding to terminate an employee. Creating and then following a system to deal with its employee aids the employer in both its present relationship with the employee and later if it decides to terminate the employee.

**TERMINATING THE EMPLOYEE**

The termination of an employee is a precarious situation for an employer because of the possibility of a jury second-guessing the employer's decision years later. When the
employer decides to terminate an employee, the reality is that employees are increasingly likely to consider litigation as the means to remedy the situation.

Before deciding to fire someone, the employer should evaluate the litigation potential involved in the termination. A wrongful termination can be based on a number of theories, such as discrimination based on the employee's protected class, retaliation for engaging in protected activity, and constructive discharge. Evaluating the employee's litigation potential at this stage makes the employer more cognizant of what the employee may possibly allege in a lawsuit.

**TEN TIPS FOR TERMINATIONS**

**MAKING THE DECISION TO TERMINATE:**

1. Prepare for the termination. Gather and accurately document all the facts. This may include reviewing performance records, attendance records, and/or discipline records. Where appropriate, get witness statements as to what happened. Give the employee the opportunity to tell his/her side of the story. Basing the termination decision on the facts, not unsupported inference, suspicion, or emotion will likely lead to a favorable outcome.

2. Have someone review the termination decision. If an employee is being terminated for poor performance, consider whether the job requirements and/or behavior standards have been adequately communicated to the employee and whether the employee has had adequate time to learn the job and/or take corrective action to meet the requirements of the job.

3. Be consistent. Consider whether terminating the employee is consistent with your past disciplinary practices. While independently evaluating the circumstances surrounding any potential disciplinary action is important, consistency in your disciplinary practices is also important. Similar infractions should receive similar punishment. Consistency in termination decisions is an important and useful tool in defending challenged terminations.

4. Consider whether there is an alternative to discharge which would be preferable, i.e., warning, suspension, referral to an employee assistance program, reassignment, etc. While considering other options from discharge, do not avoid addressing the underlying problem with the
employee. Postponing a termination decision rarely makes the decision easier.

5. Consider whether legal advice should be sought. Is there a possibility that the employee will institute legal action such as a discrimination claim (race, age, sex, national origin, religion, disability, union activity), wrongful discharge claim, retaliation, and/or other claim?

6. Conduct the termination session in a manner sensitive to the employee's best interests. Conduct the meeting in a private place and come directly to the point. Give all the real reasons for the discharge, but don't throw in each and every shortcoming that comes to mind. Keep in mind that the discharge may have to be defended down the road. Consider scheduling the meeting at such a time and location that will minimize the employee's personal contact with other employees before he/she leaves the premises. In most circumstances, have a witness present during the meeting who can recall accurately what transpired. If a discrepancy arises about what was said, then another witness to the events is available.

7. Tell the employee the truth about why he or she is being terminated, but do not get too detailed. Do not sugar coat the termination because this can hurt you in the end.

8. Consider whether to seek a release from the employee. A release is an agreement with the employee in which you agree to pay the employee some money or other benefit to which he/she is not already entitled in exchange for the employee releasing the employer from any claims he/she may have against the employer. Use legal counsel to make sure your release will be enforced if it is ever challenged.

9. Restrict disclosing the reasons for the discharge to those with a clear business need to know. Do not "make an example" of the employee by suggesting to other employees that they could be subject to the same discipline if they fail to meet performance and/or behavior standards.

10. Be prepared for requests for recommendations from potential employers of your former employees. Generally, it is safest to confirm only name, position, and dates of employment. If a previous employee has been violent in the workplace, you may need to consider varying from this policy.
OVERVIEW OF THE REVISED UCC ARTICLE 9
(The Big Changes)

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SECTION H
OVERVIEW OF REVISED ARTICLE 9--SECURED TRANSACTIONS

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Revised Article 9, recommended to the states by the American Law Institute and the National Conference of Commissioners on Uniform State Laws in 1998, is the most substantial revision of Article 9 since Kentucky adopted the Uniform Commercial Code in 1958. The 1972 revisions, adopted in Kentucky in 1986, was more of a fine tuning of the original Article. Introduced and adopted by the 2000 Kentucky General Assembly as Senate Bill 11, Revised Article 9 makes wholesale changes to the law of secured transactions. The amendments are codified at KRS Chapter 355.9, in other parts of the UCC including Article 2 on sales and Article 8 on Investment Securities, and in related laws such as the title lien statutes at KRS Chapters 186 and 186A.

Thirty-one states and the District of Columbia have adopted Revised Article 9. The remaining states all now have bills pending. Ohio and Missouri are the only states bordering Kentucky that have not adopted Revised Article 9. The problem in Missouri and Ohio has been working out a compromise with filing officers who may no longer receive fees under the new law. The adoptions by Kentucky’s neighbors, particularly the bills in Indiana and Tennessee, vary little from the Model Act. The most significant variation in Indiana is that a debtor is required to "authenticate" a financing statement.

At least forty states are expected to be on board by the July 1, 2001 model effective date. Until all states have adopted the revisions there will be serious conflict of law issues and dual perfection systems that will require close analysis by commercial lawyers.

The scope of property and transactions covered by Article 9 is enlarged but the rules for creation, priority, enforcement, and particularly filing, are simplified and more user friendly. Revised Article 9 takes into account advances in technology, particularly the trend toward paperless transactions, new forms of collateral such as healthcare receivables, and new classes of collateral such as payment intangibles. Revised Article 9 also reflects the world of electronic transactions through terms such as "authenticated" that replaces the requirement for a manual signature. The new law distinguishes hard goods from software. However, the revisions recognize that some software becomes "embedded" in goods.

The drafters primarily intend the revisions to bring greater certainty to secured transactions and thus to reduce transaction costs. The new version resolves the uncertainty of the 1972 version on where to file to perfect security interests. Transactions that require records searches, legal research and compliance with the law (that sometimes includes a filing tax) of potentially all 50
states can be handled under Revised Article 9 in a single state. A new national form financing statement, which appears as a form in the model act, will be accepted in all jurisdictions that adopt the model version which also adds to both ease of compliance and certainty of perfection. The model form is found at 9-521. The information required by the model form exceeds the requirements of 9-502 for a valid financing statement. However, 9-502 does not even require an address for the parties. A financing statement without addresses for both the debtor and secured party can be rejected by a filing officer under 9-516.

What is more important, the law that adopts Revised Article 9 for Kentucky also adopts central filing of security interests in the office of the Secretary of State. Before the adoption of Revised Article 9, Kentucky was the only state in the union that maintained a purely local filing system. Eleven states continue to have some form of dual filing that will disappear as our sister states adopt Revised Article 9. There will be a five year transition period during which dual searches will still be required, however, by July 1, 2006 there will be a complete record of non-real estate related financing statements filed in the office of the Secretary of State and searchable on the web. Existing local filings remain valid after July 1, 2001 but any action other than termination, including continuation, must be taken through a new filing with the Secretary of State. The priority of the local filing will be preserved by reference to the old filing in the new "in lieu financing statement."

The scope of Article 9, the kinds of property in which a secured party can take a security interest, is larger. More forms of transactions, including the sale of payment intangibles and promissory notes, healthcare receivables, commercial tort claims, and security interests created by certain governmental debtors are included under the rules of Revised Article 9. The inclusion of deposit accounts under Revised Article 9 will be a major change for bankers and secured creditors who want to protect their rights in proceeds of collateral. Perfection on deposit accounts will be through control of the account, easy if you are the depository, more difficult if the account is held by a third party. The primary form of perfection of a security interest in most types of collateral will continue to be the filing of a financing statement. However, perfection through control, previously recognized for only investment property, is now expanded to letter of credit rights as well as deposit accounts.

Under current Article 9, the location of collateral determines what state’s law applies to the perfection of a security interest in collateral. In contrast, to simplify various conflict of law issues, Revised Article 9 will use the law of the state where the debtor resides. Any debtor created through a state registration (corporation, LLC, etc.) is deemed to reside in the state where the organization files its charter, or in which it is registered. Lenders must ascertain if their customers that are physically located in Kentucky are actually registered organizations under Kentucky law. The Secretary of State’s web site contains a key as to whether the organization is only registered to do business here or is a registered organization under our law. There will be no more conflicts over the location of the chief executive office, principal place of business, or registered agent. Most significantly, parties secured by collateral such as inventory of a company with nationwide operations will find their transactions costs significantly lowered and their credit administration simplified.

As all states move to only central filing, the goal is for filing systems to be searchable on the Internet. Fixtures and titled property are the only forms of collateral that will require local filing.
Perfection on crops will not require local filing. The filing fee schedule in most states, including Kentucky, anticipates and encourages electronic filing without the debtor’s signature. The fee in Kentucky will be $5.00 for electronic filings, $10.00 for paper filings, and $20.00 for paper filings in excess of two pages. Filing in Kentucky will be made simple through use of the Secretary of State’s web site. Both a financing statement and an amendment will be available in template form. If you pay the filing fee by credit card or a prepaid account, filing is as simple as the enter key on your PC. As long as the secured party has an authenticated security agreement, or other authorization to file a financing statement, it has the right to file in any form without the debtor’s signature. The secretary of state is adopting filing rules, as authorized by Revised Article 9, and will publish the administrative regulation on its web site.

A significant change for agricultural lenders is the new rules for obtaining a purchase money security interest in livestock. Now livestock fall under the same rule as equipment (trace your proceeds and perfect within 20 days). Beginning July 1, 2001, a PMSI lender on livestock will have to follow the same rules as an inventory lender, obtain the security interest, perfect the security interest, and notify all prior filed secured parties before the debtor takes possession of the livestock.

A new Part 4 of Article 9, governs the rights of third parties in secured transactions. Usually, as a matter of law, Part 4 voids anti-assignability provisions. However, there are many specific exceptions, such as one included in Kentucky’s bill to preserve the rights of the beneficiaries of structured settlements and supplemental needs trusts.

The former Part 4 on filing becomes Part 5 and the former Part 5 on enforcement rights becomes Part 6. The new part on enforcement rights makes a clear distinction between consumer and commercial transactions and recognizes the rights of "secondary obligors" such as guarantors. Consumers will be entitled to a notice of how a secured creditor calculates a post sale deficiency. While giving additional rights to consumers, the revisions to the enforcement rules also introduce the concept of a safe harbor notice of sale that removes questions as to the "commercial reasonableness" of the notice. A non-uniform section of Part 6 resolves the debtor’s argument that when a secured party obtains a repossession title in its before the foreclosure sale, it is a disposition that required a notice of sale.

Kentucky’s system for perfection on titled property was amended by the same bill that adopted Revised Article 9. Kentucky’s county clerks have encountered a problem with the title lien that is good forever, or until released by the secured party. The problem results from secured parties that have gone out of business or merged five times and the paid off account cannot be located. The resolution is a seven year sunset rule on title liens except for liens on manufactured housing which will be good for 30 years. The Transportation Cabinet is working on a system for continuing title liens and will promulgate an administrative regulation on the procedures to be used. It will probably involve a filing, for which no charge is authorized, with a county clerk. The fee for filing a title lien increases from $8.00 to $12.00 on July 1, 2001. Another change in Chapter 186 removes statutory and paperwork problems related to the assignment of security interests in motor vehicles and the securitization of motor vehicle paper.

Revised Article 9 brings secured transactions and the perfection of security interest into the digital age, reduces transaction costs, bring greater certainty to the process and expands debtor
protections in the foreclosure process but simultaneously gives creditors a set of rules that are more clear and easier to follow.
ETHICAL CONSIDERATIONS FOR
FINANCIAL INSTITUTION COUNSEL

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ETHICAL CONSIDERATIONS FOR FINANCIAL INSTITUTION COUNSEL:
A Quick Treatment of Three Significant Subjects

21st Annual Conference on Legal Issues for Financial Institutions
University of Kentucky College of Law
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I. Unauthorized Practice Issues in Real Estate and Banking Transactions
[See KBA Unauthorized Practice Advisory Opinion U-58 (attached)]

II. Trust Account Overdraft Reporting Requirements
[See SCR 3.130-1.15 and “Dear Bank Officer…,” Bench and Bar Magazine, March 1999 (attached)]

III. Representing an Organization through Individuals – Who is the Client?
[See SCR 3.130-1.13 (attached)]
May real estate closings be conducted by persons who are not real parties in interest without direct supervision of a licensed attorney?

No.

May title agencies or title insurance companies conduct real estate closings?

No.

**Unauthorized Practice of Law**

Only licensed attorneys may practice law in Kentucky. The practice is regulated exclusively by the Kentucky Supreme Court. The compelling reason for such regulation is to protect the public against rendition of legal services by unqualified persons. Kentucky Rule of Professional Conduct (RPC) 5.5. The practice of law is defined by SCR 3.020 as any service:

"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."

The "unauthorized" practice of law is the performance of those services contained in the definition by "non-lawyers" for "others".

It is not the unauthorized practice of law for a party to a real estate transaction to represent himself or to prepare closing documents to which he is a real party in interest, provided that no fee is charged to any other party. SCR 3.020 Otherwise only a licensed attorney may represent a closing party, prepare conveyancing or mortgage instruments, or charge a fee for legal services related to a real estate transaction. Frazee v. Citizens Fidelity Bank & Trust Co., 393 S.W.2d 778 (Ky. 1965); Federal Intermediate Credit Bank of Louisville v. Kentucky Bar Association, 540 S.W.2d 14 (Ky. S.Ct. 1976).

**Real Estate Closings**

Real estate closings typically have either two or three real parties in interest: seller and buyer, borrower and lender, or seller, buyer-borrower, and lender. Of these three, the least complex are the two-party closings of single sale or loan transactions involving the transfer of an interest in real estate, by deed or mortgage, for purchase money or loan proceeds. The sale of real estate financed by a third-party lender is the more complex because it involves separate sale and secured loan transactions in a simultaneous closing.

The "conduct" of a closing is the culmination of such transactions. Notwithstanding the standardization of real estate closing documentation, it is unrealistic and naive to assume that, in all instances, the settlement agent can present important legal documents to the seller, buyer, borrower,
and/or lender at a closing without legal questions being asked and without giving legal advice. The preparation and presentation of closing documents is an implied representation that the documents fulfill the requirements of the parties’ contractual commitments and the law, and that the documents have been reviewed and found to be legally sufficient. Real estate closings should be conducted only under the supervision of an attorney because questions of legal rights and duties are always involved, and there is no way of assuring that lay settlement agents would raise, or would not attempt to answer, the legal questions. State v. Buyer’s Service Co., 357 S.E.2d 15 (S.C. 1987). Whether stated or not, the person conducting the closing vouches for the legal sufficiency of the documents, whether complex, simple, or pre-printed. It does not matter whether the instruments are deemed simple or complex. As Judge Pound said when closing transactions were much less complicated than today, "The most complex are simple to the skilled, and the simplest often trouble the inexperienced." People v. Title Guaranty and Trust, 125 N.E. 666 (N.Y. 1919).

The legal questions present at a closing; whether asked or should be asked, are endless, as demonstrated by the attached appendix of issues affecting the quality of title and enforceability of documents. In summary, the contract of sale or the loan commitment must be reviewed and interpreted for contract compliance and remedies. Sufficiency of the legal description or survey plat and access to public ways and utilities must be determined. The title opinion or title insurance commitment must be reviewed and interpreted to inform the purchaser of its meaning and potential risks, and the effect of restrictions, encumbrances, and other title exceptions. The closing documents must be explained.

By its very nature a real estate closing involves substantial rights and liabilities. The parties approach the closing having made commitments with other parties and invested time and money in anticipation of a mutual understanding of their contractual obligations and trusting that all legal issues have been properly addressed. If a problem arises during closing and there is no attorney-client relationship, the parties are without the benefit of independent counsel and may lack the leverage or will to halt a transaction that is not in their best interests.

Closing Supervision by Attorney

An attorney need not be physically present at the closing, so long as it is in fact conducted under his supervision and control, but the responsible attorney must be familiar with the documentation and be available at the time of closing for consultation. He bears ultimate responsibility for the closing and is subject to disciplinary action for any act or omission which otherwise would be misconduct by him or his closing employees, as well as being legally accountable under the duty imposed by Seigle v. Jasper, 867 S.W.2d 476 (Ky. App. 1993). By failing to attend or supervise a closing, the attorney who is responsible for the documentation or who has examined and opined on the quality of title may be guilty of aiding or assisting lay settlement agents in the unauthorized practice of law contrary to SCR 3.470.

Closing by Institutional Lender

When an institutional lender is a real party in interest to a real estate transaction as mortgagee, its lay employee or in-house attorney may preside over the mortgage closing with a customer not represented by an attorney. Though institutional lenders, namely banks, savings and loans, and Farm Credit Services are not subject to the same disciplinary action as attorneys, the public is protected to some degree by state
and federal requirements for licensure, capitalization, oaths of directors and officers, insured deposits, and other regulations. The lender's employee may attend to the ministerial issues of financial matters, payments, and insurance related to the loan, as these are commonly non-legal functions. KBA U-31.

The lender's employee may also prepare or select and complete necessary "form" loan documents if no fee is charged, directly or indirectly, for such services, provided that the lender's own attorney or some other licensed attorney passes judgment on and is responsible for the documents as finally executed. Federal Intermediate Credit Bank of Louisville, supra.

However, institutional lenders may not by their employees or salaried attorneys provide title opinions to their borrowers because the "analysis of recorded interests in land coupled with an opinion as to its legal status" is a service lawfully performed for others only by a licensed attorney. Kentucky State Bar Association v. First Federal Savings & Loan Association of Covington, 342 S.W.2d 397 (Ky. 1961). Moreover, no lender's lay employee may undertake to give legal advice to or answer any questions posed by the borrower or any other transaction party involving interpretation of legal provisions of closing documents or other matters requiring legal knowledge or skill. When a legal question is asked or becomes apparent, the institutional lender employee should suspend the closing to consult legal counsel in order to avoid the unauthorized practice of law. (See KBA U 31.) Such employee may not conduct any part of a real estate closing other than the mortgage loan.

Closing by Title Companies

A distinction must be made as to lay settlement agencies such as title companies and title insurance companies which are not real parties in interest to the real estate or loan transactions. Their only interest is the payment of settlement fees. They act only as a conduit to exchange funds and documents. A lay settlement agency may compile and report factual information from the public records, including abstracts of title, but may not render title opinions. They may act as an agent or broker in connection with the issuance of title insurance commitments and policies, and may provide clerical services for a closing. KBA U-21; U-31. They do not conduct a closing or examine the required documents with an eye for protecting the independent legal rights of the seller, buyer, or lender. Such agencies are not regulated and owe no legal duties to the parties other than those imposed by agency or tort law. Their employees have no mandated educational prerequisites for real estate transactions or disciplinary oversight. A title agency may not conduct real estate closings or mask legal fees for closing services under the guise of a "settlement fee" or other charge. Their conduct of a closing absent independent legal counsel constitutes the unauthorized practice of law. Virginia UPL Opinion #183 (1996); Annotation, 85 A.L.R. 2d 184.
APPENDIX

Typical Questions at Real Estate Closings That May Involve Legal Advice

• the legal name, existence, and authority of an entity-grantor;
• the nature of the estate and quality of title conveyed;
• the effect of survivorship title on estate plans;
• the difference between special and general warranties, or no warranty at all, and the purchaser's remedies for title defects;
• generic deed exceptions for easements and other encumbrances of record;
• closure of a metes and bounds description or other description deficiencies;
• rights of access to public ways and utilities;
• interpretation and impact of zoning and other land use regulations;
• completion of promised improvements by the seller or subdivider;
• air and mineral rights;
• significance of deed covenants, conditions, and restrictions;
• upstream and downstream surface drainage;
• the presence of unacceptable dominant easements, or the lack of necessary servient easements appurtenant;
• the effect of adverse possession, prescriptive use, and the champerty statute;
• eviction of tenants and trespassers;
• release of statutory liens for labor and materials furnished, unemployment contributions and federal and Kentucky death taxes;
• survey and other exceptions in the preliminary title opinion or title commitment;
• what title policies cover and what they exclude;
• the duties and liability of title attorneys, real estate agents, and lenders;
• the rights to and limitations of future advances under open-end loans;
• remedies against defaulting parties;
• interpretation of environmental site assessments and remediation of contamination;
• survival of warranties, representations, and covenants, and indemnification;
• claims for latent defects in buildings;
• disclaimers in homeowner's warranties and termite inspection reports;
• disclosures of condition of property improvements, or of the agency and loyalty of a broker;
• the tax consequences of various matters in the closing;
• the effect of marital dissolution upon loan obligations; or
• the fine print of the so-called federal closing documents.
be accord the represented person the status of client, particularly in maintaining communication.

[3] If a legal representative has already been appointed for the client, the lawyer should ordinarily look to the representative for decisions on behalf of the client. If a legal representative has not been appointed, the lawyer should see to such an appointment where it would serve the client's best interests. Thus, if a disabled client has substantial property that should be sold for the client's benefit, effective completion of the transaction ordinarily requires appointment of a legal representative. In many circumstances, however, appointment of a legal representative may be expensive or traumatic for the client. Evaluation of these considerations is a matter of professional judgment on the lawyer's part.

[4] If the lawyer represents the guardian as distinct from the ward, and is aware that the guardian is acting adversely to the ward's interest, the lawyer may have an obligation to prevent or rectify the guardian's misconduct. See Rule 1.2(d).

Disclosure of the Client's Condition

[5] Rules of procedure in litigation generally provide that minors or persons suffering mental disability shall be represented by a guardian or next friend if they do not have a general guardian. However, disclosure of the client's disability can adversely affect the client's interests. For example, raising the question of disability could, in some circumstances, lead to proceedings for involuntary commitment. The lawyer's position in such cases is an unavoidably difficult one. The lawyer may seek guidance from an appropriate diagnostician.

SCR 3.130(1.15) SAFEKEEPING PROPERTY

(a) A lawyer shall hold property of clients or third persons that is in a lawyer's possession in connection with a representation separate from a lawyer's own property. Funds shall be kept in a separate account maintained in the state where the lawyer's office is situated, or elsewhere with the consent of the client or third person. The separate account referred to in the preceding sentence shall be maintained in a bank which has agreed to notify the Kentucky Bar Association in the event that any overdraft occurs in the account. Other property shall be identified as such and appropriately safeguarded. Complete records of such account funds and other property shall be kept by the lawyer and shall be preserved for a period of five years after termination of the representation.

(b) Upon receiving funds or other property in which a client or third person has an interest, a lawyer shall promptly notify the client or third person. Except as stated in this rule or otherwise permitted by law or by agreement with the client, a lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request by the client or third person, shall promptly render a full accounting regarding such property.

(c) When in the course of representation a lawyer is in possession of property in which both the lawyer and another person claim interests, the property shall be kept separate by the lawyer until there is an accounting and severance of their interests. If a dispute arises concerning their respective interests, the portion in dispute shall be kept separate by the lawyer until the dispute is resolved.

(d) A lawyer may deposit funds in an account for the limited purpose of minimizing bank charges. A lawyer may also participate in an IOLTA program authorized by law or court rule.

[Amended by Order 98-1, eff. 10-1-98; adopted by Order 89-1, eff. 1-1-90]

COMMENTARY

Supreme Court

1989: [1] A lawyer should hold property of others with the care required of a professional fiduciary. Securities should be kept in a safe deposit box, except when some other form of safekeeping is warranted by special circumstances. All property which is the property of clients or third persons should be kept separate from the lawyer's business and personal property and, if monies, in one or more trust accounts. Separate trust accounts may be warranted when administering estate monies or acting in similar fiduciary capacities.

[2] Lawyers often receive funds from third parties from which the lawyer's fee will be paid. If there is risk that the client may divert the funds without paying the fee, the lawyer is not required to remit the portion from which the fee is to be paid. However, a lawyer may not hold funds to coerce a client into accepting the lawyer's contention. The disputed portion of the funds should be kept in trust and the lawyer should suggest means for prompt resolution of the dispute, such as arbitration. The undisputed portion of the funds shall be promptly distributed.

[3] Third parties, such as a client's creditors, may have just claims against funds or other property in a lawyer's custody. A lawyer may have a duty under applicable law to protect such third-party claims against wrongful interference by the client, and accordingly may refuse to surrender the property to the client. However, a lawyer should not unilaterally assume to arbitrate a dispute between the client and the third party.

[4] The obligations of a lawyer under this Rule are independent of those arising from activity other than rendering legal services. For example, a lawyer who serves as an escrow agent is governed by the applicable law relating to fiduciaries even though the lawyer does not render legal services in the transaction.

[5] A "clients' security fund" provides a means through the collective efforts of the bar to reimburse persons who have lost money or property as a result of dishonest conduct of a lawyer. Where such a fund has been established, a lawyer should participate.

SCR 3.130(1.16) DECLINING OR TERMINATING REPRESENTATION

(a) Except as stated in paragraph (c), a lawyer shall not represent a client, or where representation has commenced, shall withdraw from the representation of a client if:

(1) The representation will result in violation of the Rules of Professional Conduct or other law;

(2) The lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client; or

(3) The lawyer is discharged.

(b) Except as stated in paragraph (c), a lawyer may withdraw from representing a client if withdrawal can be accomplished without material adverse effect on the interests of the client, or if:

(1) The client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent;
Dear Bank Officer;

I am writing to inform you of a new ethics rule which I am required to follow as a member of the Kentucky Bar. I need your assistance and cooperation to comply with this rule, because it relates to one or more accounts at your bank.

The new rule requires that I obtain an agreement from your bank to notify the Kentucky Bar Association if and when any overdraft occurs in any escrow or trust account established by me or my firm. I will identify the particular accounts to which the rule applies.

This overdraft reporting requirement is designed to help the KBA fulfill its mission of protecting the public by maintaining a proper discipline among members of the Bar. Experience in other states has shown that overdraft reporting rules are an effective means of identifying and correcting shortcomings in the management and application of client funds by practicing attorneys. The corollary benefit to the bank is that such problems are promptly resolved.

The rule recognizes that an overdraft is not always the lawyer’s fault. A report of overdraft does not constitute a complaint or allegation of misconduct by the bank against the attorney. It is merely an informational report which permits the Bar to investigate the circumstances and determine whether any action is necessary with respect to the attorney’s management of the account.

The new requirement appears in Rule 1.15 of the Kentucky Rules of Professional Conduct (SCR 3.130-1.15). Rule 1.15 has long required that I hold any funds of clients or third persons in one or more escrow or trust accounts separate from my personal and business accounts. The new requirement was added through an amendment to the Rule, effective October 1, 1998, to which the Supreme Court of Kentucky added the following sentence:

The separate account...shall be maintained in a bank which has agreed to notify the Kentucky Bar Association in the event that any overdraft occurs in the account.

A number of banks in Kentucky are already providing their attorney customers with letters confirming their agreement to notify the KBA of any overdraft in the escrow or trust accounts maintained by those attorneys. If your bank is unable to make such an agreement, it will be my ethical obligation to move my escrow and trust accounts to another bank that does report. I am therefore eager to provide you with the information you need to understand the new requirement and assist me in bringing my accounts at your bank into compliance with the rules of the Kentucky Supreme Court that govern my professional conduct.

In order to comply with the new requirement, I need to obtain a letter from your bank confirming your agreement to notify the Kentucky Bar Association if and when any overdraft occurs in any account to which the Rule applies. I am presently maintaining the following accounts at your bank which are subject to the new requirement:

[Identify all escrow accounts, trust accounts, real estate closing accounts and other “clearing” accounts which contain funds of clients or third persons.]

I will be responsible for updating this information when any escrow or trust account is opened or closed.
Your confirmation letter should identify each of these accounts by name and number, to avoid any misunderstanding as to which accounts will be “flagged” for overdraft reporting to the KBA.

The only other essential component of your letter is the confirmation that your bank agrees to report any overdraft in the specified account(s). It is sufficient for your letter to read as follows:

Dear Attorney:

Re: [List each account by name and number]

You have advised us that your firm maintains the above-referenced account(s) at our Bank, and that such account(s) contain (or may at times contain) funds of clients or third persons. You have further advised us that Rule 1.15 of the Kentucky Rules of Professional Conduct requires you to maintain any such account at a financial institution which agrees to notify the Kentucky Bar Association in the event that any overdraft occurs in the account.

Our Bank agrees to comply with the overdraft reporting requirement with respect to the above-referenced account(s). Accordingly, this will confirm that we will immediately notify the Office of Bar Counsel at the Kentucky Bar Association, 514 West Main Street, Frankfort, Kentucky 40601, if and when any properly payable instrument is presented for payment against an account identified above which contains insufficient funds to pay the instrument in full, whether or not the instrument is actually dishonored.

s/ Bank Officer

I will maintain your letter in my files as evidence of my compliance with the new requirement. I ask that you also send a copy of your letter directly to the KBA Office of Bar Counsel at the address indicated. This will provide the KBA with the name of the appropriate contact person at your bank in the event any question arises.

For purposes of the reporting requirement, an overdraft occurs whenever a properly payable instrument is presented against an account which contains insufficient funds to pay the instrument in full. It does not matter whether the instrument is actually dishonored or paid.

When an overdraft occurs, it must be reported to the KBA. The bank does not need to concern itself with the circumstances of the overdraft or the reason it occurred, because the KBA will investigate to determine whether any further action is necessary.

The notice to the KBA must be in writing, sent to the attention of the Office of Bar Counsel at the KBA as indicated in the sample confirmation letter. The notice must provide the KBA with enough basic information about the overdraft to initiate an inquiry — i.e., the name of the attorney (or firm), the account name and number, and the date and amount of the overdraft. Otherwise, the notice does not need to follow any particular form; it can simply be a duplicate copy of the overdraft notice sent to the attorney customer, so long as it is issued when there is any overdraft as defined above.

If you have any further questions regarding the new requirement, please contact Barbara S. Rea, Chief Bar Counsel, or Benjamin Cowgill, Jr., Chief Deputy Bar Counsel, at 502-564-3795. Otherwise, I look forward to receiving your letter confirming that you will notify the KBA of any overdraft in the accounts mentioned above. Please remember to send a copy of your letter to the Office of Bar Counsel.

Sincerely yours,
Member of the Kentucky Bar

ENDNOTES

1. SCR 3.025.
2. The Rule applies to all client escrow and trust accounts, whether or not they are part of the Kentucky IOLTA program (“interest on lawyers’ trust accounts”). Under IOLTA, the interest on pooled accounts is paid into the IOLTA Fund which, in turn, grants the funds to law-related charitable organizations. The overdraft reporting requirement is separate and distinct from participation in the IOLTA program.
SCR 3.130(1.13) ORGANIZATION AS CLIENT

(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.

[Adopted by Order 89-1, eff. 1-1-90]

COMMENTARY

Supreme Court

1989:

[1] This Rule generally parallels Rule 1.11. The term “personally and substantially” signifies that a judge who was a member of a multi-member court, and thereafter left judicial office to practice law, is not prohibited from representing a client in a matter pending in the court, but in which the former judge did not participate. So also the fact that a former judge exercised administrative responsibility in a court does not prevent the former judge from acting as a lawyer in a matter where the judge had previously exercised remote or incidental administrative responsibility that did not affect the merits. Compare the Comment to Rule 1.11. The term “adjudicative officer” includes such officials as judges pro tempore, referees, special masters, hearing officers and other parajudicial officers, and also lawyers who serve as part-time judges. Compliance Canons A(2), B(2) and C of the Model Code of Judicial Conduct provide that a part-time judge, judge pro tempore or retired judge recalled to active service, may not “act as a lawyer in any proceeding in which he served as a judge or in any other proceeding related thereto.” Although phrased differently from this Rule, those rules correspond in meaning.

[2] Officers, directors, employees and shareholders are the constituents of corporate organizational clients. The duties defined in this Comment apply equally to unincorporated associations. “Other constituents” as used in this Comment means the positions equivalent to officers, directors, employees and shareholders held by persons acting for organizational clients that are not corporations.

[3] When one of the constituents of an organizational client communicates with the organization’s lawyer in that person’s organizational capacity, the communication is protected by Rule 1.6. Thus, by way of example, if an organizational client requests its lawyer to investigate allegations of wrongdoing, interviews made in the course of that investigation between the lawyer and the client’s employees or other constituents are covered by Rule 1.6. This does not mean, however, that constituents of an organizational client are the clients of the lawyer. The lawyer may not disclose to such constituents information relating to the representation except for disclosures explicitly or impliedly authorized by the organizational client in order to carry out the representation or as otherwise permitted by Rule 1.6.

[4] When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer’s province. However, different considerations arise when the lawyer knows that the organization may be substantially injured by action of a constituent that is in violation of law. In such a circumstance, it may be reasonably necessary for the lawyer to ask the constituent to reconsider the matter. If that fails, or if the matter is of sufficient seriousness and importance to the organization, it may be reasonably necessary for the lawyer to take
steps to have the matter reviewed by a higher authority in the organization. Clear justification should exist for seeking review of the board of the constituent normally responsible for it. The stated policy of the organization may define circumstances and prescribe channels for such review, and a lawyer should encourage the formulation of such a policy. Even in the absence of organization policy, however, the lawyer may have an obligation to refer a matter to higher authority, depending on the seriousness of the matter and whether the constituent in question has apparent motives to act in variance with the organization's interest. Review by the chief executive officer or by the board of directors may be required when the matter is of importance commensurate with their offices or, in a matter of public business, in the absence of…….

[5] In an extreme case, it may be reasonably necessary for the lawyer to refer the matter to the organization's highest authority. Ordinarily, that is the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions highest authority resides elsewhere; for example, in the independent directors of a corporation.

Relation to Other Rules

[6] The authority and responsibility provided in paragraph (b) are concurrent with the authority and responsibility provided in other Rules. In particular, this Rule does not limit or expand the lawyer's responsibility under Rule 1.6, 1.8, 1.16, 3.3 and 4.1. If the lawyer's services are being used by an organization to further a crime or fraud by the organization, Rule 1.2(d) can be applicable.

Government Agency

[7] The duty defined in this Rule applies to governmental organizations. However, when the client is a governmental organization, a different balance may be appropriate between maintaining confidentiality and assuring that the wrongful official act is prevented or rectified, for public business is involved. In addition, duties of lawyers employed by the government or lawyers in military service may be defined by statutes and regulation. Therefore, defining precisely the identity of the client and prescribing the resulting obligations of such lawyers may be more difficult in the government context. Although in some circumstances the client may be a specific agency, it is generally the government as a whole. For example, if the action or failure to act involves the head of a bureau, either the department of which the bureau is a part or the government as a whole may be the client for purposes of this Rule. Moreover, in a matter involving the conduct of government officials, a government lawyer may have authority to question such conduct more extensively than that of a lawyer for a private organization in similar circumstances. This Rule does not limit that authority. See note on Scope.

Clarifying the Lawyer's Role

[8] There are times when the organization's interest may be or become adverse to those of one or more of its constituents. In such circumstances the lawyer should advise any constituent, whose interest the lawyer finds adverse to that of the organization of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation. Care must be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for that constituent individual, and that discussions between the lawyer for the organization and the individual may not be privileged.

[9] Whether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case.

Dual Representation

[10] Paragraph (e) recognizes that a lawyer for an organization may also represent a principal officer or major shareholder.

Derivative Actions

[11] Under generally prevailing law, the shareholders or members of a corporation may bring suit to compel the directors to perform their legal obligations in the supervision of the organization. Members of unincorporated associations have essentially the same right. Such an action may be brought nominally by the organization, but usually is, in fact, a legal controversy over management of the organization.

[12] The question can arise whether counsel for the organization may defend such an action. The proposition that the organization is the lawyer's client does not alone resolve the issue. Most derivative actions are a normal incident of an organization's affairs, to be defended by the organization's lawyer like any other suit. However, if the claim involves serious charges of wrongdoing by those in control of the organization, a conflict may arise between the lawyer's duty to the organization and the lawyer's relationship with the board. In those circumstances, Rule 1.7 governs who should represent the directors and the organization.

SCR 3.130(1.14) CLIENT UNDER A DISABILITY

(a) When a client's ability to make adequately considered decisions in connection with the representation is impaired, whether because of [minority] age, mental disability or for some other reason, the lawyer shall, as far as reasonably possible, maintain a normal client-lawyer relationship with the client.

(b) A lawyer may seek the appointment of a guardian or take other protective action with respect to a client, only when the lawyer reasonably believes that the client cannot adequately act in the client's own interest.

[Adopted by Order 89-1, eff. 1-1-90]

COMMENTARY

Supreme Court

1989: [1] The normal client-lawyer relationship is based on the assumption that the client, when properly advised and assisted, is capable of making decisions about important matters. When the client is a minor or suffers from a mental disorder or disability, however, maintaining the ordinary client-lawyer relationship may not be possible in all respects. In particular, an incapacitated person may have no power to make legally binding decisions. Nevertheless, a client lacking legal competence often has the ability to understand, deliberate upon, and reach conclusions about matters affecting the client's own well-being. Furthermore, to an increasing extent the law recognizes intermediate degrees of competence. For example, children as young as five or six years of age, and certainly those of ten or twelve, are regarded as having opinions that are entitled to weight in legal proceedings concerning their custody. So also, it is recognized that some persons of advanced age can be quite capable of handling routine financial matters while needing special legal protection concerning major transactions.

[2] The fact that a client suffers a disability does not diminish the lawyer's obligation to treat the client with attention and respect. If the person has no guardian or legal representative, the lawyer often must act as de facto guardian. Even if the person does have a legal representative, the lawyer should as far as possi-
UK/CLE

SHORT-COURSE ON THE NEW REVISED UCC ARTICLE 9

Saturday, April 21, 2001
REVISED ARTICLE 9
OF THE
UNIFORM COMMERCIAL CODE:
AN ANALYSIS OF PARTS I, II AND III

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SECTION J
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SECTION J
REVISED ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE: 
AN ANALYSIS OF PARTS I, II AND III 
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I. INTRODUCTION. 

As we enter into the 21st Century, technology is in an ever constantly changing state of flux. Likewise, the manner in which we conduct business has undergone resulting change, as well. In keeping stride with our changing business world, Article 9 of the Uniform Commercial Code ("UCC") has been significantly revised and expanded. It is poised to become law effective July 1, 2001, in nearly all states, including Kentucky. In the remaining states in which the Revised Statute has not actually been adopted, it is pending before the state legislatures and expected to be adopted.³ To minimize substantial problems in the transition process, it is the goal of the sponsors that the Revised Act be uniformly adopted by all states effective July 1, 2001. 

Article 9 of the UCC was first enacted into law in 1953. Since that time, it has been revised only three previous times. The first revision involved only minor changes, and in 1977 and 1994, Article 9 was revised to address changes in the securities industry. The current revision process commenced in 1990, ultimately culminating in an eight-year endeavor, the product of which is the present set of revisions. The new revisions 

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³ Revised Article 9 is pending in Alaska, Delaware, Hawaii, Illinois, Indiana, Kansas, Louisiana, Maine, Minnesota, Missouri, Oklahoma, Vermont, West Virginia, and Washington, D.C.
represent a major overhaul of Article 9's scope, substantive rules and procedures. In 1998, both the American Law Institute and the National Conference of Commissioners on Uniform State Laws approved Revised Article 9, and the Official Comments were issued in early 1999.

The Drafting Committee designed the revisions with the intent of establishing greater certainty, simplicity, and uniformity in the realm of financing transactions. The drafters attempted to accomplish those goals through two mechanisms:

(1) By expanding the scope of Article 9, in terms of both the property and transactions covered; and

(2) By simplifying and clarifying the rules governing the creation, perfection, priority and enforcement of security interests.

Most pronounced is the revised version's recognition and inclusion of current technologies' role in today's world of commercial and financing transactions. New technology has brought about major changes in the manner in which transactions occur. The drafters have expanded the scope of Article 9 to incorporate those changes.

At the same time, the drafters have attempted to simplify many of the rules and provisions to make them more "user friendly." Through the revisions, the drafters hope to reduce transaction costs, as well as credit costs.

II. SCOPE.

Article 9 governs consensual security interests in personal property and fixtures. While Revised Article 9 maintains the basic structure of Current Article 9, it significantly

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1 The New Article 9 Uniform Commercial Code, Steven O. Weise, at 1 (2d ed. 2000).
2 Id.
3 Id.
expands its scope. This expansion includes new types of property and transactions, as well as creating new definitions, modernizing and simplifying the filing system for financing statements, and adding new methods of perfection and new priority rules. The particular revisions will be discussed in detail below.

Article 9 continues to promote substance over form for purposes of determining Article 9’s application to a particular transaction. The label given by the parties to a particular transaction is irrelevant. 7 Regardless of the terms or characterizations given by the parties, Article 9 applies whenever a security interest within Revised Article 9’s scope is created. 8 As will be addressed below, the types of collateral within Article 9’s scope include not only personal property 9, fixtures 10, sales of accounts, 11 letter-of-credit rights, all of which are categories of collateral that are included within Current Article 9’s scope, but additionally include new types of collateral. Revised Article 9 now brings within its scope the following new categories of collateral: sales of payment intangibles, 12 sale of promissory notes, 13 agricultural liens, 14 goods held on consignment, 15 health-care-insurance receivables, 16 commercial tort claims, 17 commercial deposit accounts, 18

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7 UCC Revised §9-109(a)(1).
8 UCC Revised §9-109(a).
9 UCC Revised §9-109(a).
10 Id.
11 Id.
12 Id.
13 Id.
14 Id.
15 Id.
16 “Health Care Insurance Receivable” included within definition of “account” under UCC Revised §102(a); Revised §9-109(d)(8).
17 UCC Revised §9-102 definition of “account”; UCC Revised §9-109(d)(12).
18 UCC Revised §9-102(a)(26); §9-102(a)(29) (defining “deposit account”); §9-109(a)(13) (excluding “consumer deposit account”).
as well as electronic letter-of-credit rights. See U.C.C. Rev. §9-109(a) and Official Comment 4(a) to §9-101.

III. PARTIES.

Revised Article 9 clarifies the identities of the parties involved in a secured transaction. It has accomplished this by adding a new term, “obligor.”

A. DEBTOR VERSUS OBLIGOR.

(1) CURRENT ARTICLE 9.

Under Current Article 9, only two party terms are used: “debtor” and “secured party.” The term “debtor” refers not only to the person who owes payment or performance of the obligation secured by the collateral, but also includes the person who owns the collateral. This dual use of the term creates confusion when the collateral is owned by someone other than the borrower. In such an instance, the term “debtor” could mean either the borrower or the owner.

(2) REVISED ARTICLE 9.

Under Revised Article 9, the confusion has been eliminated with the inclusion of a new term, “obligor.” “Obligor” is the label given to the person who owes the obligation that is the subject of the security

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19 UCC Revised §9-102(a)(51); Revised §9-203(f).
20 UCC Revised §9-102(a)(59).
21 Current §9-105(1)(d).
interest.\textsuperscript{23} The term "debtor" refers to a person having an ownership interest in the collateral, other than the secured party or some other type of lienholder.\textsuperscript{24} "Secured parties and other lienholders are excluded from the definition of 'debtor' because the interests of those parties normally derive from and encumber a debtor's interest."\textsuperscript{25}

Under Current Article 9, "debtor" includes a seller of accounts or chattel paper.\textsuperscript{26} Revised Article 9 likewise including those categories of persons as "debtors" and, in addition, extends the definition, to sellers of payment intangibles and promissory notes,\textsuperscript{27} persons with a property interest in collateral subject to an agricultural lien,\textsuperscript{28} and consignees.\textsuperscript{29}

B. SECURED PARTY.

Under both Current Article 9 and Revised Article 9, the "secured party" is the person to whom a security interest is granted.\textsuperscript{30} Under Current Article 9, the term "secured party" includes buyers of accounts or chattel paper.\textsuperscript{31} Revised Article 9 not only incorporates those categories of secured parties, but additionally includes buyers of payment intangibles and promissory notes,\textsuperscript{32} holders of agricultural liens,\textsuperscript{33} and consignors.\textsuperscript{34}

\textsuperscript{23} Revised §9 - 102(a)(59).
\textsuperscript{24} Revised §9-102(a)(28)(A); Official Comment 2(a) to Rev. 9-102(a)(28)(A).
\textsuperscript{25} Official Comment 2(a) to Revised §9-102(a)(28)(A).
\textsuperscript{26} Current §9-105(1)(d).
\textsuperscript{27} Revised §9-102(a)(28)(B).
\textsuperscript{28} Revised §9-102(a)(28)(A).
\textsuperscript{29} Revised §9-102(a)(28)(C).
\textsuperscript{30} Current §9-105(1)(m); Revised § 9-102(a)(72)(A).
\textsuperscript{31} Current §9-105(1)(m).
\textsuperscript{32} Revised §9-102(a)(72)(D).
\textsuperscript{33} Revised §9-102(a)(72)(B).
\textsuperscript{34} Revised §9-102(a)(72)(C).
IV. COLLATERAL.

Current Article 9 classifies collateral into a variety of categories. Revised Article 9 retains those classifications, while at the same time expanding the types of collateral and the kinds of transactions governed. In addition, new terminology has been added, and definitions of historical Article 9 terminology have been significantly revised. The traditional collateral categories includes accounts, inventory, equipment, instruments, investment property, chattel paper, consumer goods, firm products and general intangibles. Revised Article 9 expands the categories of collateral within its scope to include the following: commercial tort claims, deposit accounts, electronic chattel paper, health-care-insurance receivables, non-possessory statutory agricultural liens, and software. In addition, Article 9 brings within its scope the sale of payment intangibles and promissory notes. These will be discussed individually at length below.

Some of the new categories of collateral are simply not subject to the provisions of Current Article 9. They include deposit accounts, health-care-insurance receivables, agricultural liens, and commercial tort claims. However, other types of categories that are now been expressly included in Revised Article 9, have been construed as coming within the scope of Current Article 9, but are not specifically addressed. They include sales of payment intangibles, electronic chattel paper, and software. They have been construed as falling within the broader collateral category of "general intangibles."\textsuperscript{35}

\textsuperscript{35} The New Article 9, at 21: John M. McElroy, It's new! It's (somewhat)complicated! It's (going to be) law! It's UCC Article 9 Revisions, The Journal of Lending and Credit Risk Management.
A. GOODS.

The definition of "goods" is substantially the same in both the Current Article 9 and Revised Article 9. "Goods" means "all things that are moveable when a security interest attaches." Excluded from the definition are: money, documents, instruments, investment property, accounts, chattel paper, and general intangibles, as well as minerals before extraction. Revised Article 9 extends the exclusions to include deposit accounts and letter-of-credit rights.

The category of "goods" is divided into four subcategories: consumer goods, inventory, farm products, and equipment. The four classes of goods are mutually exclusive. Thus, the same property cannot simultaneously fall into two separate categories of "goods." However, goods can fall into different classes at different points of time. For example, a television set maybe inventory while in the possession of a retail store, but a consumer good once in the hands of the purchaser. The four categories of "goods" will be discussed as follows.

(1) CONSUMER GOODS.

Under both Current Article 9 and Revised Article 9, "consumer goods" are goods that are "used or bought for use primarily for personal, family, or household purposes." Thus, the classification turns on the debtor's intended purpose for the goods.

36 Current §9-105(1)(h); Revised §9-102(a)(44).
37 Revised §9-102(a)(44).
38 Official Comment 4(a) Rev. §9-102.
39 Id.
40 Current §9-109(1); Rev. §9-102(a)(23).
41 Official Comment 4(a) Rev §9-102.
(2) INVENTORY.

Under both Current Article 9 and Revised Article 9, “inventory” consist of goods, other than farm products, which are: (1) leased by a person as lessor; (2) held by a person for sale or lease or to be furnished under a contract of service; (2) furnished by a person under a contract of service; or (4) raw materials, work in process, or materials used or consumed in a business. \(^42\)

(3) FARM PRODUCTS.

Revised Article 9 expands the definition of farm products that exist under Current Article 9. Under Current Article 9, to constitute “farm products,” goods must: (1) be in the possession of the debtor, and (2) the debtor must be a farmer. \(^43\) Under Revised Article 9, goods are “farm products” if they are “goods, other than standing timber, with respect to which the debtor is engaged in a farming operation.” In addition, the goods must either be (1) crops, (2) livestock, (3) supplies used or produced in a farming operation, or (4) products of crops or livestock in their unmanufactured state. \(^44\) Significantly, the terms “crops” and “livestock” are not defined. \(^45\)

\(^{42}\) Current §9-109(4); Rev. §9-102(a)(48); Official Comment 4(a) to Rev. §9-102.

\(^{43}\) Current §9-109(3).

\(^{44}\) Revised §9-102(a)(34).

\(^{45}\) Official Comment 4(a) to Rev. §9-102.
Revised Article 9 expressly extends the term “farming operations” to include aquatic farming operations, and extends the term “farm products” to include aquatic goods.\textsuperscript{46}

It is important to note that under both Current Article 9 and Revised Article 9 crops, livestock, and the products thereof cease to be “farm products” when they cease to be used in the debtor’s farming operations. For example, once a poultry farmer sells eggs to a manufacturer or distributor, they cease to be farm products and, instead, become inventory of the manufacturer or distributor.

Also significant, is the fact that products of crops or livestock lose their status as “farm products” if they are subject to a manufacturing process, even if they remain in the possession of a person engaged in farming operations. For example, once a crop, such as green beans, is subjected to an extensive canning operation, it would then be classified as being in a manufactured state. On the other hand, some processes are “so closely connected with farming – such as pasteurizing milk or boiling sap to produce maple syrup or sugar – that they would not constitute manufacturing.”\textsuperscript{47}

\textsuperscript{46} Revised §9-102 (a) (34); The New Article 9, at 22.
\textsuperscript{47} Official Comment 4(a) to Rev. §9-102.
(4) EQUIPMENT.

Under both Current Article 9 and Revised Article 9, “equipment” is a residual category. It is defined as “goods other than inventory, farm products, or consumer goods.”

B. GOODS VERSUS SOFTWARE.

Revised Article 9 specifically addresses “software.” With today’s technology, software is often an integral part of a particular good. Revised Article 9 draws a distinction between “goods” and “software.” When software is an integral part of the goods, Revised Article 9 treats the software as “goods,” as well. However, when the software maintains its independence, it is considered a “general intangible.” Thus, “the term does not include a computer program embedded in goods that consists solely of the medium on which the program is embedded.”

C. INVESTMENT PROPERTY.

The category of “investment property” is comprised of certificated and uncertificated securities, securities accounts, and security entitlements. These are defined in Article 8 of the UCC. Commodity contracts and commodity accounts are additionally included within the category of “investment property.”

The rules governing investment property are contained in Current Article 9 in §9-115. Revised Article 9 continues the rules governing investment property;

48 Current §9-109(2); Rev §9-102(a)(33).
49 Rev. §9-102(44); see also The New Article 9, at 2.
50 UCC §115(1)(f); Rev. § 9-102(a)(49); UCC §§ 8-102(a)(15)(defining “security”), 8-501, 8-102(a)(17)(defining “security entitlement”).
51 Current 9-115 (1)(a) and (b); Rev. §9-102(a)(14)(15).
however, the rules are no longer found in one section. Rather, Revised Article 9 distributes the rules governing investment property to the relevant provisions throughout the Revised Article pertaining to the particular subcategories of "investment property."52

D. SEMI-INTANGIBLES.

Certain types of movables have been described as "conventional tangible embodiments of intangible rights of the debtor." 53 Those types of movables include instruments, documents, chattel paper and letter-of-credit rights. Each of those semi-intangibles will be addressed as follows.

(1) INSTRUMENTS.

An "instrument" is defined by Revised § 9-102 (a) (47) as "a negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in the ordinary course of business is transferred by delivery with any necessary endorsement or assignment." Thus, the term includes not only negotiable instruments governed by UCC Article 3, but also other writings evidencing a right to the payment of money that, in the ordinary course of business, are transferred by delivery accompanied by any necessary endorsement or assignment.

It is significant to note that Revised Article 9 has defined "promissory notes" as a subset of "instruments."54 While Current Article 9 additional includes promissory notes as a category of collateral in credit

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52 The New Article 9, at 3 and 22.
53 Id. at 22.
transaction. Revised Article 9 includes "the sale of promissory notes" in recognition of the fact that the sale of a promissory note can function as a financing transaction.\textsuperscript{55} The term does not, however, include leases, investment property, letters-of-credit, or writings evidencing a right to payment arising out of the use of a credit or charge card.\textsuperscript{56}

(2) DOCUMENTS.

Under both Current Article 9 and Revised Article 9, a "document" means a document of title. This includes bills of lading and warehouse receipts.\textsuperscript{57}

(3) CHATTEL PAPER.

Both Current Article 9 and Revised Article 9 define "chattel paper" as including any writings that evidence both a monetary obligation and a security interest in specific goods or a lease of specific goods.\textsuperscript{58} Significantly, under Revised Article 9, chattel paper may now be evidenced by electronic records, as well as by a writing. Additionally, chattel paper includes not only security interests or leases in specific goods, but also in the software used in those goods.\textsuperscript{59}

In clarifying Revised Article 9's inclusion of "electronic chattel paper," the Official Comments to Revised § 9-102 state that "the
definition of electronic chattel paper does not dictate that it be created in any particular fashion. For example, a record consisting of a tangible writing may be converted to electronic form." Likewise, "records may be initially created and executed in electronic form. In both cases, the resulting records are electronic chattel paper." Id.

Lastly, Revised Article 9 contains two exclusions with regard to the term “chattel paper.” First, charters of vessels are expressly excluded from the definition. They are instead “accounts.” The term “charter” includes “barefoot charters, time charters, successive voyage charters, contracts of affreightment, contracts of carriage, and all other arrangements for the use of vessels.” Also, excluded from the definition are records evidencing a right to payment arising out of the use of a credit or charge card.

(4) LETTER-OF-CREDIT RIGHTS.

Current Article 9 uses the term "rights to proceeds of a written letter-of-credit." That term was defined to mean a beneficiary’s right to payment upon a drawing under a letter-of-credit. In comparison, Revised Article 9 uses a slightly different term. The revisions incorporate the term "letter-of-credit right," which is defined by the Revised Article to mean a right to payment or performance under a letter-of-credit. Letter-of-credit rights are included within the scope of Revised Article 9 whether

60 Revised § 9-102 (a) (11).
61 Official Comment 5b to Revised §9-102.
62 Current § 9-105 (3).
63 Current § 5-102.
the letter-of-credit is written or electronic. The term does not, however, include "the right of a beneficiary to demand payment or performance under a letter-of-credit." This difference grows out of UCC Article 5's transfer of a beneficiary's right to demand payment or performance is governed by Article 5. Section 5-114(e) provides that "the rights of a transferee beneficiary or nominated person are independent of the beneficiary" assignment of the proceeds of a letter-of-credit and are superior to the assignee" right to the proceeds." Thus, Article 9 recognizes the independent and superior rights of a beneficiary transferee under Article 5.65

E. OTHER INTANGIBLES.

Revised Article 9 has broadened the scope of "other intangibles." Current Article 9 recognizes only two types of pure intangibles that are not investment properties: accounts and general intangibles. Revised Article 9 broadens this category to additionally include deposit accounts and commercial tort claims. Revised Article 9 also expands the definition of "accounts" to now include certain rights to payment that presently fall within the definition of "general intangibles" under Current Article 9.

(1) ACCOUNTS.

Under Current Article 9, an "account" is defined as a right to payment for goods sold or leased, or for services rendered that is not

64 Revised § 9-102 (a) (51); Official Comment 5(e) to Revised § 9-102.
65 Official Comment 4 to Rev. §9-108.
evidenced by an instrument or chattel paper. Under Revised Article 9, the definition of "account" has been expanded and reformulated. It is no longer limited to rights to payment relating only to goods or services. Many categories of rights to payment classified as "general intangibles" under Current Article 9 are now classified as "accounts" under Revised Article 9. Accordingly, under the Revised classifications, "accounts" includes a right to payment, whether or not earned by performance, arising from: the sale of real property; the licensing of intellectual property; the issuance of a policy of insurance; a secondary obligation incurred or to be incurred; energy provided or to be provided; the use or hire of a vessel under a charter or other contract; the use of a credit card or charge card; and licensed lottery winnings.66

In addition, the revised definition of "account" now specifically includes health-care-insurance receivables, previously excluded by Current Article 9. A "health-care-insurance receivable" is defined as an "interest in or claim under a policy of insurance which is a right to payment of a monetary obligation for health-care goods or services provided."67

(2) DEPOSIT ACCOUNT.

A "deposit account" is an account maintained with a bank. The term includes demand accounts, time savings accounts, passbook

66 Revised § 9-102 (a) (2); Official Comment 5(a); The New Article 9, at 24.
67 Revised § 9-102 (a) (2) and (46); Official Comment 5(a)
accounts, and other similar bank accounts. The term does not, however, include investment property or an account evidenced by an instrument.68

The revised definition clarifies the proper treatment of non-negotiable or uncertificated certificates of deposit. Under the revised definition, an uncertificated certificate of deposit comes within the parameters of a "deposit account" (assuming there is no written document evidencing the bank's obligation to pay), while a non-negotiable certificate of deposit constitutes a "deposit account" only if it is not an "instrument" as defined by Revised § 9-102. As Official Comment 12 to Revised § 9-102 makes clear, that determination turns on whether the non-negotiable certificate of deposit is "of a type that in ordinary course of business is transferred by delivery with any necessary endorsement or assignment."

(3) COMMERCIAL TORT CLAIMS.

Current Article 9 excludes tort claims from its scope. Revised Article 9 continues to exclude personal tort claims; however, the Revised Article makes an exception for "commercial tort claims," bringing those within its scope.69 Under Revised Article 9, the definition of "commercial tort claims" encompasses two types of tort claims: (1) a claim of an organization arising in tort; and (2) a claim of an individual arising in the

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68 Revised § 9-102 (a) (8) and (29); Official Comment 12 to Revised § 9-102.
69 Revised § 9-102 (a) (13); Revised § 9-109 (d) (12).
course of the individual's business, as long as it does not involve a personal injury.\textsuperscript{70}

It is important to note that a secured party may not take a security interest in an after-acquired commercial tort claim.\textsuperscript{71}

Lastly, if a security interest is granted in a commercial tort claim, the security agreement must describe the commercial tort claim with specificity.\textsuperscript{72}

(4) GENERAL INTANGIBLES.

Current Article 9 defines "general intangibles" as personal property other than goods, accounts, chattel paper, documents, instruments, investment property, rights to proceeds of written letters-of-credit, or money.\textsuperscript{73} Revised Article 9 retains that definition, but expands the exclusions to encompass commercial tort claims and deposit accounts. As addressed above, those types of property are now incorporated as separate categories of Revised Article 9. Additionally, Revised Article 9 uses the term "letter-of-credit rights," rather than the more narrow term "right to proceeds of written letters-of-credit," used in Current Article 9.\textsuperscript{74}

Revised Article 9 adds two special subcategories to the category of "general intangibles": payment intangibles and software. A "payment intangible" is defined by the Revised Article as a general intangible under

\textsuperscript{70} Revised § 9-102 (a) (13).
\textsuperscript{71} Revised § 9-204 (b) (2).
\textsuperscript{72} Revised § 9-108 (e) (1).
\textsuperscript{73} Current § 9-106.
which the principle obligation of the account debtor is to pay money.\textsuperscript{75}

"Software" is defined by the Revised Article as "a computer program and any supporting information provided in connection with a transaction relating to the program." It is important to note, however, that the term does not include a computer program that is included in the definition of "goods."\textsuperscript{76} That is, software that has become an integral part of a particular good.

V. ATTACHMENT.

The term "attachment" refers to the creation of a security interest. It specifically refers to the moment at which a security interest becomes enforceable against the debtor.\textsuperscript{77} The current rules for creation and attachment of a security interest remain substantially the same in many respects under the new revisions. Both versions require basically three elements for an attachment to occur: (1) value must be given; (2) the debtor must have rights in the collateral; and (3) the collateral must be in the possession of the secured party by agreement of the debtor, the secured party must have "control" of the collateral for certain types of designated property, or the debtor must have executed a security agreement that contains a description of the collateral.\textsuperscript{78}

Revised Article 9 expands the types of collateral in which attachment may occur by the secured party taking "control" of the collateral. Additionally, it alters to some extent the requirements for executing a security agreement. Lastly, Revised Article 9 provides for automatic perfection of a security interest in several circumstances,

\textsuperscript{74} Revised § 9-102 (a) (42).
\textsuperscript{75} Revised § 9-102 (a) (61).
\textsuperscript{76} Revised § 9-102 (a) (75); The New Article 9, at 25.
\textsuperscript{77} Current § 9-203 (2); Revised § 9-203 (a); The New Article 9, at 25.
including the sale of payment intangibles, the sale of promissory notes and supporting obligations.

The individual requirements necessary for attachment of a security interest are:

A. VALUE.

Value is deemed to have been given where there is any consideration sufficient to support a simple contract. Value not only includes loans of money, a binding contract to lend money, the issuance of a guaranty, but also includes whole or partial satisfaction of pre-existing claims, as well as value previously given.79

B. RIGHTS IN THE COLLATERAL.

A debtor must possess rights in the collateral before the debtor can grant a security interest therein. That is, a debtor can only grant a security interest in the ownership or other rights it holds with regard to the collateral. Likewise, a secured party can only obtain security interests in collateral to the extent of the debtor’s rights in that collateral.80 Significantly, however, Revised Article 9 does clarify that a debtor’s "power to transfer collateral" is sufficient to satisfy the "rights in the collateral" requirement.81

C. SECURITY AGREEMENTS.

The third element necessary for attachment requires the debtor to execute a security agreement, or in the alternative the secured party may take possession or control (in certain instances) of the collateral. To execute a valid security agreement, the

78 Current § 9-203 (1); Revised § 9-203 (b).
79 UCC § 1-201 (44) (b); The New Article 9, at 25.
80 Current § 9-203 (1); Revised § 9-203 (b); Official Comment 62 to Revised § 9-203.
81 Revised § 9-203 (b) (2).
Article 9. A "reasonable identification" may be provided in a variety of ways; In addition to requiring the debtor to authenticate the security agreement, Revised § 9-203 (b) (3) (A) mandates the debtor to "authenticate" a security agreement that "provides a description of the collateral." The term "authenticate" replaces the term "sign." While the term "authenticating" includes "signing," it additionally includes encrypting a record.82 Thus, a debtor may now not only sign a written document in order to execute a security agreement, but may in the alternative execute an electronic transmission.83

In addition to requiring the debtor to authenticate the security agreement, Revised § 9-203 (b) (3) (A) additionally requires that the security agreement contain a description of the collateral. This requirement is retained from Current Article 9.84 A "reasonable identification" may be provided in a variety of ways; including, a specific listing, category, type, quantity, or computational formula.85 However, the Revised Article makes it clear that an overly general description of collateral, such as, "all the debtor's assets" or "all the debtor's personal property," does not constitute a sufficient description of collateral.86

A detailed description of collateral is required where the collateral in which a security interest is taken is a commercial tort claim, consumer goods (in the case of a consumer transaction), a security entitlement, a securities account, or a commodity account. A description only by "type" is insufficient in those

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82 Revised § 9-203 (b) (3) (A); Revised § 9-102 (a) (7).
84 Current § 9-203 (1).
85 Revised § 9-108 (b).
86 Revised § 9-108 (c).
instances. Finally, if the collateral is "timber to be cut," a real-estate description is required to be included in the security agreement.

D. POSSESSION AND CONTROL BY THE SECURED PARTY.

Under Current Article 9, the secured party is given two options in lieu of a security agreement. The secured party may either possess the collateral or, if the collateral is investment property, the secured party may acquire "control" of the property. Revised Article 9 has retained those two options, while at the same time expanding them.

(1) POSSESSION.

While a secured party could satisfy the possession requirement under both Current Article 9 and Revised Article 9 by taking possession of the collateral, Revised Article 9 expands this option. The possession requirement may now be satisfied through the possession of the collateral by a third party. The possession requirement is met if the third party is in possession of the collateral by agreement of the debtor and the third party authenticates a record acknowledging that it holds the collateral for the secured party.

In situations where the collateral is a certificated security in registered form, Revised Article 9 requires that the certificated security be delivered to the secured party under § 8-301.

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87 Revised § 9-108 (e).
88 Revised § 9-203 (b) (3) (A).
89 Current § 9-203 (1).
90 Revised § 9-203 (1) (a).
91 Revised § 9-102 (a) (7) and (69); Revised § 9-203 (b) (3) (B); Revised § 9-313 (c) (1).
92 Revised § 9-203 (b) (3) (C).
(2) CONTROL.

Current Article 9 allows the third requirement of attachment to be met by "control" where the collateral is investment property. The concept of "control" is expanded under Revised Article 9 to include not only investment property, but also deposit accounts, electronic chattel paper and letter-of-credit rights. 93

(3) PRACTICE POINTERS.

As a matter of good practice and sound business judgment, a secured party should always obtain a security agreement whenever possible, even where Article 9 permits a security interest to be perfected by control or possession. A security agreement not only provides better evidence of the transaction, it also provides an opportunity to obtain numerous contractual protections that augment the rights provided a secured party under Article 9.

E. AFTER-ACQUIRED PROPERTY.

Revised Article 9 continues the rules set forth in Current Article 9 regarding after-acquired property. Both versions of Article 9 permit the attachment of a security interest in after-acquired property. 94

Revised Article 9 continues Current Article 9's limitation with regard to after-acquired consumer goods. Under both versions, a security interest may not be granted in after-acquired consumer goods as original collateral, unless the

93 Revised § 9-203 (b) (3) (G).
94 Current § 9-204 (1); Revised § 9-204 (a).
debtor acquires rights in those goods within 10 days of the secured party giving value.95

Significantly, however, there is one additional class of after-acquired collateral that Revised Article 9 precludes creditors from taking a security interest: commercial tort claims. As discussed above, commercial tort claims are new to Revised Article 9. Revised Article 9 provides that a security interest can only attach to current commercial tort claims existing at the time the security interest is authenticated.96

F. SUPPORTING OBLIGATIONS.

The term "supporting obligation" is new in Revised Article 9. It is defined as a letter-of-credit right or secondary obligation that supports the payment or performance of an account, chattel paper, document, general intangible, instrument or investment property. Revised Article 9 recognizes that a secured party typically desires to obtain a security interest in the secondary, supporting obligation, as well as in the original collateral, itself.97 Thus, Revised Article 9 treats the supporting obligation as "part and parcel of the collateral it supports."98 Revised Section 9-203(f) expressly provides that the attachment of a security interest in collateral effects an automatic attachment of a security interest in any supporting obligations, as well.99

95 Current § 9-204 (2); Revised § 9-204 (b) (1).
96 Revised § 9-204 (b) (2); See also The New Article 9, at 27; Official Comment to Revised § 9-204 (b)(2).
97 Id.
98 Id.
99 Revised § 9-203 (f).
G. FUTURE ADVANCES.

Revised Article 9 continues Current Article 9's treatment of security interests in future advances. Under both versions, a security interest may secure future advances and provide for cross-collateralization of obligations. Importantly, however, several cases under Current Article 9 required the future advances to be of the same type or otherwise related to the original advance. Official Comment 5 to Revised § 9-204 expressly rejects the holding of those cases, and eliminates such requirements.

H. PROCEEDS.

Under both Current Article 9 and Revised Article 9, the attachment of a security interest in collateral also gives rise to a security in the proceeds of that collateral. While under both versions of Article 9, "proceeds" refers to whatever is received upon the sale, exchange, collection, or other disposition of collateral, Revised Article 9 greatly expands the definition to include: (1) rights and claims arising out of the collateral; (2) collections on and distributions on account of the collateral; and (3) claims arising from insurance proceeds paid as a result of loss, damage to, defects in, or nonconformity of the collateral.

Revised Article 9 also includes a new provision addressing the situation that arises when proceeds are commingled with other property. Revised Section 9-315 (b) adopts the position of many cases under Current Article 9 that common law tracing methods may be utilized.

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100 Current § 9-204 (3); Revised § 9-204 (c).
102 Current § 9-306 (2); Revised § 9-203(f) and § 9-315 (a) (2).
103 Current § 9-306(1); Revised § 9-102 (a) (64).
VI. PERFECTION.

Once a security interest has attached, additional steps must be taken to "perfect" that interest. "Perfection," in general, protects the secured party against other creditors and transferees of the debtor, including any representatives of creditors in insolvency proceedings instituted by or against the debtor.¹⁰⁵ A security interest is perfected if it has attached and all of the requirements for perfection as set forth in Revised §§ 9-310 through 9-316 have been satisfied.¹⁰⁶

Revised Article 9 for the most part retains, but clarifies, the former rules. It additionally expands to some extent the methods for perfection.

There are three primary ways in which to perfect a security interest once it has attached, which vary somewhat depending upon the nature of the collateral.¹⁰⁷ First, the secured party may file a properly completed financing statement in the appropriate UCC filing office(s) for most types of collateral.¹⁰⁸ Second, the secured party may take possession of the collateral (for “possessable” collateral), or for certain specified types of collateral may assert control thereof.¹⁰⁹ Third, in a few specified situations, the security interest may be automatically perfected upon attachment.¹¹⁰

A. PERFECTION BY FILING.

Most security interests may be perfected by filing a properly completed financing statement in the appropriate UCC filing office(s).¹¹¹ The required

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¹⁰¹ Revised § 9-102 (a) (64) (A)-(E).
¹⁰² Official Comment 2 to Revised § 9-308; See also Revised § 9-317.
¹⁰³ Revised § 9-308.
¹⁰⁴ Only an “attached” security interest may be perfected. Revised § 9-308.
¹⁰⁵ Current § 9-302 (1); Revised § 9-310 (a).
¹¹² Current § 9-302 (1); Revised § 9-310 (a).
contents of the financing statement, as well as the rules for filing, are addressed in Parts IV and V of Revised Article 9, and are outside the scope of this paper.

B. PERFECTION BY POSSESSION.

(1) POSSESSION REQUIRED: MONEY.

Under both Current Article 9 and Revised Article 9, certain types of collateral are required to be perfected by the method of possession. Under Current Article 9, possession is required where the collateral is money, an instrument, or a written letter-of-credit. While Revised Article 9 retains the possession requirement for perfection of a security interest in money, it has revised the rule as applied to instruments and letter-of-credit rights.

(2) INSTRUMENTS.

Under Revised Article 9, a security interest in an instrument may be perfected by either possession or filing. Nevertheless, it is essential to note that such a perfected security interest may in some circumstances still be defeated by others, e.g., a holder in due course. See VII.A. below, addressing priority issues as effected by Articles 3, 7 and 8.

(3) LETTER-OF-CREDIT RIGHTS.

Under Revised Article 9, "possession" of a written letter-of-credit will no longer be effective to perfect a security interest in that collateral.

112 Current § 9-304 (1).
113 Revised § 9-312 (b) (3).
114 Revised §§ 9-312(a) and 9-313 (a).
security interest in a letter-of-credit must be perfected by control (discussed below). There is one exception to this rule: where a security interest is taken in a letter-of-credit right that is a supporting obligation. In that instance, the security interest is automatically perfected, if the security interest in the related collateral has been perfected.

(4) OTHER TYPES OF COLLATERAL WHERE PERMISSIVE POSSESSION IS ALLOWED.

There are additional types of property where both Current Article 9 and Revised Article 9 permit perfection by possession. Perfection may be accomplished by possession where the collateral falls into one of the following categories: goods, negotiable documents and certificated securities (as distinguished from uncertificated securities). Chattel paper is also included in that list, but involves additional rules. While Current Article 9 simply allows for perfection of a security interest in chattel paper by possession, Revised Article 9 limits perfection by possession of chattel paper to tangible chattel paper. Where the collateral is electronic chattel paper, perfection may only be effected by control or filing.

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115 Revised § 312 (b) (2); Official Comment 6 to Revised § 312 (b) (2).
116 Id.; Revised § 9-308 (d).
117 Current § 9-305 and § 8-301; Revised §9-313 (a).
118 Current § 9-305.
119 Revised §§ 9-313 (a) and 9-314 (a). ; Official Comment 2 to Revised § 9-314.
(5) EXCLUDED COLLATERAL.

Article 9 excludes the following types of collateral from the perfection by possession rule: accounts, commercial tort claims, deposit accounts, investment property, letter-of-credit rights (discussed above), uncertificated securities (see discussion VI.C.(1) regarding perfection by control of investment property), and oil, gas or other minerals before extraction.120

(6) POSSESSION BY THIRD PARTIES.

Both Current Article 9 and Revised Article 9 address the situation of goods held by a bailee. Current Article 9 permits perfection of a security interest in goods held by a bailee by simply giving notification to the bailee of that security interest.121

Revised Article 9 imposes more extensive requirements and distinguishes between goods in the possession of a bailee who has issued a document of title covering the goods (addressed by Revised § 9-312 (d)), and goods in the possession of a bailee who has not issued a document of title (addressed by Revised § 9-313 (c)).

Where the goods are not covered by a document of title, Revised § 9-313 (c) requires not only that the secured party give the bailee notice of the security interest. It now additionally requires the bailee to "authenticate" a "record" acknowledging that it is holding the collateral for

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120 Official Comments 2 to Revised § 9-313.
121 Current § 9-305.
the secured party. For perfection by this method to be effective, Revised Section 9-313 (c) also requires that the bailee in possession may not be the debtor, the secured party or a lessee of the collateral from the debtor in the ordinary course of the debtor's business.122 It is important to note that Revised § 9-313 (c)'s exclusion of "lessees of the collateral from the debtor in the ordinary course of the debtor's business" overrules In re Atlantic Systems, Inc., 135 BR 463 (Banker. S.D.N.Y. 1992) (holding that notification to a debtor-lessee's lessee was sufficient to perfect a security interest in leased goods).

With regard to goods covered by a non-negotiable document of title, Revised § 9-312 (d) continues the previous rule that the bailee's receipt of notification of the secured party's interest is sufficient to perfect that security interest, even without the bailee's "authentication of a record" acknowledging receipt.123

With regard to goods covered by a negotiable document of title, Revised § 9-313 (c) clarifies the perfection and priority rules in Current § 9-304 (2) that a security interest in goods covered by a negotiable document may be perfected by either perfecting a security interest in the document, or by the method of filing. Thus, title to the goods is, so to speak, "locked up in the document."124 This remains the rule, even when the goods are in the possession of a bailee.125

122 Revised § 9-313 (c); Official Comment 4 to Revised § 9-313 (c); The New Article 9, at 30.
123 Revised § 9-312 (d); Official Comment 4 to Revised § 9-313.
124 Official Comment to Revised § 9-312; Revised § 9-312 (c).
125 Id.
C. PERFECTION BY CONTROL.

Current Article 9 provides for perfection of a security interest by the method of "control" for one category of collateral: investment property.\textsuperscript{126} Revised Article 9 expands the types of collateral in which a security interest can be perfected by that mechanism. Under Revised Article 9, a security interest in deposit accounts, electronic chattel paper, and letter-of-credit rights, in addition to investment property, may be perfected by control.\textsuperscript{127}

(1) INVESTMENT PROPERTY.

Under both Current Article 9 and Revised Article 9, a security interest in investment property may be perfected by either control or by filing. Revised Article 9 expressly incorporates the concept of control as provided in UCC § 8-106.\textsuperscript{128} Under Article 8, control of investment property includes:

- delivery with endorsements, to the security party;
- an agreement by the issuer of uncertified securities that the issuer will follow the instructions of the secured party, rather than the debtor and with no further consent of the debtor;
- an agreement by a commodity intermediary or a securities intermediary, such as a bank or broker, holding a securities account that it will honor the instructions of the secured

\textsuperscript{126} Current § 9-115 (4)
\textsuperscript{127} Revised §§ 9-104, 9-105, 9-106, 9-107 and 9-314 (a).
\textsuperscript{128} Revised § 9-106 (a); Official Comment 2 to Revised § 9-106.
party, rather than the debtor and with no further consent of
the debtor; or

(d) registering securities, a securities account, or a commodity
account in the name of the secured party.\textsuperscript{129}

When the secured party happens to be the securities or commodity
intermediary, control is automatically effected.\textsuperscript{130}

(2) DEPOSIT ACCOUNTS.

A security interest in a deposit account may \textit{only} be perfected by
the mechanism of control. The secured party must obtain control over the
deposit account in order to perfect the security interest. This may be
accomplished only by the following specific methods:

(a) A secured party has control over a deposit account if the
secured party is the bank with which the deposit account is
maintained; or

(b) A secured party may exercise control over a deposit
account if the bank with which it is maintained executes an
agreement with the secured party that it will follow the
instructions of the secured party, rather than the debtor,
with no further consent from the debtor.\textsuperscript{131}

\textsuperscript{129} Revised § 9-106; UCC § 8-106; Official Comment 4 § 9-106.
\textsuperscript{130} Revised § 9-106 (b) (1).
\textsuperscript{131} Revised § 9-104 (a); Official Comment 3 to Revised § 9-104.
(3) ELECTRONIC CHATTEL PAPER.

A secured party may perfect a security interest in electronic chattel paper by either control or filing.\textsuperscript{132} To perfect a security in electronic chattel paper by \textit{control}, six requirements must be met:

(a) there must be only one authoritative or identifiable copy of the electronic record of the chattel paper;

(b) the copy of the electronic record must identify the secured party and its interest;

(c) the copy of the electronic record must be communicated to and maintained by the secured party or its designated custodian;

(d) copies that purport to assign the authoritative copy can only be made with the participation of the secured party;

(e) any copies of the authoritative copy must be \textit{readily identifiable} as a copy thereof and not the authoritative copy, itself; and

(f) any revision to the authoritative copy must be \textit{readily identifiable} as having been authorized or unauthorized.\textsuperscript{133}

Thus, it is imperative that the authoritative copy be made distinguishable in some manner from any other copy or revision thereto.

\textsuperscript{132} Revised §§ 9-312 (a) and 9-314 (a).
\textsuperscript{133} Revised § 9-105.
(4) LETTER-OF-CREDIT RIGHTS.

A security interest in a letter-of-credit right, other than one that is a supporting obligation for other collateral, must be perfected by control. That is the only method accepted for perfection of a security interest in that category of collateral. The secured party may assert control over a letter-of-credit right if the issuer or nominated person consents to an assignment of the proceeds thereof.

D. AUTOMATIC PERFECTION.

Both Current Article 9 and Revised Article 9 recognize a few limited circumstances in which perfection occurs automatically, upon attachment of the security interest. Current Article 9 recognizes automatic perfection in the following instances: a purchase-money security interest in consumer goods; an assignment of accounts that does not transfer a significant portion of the assignor’s outstanding accounts; security interests arising under UCC Articles 2, 2A or 4; a security interest in investment property held by the securities intermediary or commodity intermediary; security interests in instruments, certificated securities and negotiable documents, which are temporarily perfected for a period of 21 days (under Current Article 9); and a security interest in proceeds, which is temporarily perfected for 10 days (under Current Article 9).

134 Revised § 9-312 (b)(2) and 9-314 (a).
135 Id.; See also UCC § 5-114.
136 Current § 9-302 (1); Revised § 9-309.
137 Current §§ 9-115 (4) and 9-302 (1).
Revised Article 9 not only incorporates this same list,\textsuperscript{138} it expands the list to include: the sale of payment intangibles and promissory notes; a security assignment of payment intangibles that does not transfer a significant portion of the assignor's payment intangibles; an assignment of a health-care-insurance receivable to the healthcare provider; and a security interest held by an issuer or nominated person in documents presented to the issuer or nominated person for draw under a letter-of-credit.\textsuperscript{139}

Revised Article 9 also provides that perfection of a security interest in collateral automatically perfects a security interest in any supporting obligations for the collateral.\textsuperscript{140} A supporting obligation is a secondary obligation that supports the payment or performance of an account, chattel paper, document, general intangible, instrument or investment property.\textsuperscript{141}

Revised Article 9 has deleted one category of collateral for which Current Article 9 recognizes automatic perfection: a beneficiary's interest in a common law trust.\textsuperscript{142} Filing is now the required method of perfection.\textsuperscript{143}

Finally, Revised Article 9 changes the time period for temporary perfection of security interests in instruments, certificated securities and negotiable documents, reducing it from 21 days to 20 days.\textsuperscript{144} It also makes the temporary perfection period for proceeds consistent, expanding it from 10 days to

\textsuperscript{138} Revised §§ 9-304, 9-306, 9-309 and 9-312.
\textsuperscript{139} Revised §§ 9-309, 9-312 and 9-203; The New Article 9, at 32.
\textsuperscript{140} Revised § 9-308 (d).
\textsuperscript{141} Revised § 9-102 (a) (77).
\textsuperscript{142} Current § 9-302 (1).
\textsuperscript{143} Revised § 9-309 (13).
\textsuperscript{144} Revised §9-312 (e).
20 days.\textsuperscript{145} Under Revised § 9-315 (c) and (d), a security interest in proceeds is perfected automatically for 20 days if the security interest in the original collateral is perfected. Perfection of a security interest in proceeds extends even beyond the 20 days, however, in several instances. First, perfection continues where the following three conditions are met: (1) a filed financing statement covers the original collateral; (2) the proceeds are collateral in which a security interest may be perfected by filing in the same office where the financing statement covering the original collateral has been filed; and (3) the proceeds are not acquired with cash proceeds.\textsuperscript{146} This rule is in essence a continuation of Current § 9-306 (3) (a).

Additionally, perfection of a security interest in proceeds likewise continues beyond the 20 days where the proceeds are identifiable cash proceeds and the security interest in the original collateral was perfected by any method.\textsuperscript{147} This is an expansion of Current Article 9’s recognition of continued perfection in proceeds where either the security interest in the original collateral was perfected by a \textit{filed} financing statement,\textsuperscript{148} or the original collateral was investment property.\textsuperscript{149} The Revised Article extends the continued perfection rule to identifiable cash proceeds of \textit{all} categories of original collateral in which a security interest is perfected by any method.\textsuperscript{150}

\begin{footnotesize}
\begin{enumerate}
\item Revised § 9-315 (d).
\item Revised § 9-315 (d) (1).
\item Revised § 9-315 (d) (2).
\item Current § 9-306 (3) (b).
\item Current § 9-306 (3) (c).
\item Revised § 9-315 (d) (2); Official Comment 7 to Revised § 9-315.
\end{enumerate}
\end{footnotesize}
E. PERFECTION UNDER OTHER FEDERAL AND STATE STATUTES.

Both Current and Revised Article 9 acknowledge that certain state and federal statutes, regulations, and United States Treaties provide means for perfecting security interests in specific types of property; including, vessels, aircraft, intellectual property and title goods (such as motor vehicles). Both versions of Article 9 provide that compliance with these statutory and regulatory forms of perfection is equivalent to filing a financing statement under Article 9.151

Excluded from this treatment are motor vehicles that are inventory of a dealer, held for sale. Current Article 9 requires perfection by filing. Notation of the security interest on the certificate of title is not sufficient.152 However, Current Article 9 gives a different rule for goods held for lease153. With regard to goods held for lease, the secured party must comply with the pertinent state’s certificate-of-title statute.

Revised Article 9 establishes uniformity with regard to motor vehicles held by a dealer for sale or lease. The drafters recognized that quite often a dealer does not know whether a particular automobile will be sold or leased. Revised Article 9 now requires that in both instances a security interest be perfected by filing.154 Once the goods are removed from inventory, the applicable certificate-of-title statute governs perfection. This includes not only the sale or

151 Current § 9-302 (3) and (4); Revised § 9-311 (a) and (b).
152 Current § 9-302 (3) (b).
153 Current § 9-302 (3); Official Comment 4 to Revised § 9-311.
154 Revised § 9-311(d); Official Comment 4 to Revised § 9-311.
lease of the vehicle, but also removal of the vehicle from inventory by the dealer for use in his business.155

VII. PRIORITY.

Once a security interest has attached and has become perfected, it still may not prevail over competing interests held by other creditors and claimants. Article 9 sets forth rules for prioritizing the competing interests. The general rule under both versions of Article 9 is that the first secured party to perfect its security interest has priority. This is known as the "first-to-perfect" rule. There are, however, many non-temporal exceptions to the rule based on the method of perfection. The priority rules are addressed as follows:

A. EFFECT OF OTHER UCC ARTICLES.

Revised Article 9 defers to the other Articles of the UCC in two instances. It defers to the rights of holders in due course and protected purchasers of securities under Articles 3, 7 and 8.156 Revised Section 9-331 (a) provides that holders in due course and purchasers of securities "take priority over an earlier security interest, even if perfected, to the extent provided in Articles 3, 7, and 8."

B. GENERAL UNSECURED CREDITORS VERSUS SECURED CREDITORS.

Under both versions of Article 9, a secured creditor takes priority over a general unsecured creditor, even if the secured party has failed to perfect its security interest.157

155 Official Comment 4 to Revised § 9-311.
156 Revised § 9-221 (a).
157 Current §§ 9-201 and 9-301 (1) (b); Revised §§ 9-201(a) and 9-317(a).
C. LIEN CREDITORS VERSUS SECURED CREDITORS.

A lien creditor is a creditor who has obtained a lien on the debtor's property by attachment, levy, or by other judicial means. It also includes assignees for the benefit of creditors, trustees in bankruptcy, and receivers in equity.\textsuperscript{158}

Under both versions of Article 9, a perfected secured party takes priority over a lien creditor, as long as the secured party's interest was perfected at or before the lien creditor's lien arose.\textsuperscript{159} This is, however, subject to the future advance rules.

Revised Article 9 continues Current Article 9's priority rules regarding future advances by a secured party. Future advances against collateral in which a secured creditor's security interest has priority over a lien creditor will likewise have priority over the lien creditor, as long as two requirements are met: (1) the future advances must be made within 45 days after the lien creditor's lien arose, and (2) the lien arose before the secured party has knowledge of the lien.\textsuperscript{160}

Both versions of Article 9 also grant priority to a secured creditor taking a purchase-money security interest as against a lien creditor, as long as the secured party perfects that interest by filing within a specified period of time following the debtor's receiving possession of the collateral.\textsuperscript{161} Under Current Article 9, the secured party must file a financing statement covering the collateral within 10

\textsuperscript{158} Revised § 9-102 (a) (52).
\textsuperscript{159} Current § 9-301 (1) (b); Revised § 9-317 (a) (2).
\textsuperscript{160} Current § 9-301 (4); Revised § 9-323 (b).
\textsuperscript{161} Current § 9-301; Revised § 9-317.
days of the debtor's receipt of possession.\textsuperscript{162} Revised Article 9 extends the period to 20 days.\textsuperscript{163}

D. UNPERFECTED SECURITY INTERESTS VERSUS UNPERFECTED SECURITY INTERESTS.

Where there are two competing unperfected security interests, Revised Article 9 continues the rule of Current Article 9 that the first to attach has priority.\textsuperscript{164}

E. PERFECTED SECURITY INTERESTS VERSUS UNPERFECTED SECURITY INTERESTS.

While it is implicit under Current Article 9, Revised Article 9 expressly states the rule that a perfected security interest has priority over an unperfected security interest in the same collateral.\textsuperscript{165}

F. PURCHASE-MONEY SECURITY INTERESTS.

A purchase-money security interest is a security interest that is either (1) taken by the supplier of the collateral to secure the collateral's purchase price, or (2) taken by a third-party lender who has loaned the debtor money to finance the purchase of the collateral.\textsuperscript{166} According to the new Official Comments, Current Article 9 requires the collateral to be "goods" in order to qualify as purchase-money collateral. Revised Article 9 expands the classification to include software sold or licensed with goods where the software is to be principally used with the goods.\textsuperscript{167}

\begin{itemize}
\item \textsuperscript{162} Current § 9-301 (2).
\item \textsuperscript{163} Revised § 9-317 (e).
\item \textsuperscript{164} Current § 9-312 (5) (b); Revised § 9-322 (a) (3).
\item \textsuperscript{165} Revised § 9-322(a)(2).
\item \textsuperscript{166} Current § 9-107; Revised § 9-103.
\item \textsuperscript{167} Official Comment 5 to Rev. §9-103.
\end{itemize}
Creditors who hold a purchase-money security interest and follow the proper steps for perfecting that interest achieve a super-priority status. Their purchase-money security interest takes priority over all other security interests, regardless of when those other security interests were perfected. To achieve the super-priority status, certain steps must be taken, depending on the type of collateral involved.

(1) INVENTORY.

To perfect a purchase-money security interest in inventory, Revised § 9-324(b) sets forth four requirements that must be met before the debtor even receives possession of the inventory:

(a) The secured party must perfect its purchase-money security interest;

(b) The secured party must send an authenticated notification to any entity holding a conflicting security interest;

(c) The holder of a conflicting security interest must receive the notification within five years before the debtor receives possession of the inventory; and

(d) The notification must describe the inventory and state that the party sending the notification either has or expects to acquire a security interest in the inventory.
Again, it must be stressed that these requirements must be completed before the debtor ever receives possession of the inventory. The requirements may be accomplished at any time within the five year time frame preceding the debtor’s receipt.\textsuperscript{168}

It is also important to note that the 20 days grace period for purchase-money security interests in "goods",\textsuperscript{169} does not apply to inventory.\textsuperscript{170}

\textbf{(2) LIVESTOCK THAT ARE FARM PRODUCTS.}

Revised Article 9 adopts the same four requirements for perfecting a purchase-money security interest in livestock that are farm products that apply to inventory, with one small modification. The notification must be sent within \textit{six months} before the debtor receives possession of the livestock.\textsuperscript{171} As with inventory, the required steps for perfecting the purchase-money security interest must be taken before the debtor receives possession of the livestock. But, in this case, cannot be done earlier than six months preceding the receipt.\textsuperscript{172}

Once again, the 20 day grace period applicable to purchase-money security interests in goods is inapplicable to livestock.\textsuperscript{173}

\textsuperscript{168} Revised § 9-324 (b).
\textsuperscript{169} Revised § 9-324 (a).
\textsuperscript{170} Official Comment 4 to Revised § 9-324.
\textsuperscript{171} Revised § 9-324 (d).
\textsuperscript{172} Id.
\textsuperscript{173} Revised § 9-324 (a).
(3) OTHER COLLATERAL.

As stated above, for all other types of goods (other than inventory and livestock) serving as collateral, a purchase-money security interest must be perfected within 20 days after the debtor receives possession of those goods to achieve priority over all other competing security interests. 174

(4) COMPETING PURCHASE-MONEY SECURITY INTERESTS.

Revised Article 9 adds a new section in recognition of the fact that buyers frequently borrow money from a lender to finance the purchase price of certain goods, and also grant a purchase-money security interest to the supplier. In those situations, both the supplier of the goods and the lender may have competing purchase-money security interests in the same collateral. 175 The Revised Article adds § 9-324 (g) to address this situation. It grants priority to the supplier.

Lastly, the Revised Article recognizes that purchase-money security interest transactions are occasionally intermingled with non-purchase-money security interest transactions. For example, a debtor may have a $10,000.00 loan secured by a purchase-money security interest, which he subsequently refinances and as part of the transaction borrows additional funds. Those additional funds were not utilized in the purchase of the collateral, and therefore, do not qualify for purchase-money security

174 Revised § 9-324 (a).
175 Official Comment 13 to Revised § 9-324 (g).
interest status.\textsuperscript{176} By the same token a purchase-money obligation may be secured by collateral in addition to the purchase-money collateral.

Section 9-103 (f) of the Revised Article states that the purchase-money security interest in a commercial transaction does not lose its status as a result of this kind of intermingling of transactions.

G. BUYERS IN THE ORDINARY COURSE OF BUSINESS VERSUS SECURED CREDITORS.

Revised Article 9 continues the priority rule of Current Article 9 that a buyer in the ordinary course of the debtor's business takes free and clear of the security interests created by the seller, \textit{even if} the security interest is perfected and the buyer knows of its existence.\textsuperscript{177}

Revised Article 9 does, however, establish a new rule for situations in which the secured party is in possession of the goods. In that instance, a buyer of the goods does not take free and clear of the secured party's interest.\textsuperscript{178} This new rule overrules the holding of Tanbro Fabrics Corp. v. Deering Milliken, Inc., 39 N.Y.2d 632, 385 N.Y.S.2d 260, 350 N.E.2d 590 (N.Y. 1976).\textsuperscript{179}

H. BUYERS OUTSIDE OF THE ORDINARY COURSE OF BUSINESS VERSUS SECURED CREDITORS.

The general rule under both versions of Article 9 is that where property is sold, leased, licensed, exchanged or otherwise disposed of outside the ordinary

\textsuperscript{176} Id.
\textsuperscript{177} Revised § 9-320 (a); Current § 9-307 (1).
\textsuperscript{178} Revised § 9-320 (5).
\textsuperscript{179} Official Comment 8 to Revised § 9-320.
course of business, the security interest continues unmarred in the collateral. Thus, the secured party has priority over the purchaser.  

There are some limited exceptions. Revised Article 9 continues the rule under Current Article 9 that when a debtor sells encumbered household goods — defined as goods that were used or bought by the debtor primarily for personal, family or household use — the purchaser takes free of the security interest if:

1. The purchaser was without knowledge of the security interest;
2. gave value;
3. purchased the goods for personal, family or household use; and
4. purchased the goods before a financing statement covering the goods was filed.

One other exception that is recognized is where the secured interest is unperfected. In that instance, the buyer will prevail over the secured party if the buyer gave value and had no knowledge of the security interest at the time the buyer received delivery of the goods. While Current Article 9 has been construed by case law as merely “subordinating” the interest of the secured party to that of the buyer, Revised Article 9 expressly provides that the buyer “takes free” of the security interest.

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180 Official Comment 8 to Revised § 9-321.
181 Current §§ 9-307 (2); Revised § 9-320 (b).
182 Revised § 9-317 (b).
183 Revised § 9-317 (b) (overruling Aircraft Trading and Services, Inc. v. Braniff, Inc., 819 F. 2d 1277 (2d Cir. 1987)).
I. CONSIGNORS.

Revised Article 9 incorporates consignments within its scope, treating them as purchase-money security interests. Thus, consignors must comply with the rules for purchase-money security interests in order to establish priority.

J. NEGOTIABLE DOCUMENTS COVERING GOODS HELD BY BAILEES.

Like Current Article 9, Revised Article 9 provides that while goods are in the possession of a bailee that has issued a negotiable document covering the goods, “a security perfected in the document has priority over any security interest that becomes perfected in the goods by another method during that time.”

As stated above, Article 9 defers to Article 7 where goods are evidenced by a negotiable document. Thus, the holder of a duly negotiated document prevails over an earlier security interest to the extent provided in Article 7.

K. INSTRUMENTS.

Under Current Article 9, a security interest in instruments can only be perfected by possession. Under Revised Article 9, a security interest in instruments may be perfected by either possession or filing. Thus, for the first time there is the potential for a priority dispute. Revised Article 9 provides that a purchaser of an instrument who takes possession has priority over a security interest perfected by filing, as long as the purchaser with possession:

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184 Revised §§ 1-201 (37) and 9-103 (d); Official Comment 6 to Revised § 9-103.
185 Revised § 9-312 (c)(2); See also Current § 9-304 (2).
186 Revised §§ 9-309 and 9-331 (a).
(1) gave value;
(2) took possession in good faith; and
(3) without knowledge that the purchase violates the rights of the secured party.\textsuperscript{187}

With regard to holders in due course of negotiable instruments, it is important to note that it is one of the categories for which Revised Article 9 defers to Article 3.\textsuperscript{188}

Significantly, Revised § 9-309 (4) provides that the buyer of a promissory note enjoys automatic perfection of its security interests. This rule is similar to the rule pertaining to the purchaser of a payment intangible, who also enjoys automatic perfection of its security interest. But automatic perfection for promissory notes and payment intangibles don’t necessarily protect each to the same extent because with “payment intangibles” there is nothing to possess. Consequently, the first buyer of the payment intangible will always have priority. In comparison, however, a buyer of a promissory note that relies on automatic perfection and does not take possession of the promissory note will lose to a subsequent buyer of the promissory note who does take possession thereof.\textsuperscript{189}

**L. CHATTEL PAPER.**

Current Article 9 allows for perfection of a security interest in chattel paper by filing or possession. As discussed above, Revised Article 9 expands the perfection methods, now allowing for perfection by possession (for tangible

\textsuperscript{187} Revised § 9-330 (d).
\textsuperscript{188} Revised §§ 9-309 and 9-331 (a).
\textsuperscript{189} Revised § 9-330 (d); the New Article 9, at 3.
chattel paper) and control (for electronic chattel paper). As a result, there are also new priority considerations with regard to chattel paper.

Revised Section 330 (b) mirrors Current Section 9-310, but adds references to perfection by control. It provides that a purchaser who takes possession or control takes priority over a competing security interest (perfected by filing), if the following requirements are met:

1. The purchaser gave new value;
2. took possession (of tangible chattel paper) or took control (of electronic chattel paper) in good faith;
3. took possession or control in the ordinary course of the purchaser's business; and
4. took without knowledge that the purchase violated the rights of the secured party.

Significantly, paragraph (f) of Revised § 9-330 imputes knowledge of the security interest to the purchaser, if the chattel paper indicates it has been assigned to an identified secured party.

M. LETTER-OF-CREDIT RIGHTS.

Revised Article 9 requires perfection of a security interest in letter-of-credit rights to be perfected by control. However, where the letter-of-credit rights, are supporting obligations, Revised Article 9 provides that perfection of a security interest in the original collateral automatically perfects a security interest in the letter-of-credit rights. In the event of a priority contest between a

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190 Revised §§ 9-312(b)(2) and 9-314(a).
191 Revised § 9-308 (d).
security interest in letter-of-credit rights perfected by control and one perfected automatically, the security interest perfected by control takes priority.\textsuperscript{192} If there are competing security interests, each perfected by control, they rank in priority in accordance with the temporal order in which control was obtained.\textsuperscript{193}

N. INVESTMENT PROPERTY.

Under both Current Article 9 and Revised Article 9, a security interest in investment property may be perfected by either filing or control.\textsuperscript{194} Revised Article 9 reiterates the priority rules of Current Article 9, providing that perfection by control takes priority over perfection by filing.\textsuperscript{195} With one exception involving brokers, securities intermediaries, and commodity intermediaries (discussed below), where there are competing security interests each perfected by control, they rank temporally in the order in which control was obtained (contrary to the rule of equal priority for those security interests under Current Article 9).\textsuperscript{196}

A special rule applies to a security interest held by a securities intermediary in a securities entitlement or securities account maintained with the securities intermediary. Such a security interest takes priority over a competing security interest perfected by control or by filing.\textsuperscript{197}

Additionally, a special rule applies to security interests in security certificates in registered form which are perfected by possession under § 9-313(a).
Such a security interest takes priority over a security interest perfected by filing.\textsuperscript{198} That rule "eliminates the need to conduct a search of public records only insofar as necessary to serve the needs of the securities market."\textsuperscript{199}

Security interests created by brokers, securities intermediaries, or commodity intermediaries which are perfected \textit{without control}, all rank equally.\textsuperscript{200}

\textbf{O. DEPOSIT ACCOUNTS.}

Deposit accounts are excluded from the scope of Current Article 9, but have been brought within the scope of Revised Article 9. Accordingly, Revised Article 9 has set forth priority rules with regard to deposit accounts.

The primary rule is that a security interest in a deposit account perfected by control defeats a competing security interest perfected by another method.\textsuperscript{201}

Competing security interests each perfected by control rank temporally in accordance with the order in which control was obtained.\textsuperscript{202}

Where the bank in which the deposit account is maintained has a security interest in the account, the bank's security interest generally defeats any conflicting security interests.\textsuperscript{203} This rule permits a bank to extend credit to its depositors without having to determine whether another party has a security interest in their customers' deposit accounts.\textsuperscript{204} The Official Comments to Revised § 9-327 explain that a secured party who takes a security interest in a

\textsuperscript{198} Revised § 9-328 (5).
\textsuperscript{199} Official Comment 6 to Revised § 9-328.
\textsuperscript{200} Revised § 9-328 (6).
\textsuperscript{201} Revised § 9-327 (1).
\textsuperscript{202} Revised § 9-327(2).
\textsuperscript{203} Revised § 9-327 (3).
\textsuperscript{204} Official Comment 4 to Revised § 9-327.
deposit account as *original collateral* can escape the results of that rule, and gain priority over the bank’s security interest, in two ways. The secured party can take control of the deposit account by becoming the depository bank’s customer with respect to that deposit account. That arrangement will *subordinate the bank’s security interest.* In the alternative, “the secured party can obtain a subordination agreement from the bank.”

When funds are transferred from the deposit account, the transferee takes free of any security interests therein. There is, however, one exception to that rule. The security interest retains its priority if it is determined that the transferee acted in collusion with the debtor to violate the secured party’s interest.

**P. STATUTORY LIENS.**

Revised Article 9 continues the rule under Current Article 9 that a possessory lien on goods, created by statute or common law, which *secures* payment or performance of an obligation for services rendered or *materials* furnished in the ordinary course of business with regard to those *goods* has priority over a competing security interest in the goods. The only exception to this rule is where the statute creating the lien expressly provides otherwise.

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205 Official Comment 5 to Revised § 9-327; Revised § 9-327 (4).
206 Official Comment 5 to Revised 9-327.
207 Revised § 9-332 (b).
208 Revised § 9-333 (a) and (b).
Q. AGRICULTURAL LIENS.

Where agricultural liens are concerned, Revised Article 9 directs that they are to be treated the same as other security interests. Thus, the general rules of priority apply.

The one exception recognized is where the agricultural lien is created pursuant to state statute which grants priority to the lien. Revised Section 9-322 (g) defers to the statute in that instance, as long as the agricultural lien is properly perfected.

R. CROPS.

Current Article 9 defers to the individual states’ real estate laws for determining priority among competing interests in crops. Generally, the competition is between the holder of a perfected security interest in the crops and the owner or mortgagee of the real estate. Under Current Article 9, priority hinges on the state’s real estate law’s treatment of crops.

Under Revised Article 9, crops are “goods” in which a security interest may be created and perfected. A perfected Article 9 security interest in crops takes priority over a competing interest of the owner or mortgagee of the real property. The one requirement is that the debtor either have an interest of record in the real property or be in possession thereof.

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209 Revised § 9-322 (a); Official Comment 12 to Revised § 9-322 (a).
210 See also Official Comment 12 to Revised § 9-322.
211 The New Article 9, at 42.
212 Official Comment 12 to Rev. §9-335.
213 Revised § 9-334 (i).
S. FIXTURES.

Revised Article 9 for the most part continues the priority rules for fixtures set forth in Current Article 9, with only one slight modification extending the time period in which to file fixture filings and an addition of a new rule regarding manufactured homes.

Under both versions, the term “fixture” is defined as a good which has become so related to a particular parcel of real property that an interest arises in the goods under real estate law. A security interest in fixtures may either be perfected by a regular Article 9 filing or by a fixture filing filed in the office where a real estate mortgage on the real property would be filed.

As with crops, there is also the potential for conflicts between real estate interests and security interests in fixtures. Generally, the conflicting interests are in the form of interests held by the owner of the real estate and/or by mortgagees. A security interest takes priority over the competing interests of an owner or mortgagee of real estate if three requirements are met:

1. The debtor has an “interest of record” in the real property or is in possession thereof;

2. The security interest was perfected by fixture filing before the interest of the mortgagee or owner was of record; and

3. The security interest has priority over any conflicting interest of a predecessor in title of the owner or mortgagee.

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214 Current § 9-313 (1) (a); Revised § 9-102 (a) (41).
215 Current §§ 9-313 (4) (d) and 9-402(5); Revised § 9-334 (e).
216 Current § 9-313 (4) (b); Revised § 9-334 (e) (1).
There is a separate rule which grants priority to holders of security interests in the following specified types of readily movable goods: (1) factory and office machines; (2) equipment that is not primarily used or leased for use in the operation of the real property; and (3) replacements of domestic appliances that are consumer goods. Revised Section 9-334(e)(2) gives priority to a security interest in such goods, as long as it is perfected before the goods become fixtures. Official Comment 8 to Revised Section 9-334 explains that this rule was included as a result of confusion that sometimes arises as to whether and when these types of goods become fixtures. Revised Section 9-334(e)(2) eliminates this confusion by protecting a creditor who files a financing statement, rather than a fixture filing.217

Revised Section 9-334 also addresses purchase-money security interests in goods that become fixtures. It grants priority to the purchase-money security interest as against an already existing interest of record of the owner or a mortgagee of the real estate, if a fixture filing covering the goods is filed within a specified time after the goods become fixtures.218 The specified period under Current Article 9 is 10 days.219 Revised Article extends the period to 20 days,220 thus allowing for a 20 day grace period.

It is important to note that Revised Article 9, like Current Article 9, has a provision specially dealing with construction mortgages.221 Construction mortgages generally take priority over a security interest in fixtures where the

217 Official Comment 8 to Revised § 9-334.
218 Current § 9-313 (4) (a); Revised § 9-334 (d).
219 Current § 9-313 (4) (a).
220 Revised § 9-334(d).
goods have become fixtures before construction is completed, with the exception of the security interests addressed above (pertaining to security interests perfected by a fixture filing before the interest of the owner or the interest of mortgagee -- including, a construction mortgagee -- has been filed of record, and the priority rule governing readily moveable machines, equipment and collateral.)

A construction mortgage is also junior to a security interest in a manufactured home transaction under an applicable certificate of title statute. Revised Article 9’s inclusion within its scope of manufactured homes that become fixtures is new. Current Article 9 does not address manufactured homes. Revised Article 9 incorporates a new rule which grants priority to certain security interests in “manufactured homes” created as part of a “manufactured home transaction.” Under the new rule, the security interest in a manufactured home that becomes a fixture takes priority over a conflicting interest of an owner or encumbrance of the real property, as long as the security interest is perfected under a certificate-of-title statute.

T. ACCESSIONS.

Accessions are “goods that are physically united with other goods in such a manner that the identity of the original goods is not lost.” For example, a new engine installed in the debtor’s tractor would be an accession. Current Article 9 contains special rules governing the priority between holders of security interests.

221 Current § 9-313(6); Revised § 9-334 (h).
222 Current § 9-313 (4) (c); Revised § 9-334 (h) and (e).
223 Revised § 9-334 (h) and (e) (4).
224 Revised § 9-334 (e) (4).
225 Revised § 9-102 (a)(1).
226 Id.; Official Comment 10 to Revised § 9-334.
227 Revised § 9-102 (a)(1).
in accessions to goods and the holders of security interests in the goods as a whole.\textsuperscript{228} Revised Article 9, however, with one exception, leaves the resolution of priority disputes involving accessions to the priority rules set forth in the other sections of Part 3 of Revised Article 9.\textsuperscript{229} Revised Section 9-335 does contain a special priority rule applicable where the competing security interest in the goods as a whole is perfected in compliance with a certificate-of-title statute. In that instance, the security interest in the accession is subordinated to the competing interest.\textsuperscript{230}

An example of this type of competing security interests can be seen where a debtor grants a secured party a security interest in a vehicle, perfected in accordance with the governing certificate-of-title statute. The dealer then purchases a car stereo system from a retail electronics store, granting the retail seller a security interest in the stereo system, which the seller timely perfects. Thereafter, the stereo system is installed in the debtor’s vehicle. Under Revised §9-335(d), the security interest in the accession (the stereo system) will be subordinated to the security interest in the whole (the vehicle).

**U. COMMINGLED GOODS.**

Priority disputes with regard to “commingled goods” arise when goods subject to a security interest by one creditor are mixed with goods subject to a security interest held by another creditor, such that the individual identity of the goods is lost in a product or mass. Upon the commingling, the security interest in the commingled goods attaches to the entire product or mass. If neither secured

\textsuperscript{228} Current § 9-314.

\textsuperscript{229} Revised § 9-335(c); Official Comment 5 to Revised § 9-335.
party would otherwise have priority in the other’s collateral, Article 9 sets forth a formula for ranking their priority.\textsuperscript{231} Under Current Article 9, the formula is somewhat ambiguous.\textsuperscript{232} Thus, Revised Article 9 has sought to clarify the formula, which now reads that “the security interests rank equally in proportion to the value of the collateral at the time it became commingled goods.”\textsuperscript{233}

V. PROCEEDS.

Revised Article 9 continues the general rule under Current Article 9 that a secured party’s priority in proceeds generally relates back in time to the date the secured party perfected its interest in the collateral from which the proceeds were generated.\textsuperscript{234} Thus, the security interests in proceeds rank in priority in accordance with the first-to-file-or-perfect rule in the original collateral. There are however, some exceptions that warrant being separately addressed.

(1) INVENTORY PURCHASE-MONEY SECURITY INTEREST.

As addressed above, in certain instances an inventory purchase-money security interest will take priority over a security interest perfected by an earlier filing. In that event, the “inventory purchase-money security party” is entitled to priority in the proceeds of the inventory, as well, in certain limited circumstances. First, the “inventory purchase-money secured party” takes priority if (1) the proceeds are identifiable cash proceeds, and (2) the proceeds are received by the debtor \textit{on or before}

\textsuperscript{230} Id.
\textsuperscript{231} Revised §9-336(f).
\textsuperscript{232} Current § 9-315 (2).
\textsuperscript{233} Revised § 9-336 (f).
\textsuperscript{234} Current § 9-312 (b); Revised § 9-322 (b) (1).
delivery to the purchaser of the inventory from which the proceeds were generated. Second, Revised Article 9 also grants the "inventory purchase-money secured party" priority in proceeds where the proceeds take the form of: instruments, chattel paper, and proceeds of chattel paper to which the secured party is entitled to priority under § 9-330.

Lastly, Revised Article 9 grants priority to the "inventory purchase-money secured party’s" interest in proceeds of inventory consisting of farm products livestock.235

(2) TRANSFEREES OF MONEY.

Revised Article 9 adds a new section addressing the rights of a transferee of money in which another party claims a security interest. A transferee of money takes priority over a secured party claiming a security interest in the same funds as proceeds. The one exception is where it can be demonstrated that the transferee acted in collusion with debtor in violation of the secured party’s rights.236

(3) SECURITY INTERESTS PERFECTED BY POSSESSION OR CONTROL IN DEPOSIT ACCOUNTS, INVESTMENT PROPERTY, LETTER-OF-CREDIT RIGHTS, CHATTEL PAPER, INSTRUMENTS AND NEGOTIABLE DOCUMENTS.

As addressed above, under Revised Article 9, a security interest in deposit accounts, investment property, letter-of-credit rights, chattel paper, instruments and negotiable documents may be perfected by possession or control. A security interest perfected by either of those mechanisms under

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235 Revised § 9-324 (b) and (d).
Revised Article 9 may in certain instances take priority over a competing security interest perfected by an earlier filing. In such cases, Revised Article 9 grants the secured party priority in the proceeds of that collateral as well, if: (1) the proceeds are cash proceeds; or (2) the proceeds are of the same type as the original collateral.237

Where there are proceeds of proceeds, the secured party who has perfected by possession or control retains priority as long as one of the following three conditions is met: (1) all of the intervening proceeds are cash proceeds; (2) all intervening proceeds are of the same type as the original collateral; or (3) the proceeds are an account relating to the collateral.238

However, a special rule applies where: (1) the proceeds are not cash proceeds, a deposit account, investment property, letter-of-credit right, chattel paper, an instrument or a negotiable document; and (2) there is a competing security interest in the proceeds that was perfected by filing. In that instance, the security interests rank according to priority in time of filing. That is, a first-to-file rule displaces the first-to-file-or-perfect rule.239

236 Revised § 9-332 (a).
237 Revised § 9-322 (c).
238 Revised § 9-322 (c); See also The New Article 9, at 40.
239 Revised § 9-322 (d) and (e).
(4) INSOLVENCY.

Current Article 9 contains special rules governing priority of interests in proceeds in the event of insolvency. Revised Article 9 has eliminated those rules.

(5) RETURNED OR REPOSSESSED GOODS.

Current Article 9 contains special rules for returned or repossessed goods. Revised Article 9 deletes those rules, as well. However, Official Comments 9 through 11 to Revised § 9-330 explain how the same results under Current Article 9 flow from the proceeds provisions incorporated by Revised Article 9.

(6) PROCEEDS OF AGRICULTURAL LIENS.

Revised Article 9 includes agricultural liens within its scope, but does not address the proceeds of such liens. Revised Article 9 defers to the state law governing agricultural liens.

W. CONTRACTUAL SUBORDINATION.

Revised Article 9 continues the rule under Current Article 9 that a party entitled to priority may contractually subordinate its claim. Official Comment 2 to Revised § 9-339 makes it clear that a person’s or entity’s rights may only be subordinated by an agreement to which the person or entity is a party.

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240 Current § 9-306 (4).
241 Current § 9-306 (5).
242 The New Article 9, at 40.
243 Official Comment 9 to Revised § 9-315; See Also The New Article 9, at 40.
244 Revised § 9-339.
VIII. DUTIES OWED BY THE SECURED PARTY.

Revised Article 9 continues the duties imposed by Current Article 9 upon a secured party. The secured party’s duties fall into three basic categories. First, the secured party bears a duty to use reasonable care to preserve collateral in the secured party’s possession or control.245 Both versions of Article 9 permit the secured party to charge the collateral reasonable expenses incurred in its preservation.246

Second, under both versions of Article 9 the debtor may request an accounting from the secured party. Upon such a request the secured party has the duty to account to the debtor with regard to the amount of the secured obligations and the identity of the collateral.247 If the secured party has sold its interest in the secured obligations and the collateral, the secured party must give an accounting of the assignee or successor in interest.248 The secured party must respond within 14 days to a debtor’s request for accounting.249 During any six month period, a debtor is entitled to one free accounting.250 Thereafter, debtor must pay a charge not exceeding $25.00 for any additional accounting requested within that period.251 That is an increase from the $10 charge permitted under Current Article 9.

The secured party’s third, and final, duty is the duty to terminate or release the security interest once the obligation has been satisfied. That is covered by Parts IV and V of Revised Article 9 and is outside the scope of this paper.

245 Current § 9-207; Revised § 9-207.
246 Id.
247 Current § 9-207 (1); Revised § 9-207 (a).
248 Current § 9-208 (2); Revised § 9-210 (d).
249 Revised § 9-210 (b) – (d).
250 Revised § 9-210 (f).
IX. CHOICE OF LAW.

Article 9 contains choice of law rules governing the attachment, perfection and priority of security interests. Often times the security agreement itself, will specify which state's law shall govern the parties' rights thereunder. The forum jurisdiction will generally respect the state law specified, as long as the transaction bears a reasonable relation to that jurisdiction. However, the parties are precluded from contractually altering the mandatory choice of law rules set forth in Article 9 governing the perfection and priority of security interests. Those rules cannot be contractually altered under either Current or Revised Article 9, with the one exception that a party may contractually subordinate its own claim (discussed above).

The mandatory rules governing perfection and priority are as follows.

A. PERFECTION AND PRIORITY: GENERAL RULE.

Under Current Article 9, the choice of law rules governing perfection are found in § 9-103. Current Article 9 divides collateral into the following six categories for choice of law purposes: (1) documents, instruments, and ordinary goods; (2) collateral with certificates of title; (3) certain accounts, general intangibles, and non-titled mobile goods; (4) chattel paper; (5) minerals; and (6) investment property.

In revising Article 9, the drafters engaged in a major overhaul of the choice of law rules. Revised Article 9 not only incorporates dramatic changes,
but also expands the scope of the choice of law rules to include the new categories of collateral incorporated by Revised Article 9.

At the outset, Revised Article 9 has adopted a general rule to be applied in the majority of instances. The general rule is designed to simplify the perfection process and to eliminate the need for filing financing statements in multiple jurisdictions. Under Revised Article 9, the general rule is that the law of the jurisdiction where the debtor is located governs perfection of security interests in both tangible and intangible collateral, whether perfected by filing or automatically.252 Thus, the revised rule eliminates Current Article 9's divergent rules governing the various categories of collateral, and instead replaces the old system with one general rule which applies the law of a single jurisdiction.

Current Article 9 incorporated a "last event test" in its choice of law provisions governing the perfection of security interests in ordinary goods. Revised Article 9 eliminates this test and replaces it with the new simplified rule that merely looks to the jurisdiction where the debtor is located.253

Revised Article 9 contains the following clear rules for determining the jurisdiction in which the debtor is located:

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252 Revised § 9-301 (1); Official Comment 4 to Revised § 9-301.
253 Id.
(1) INDIVIDUALS.

An individual is located at his or her principal place of residence.254

(2) UNREGISTERED ORGANIZATIONS WITH ONLY ONE PLACE OF BUSINESS.

An unregistered organization that has only one place of business is located at that place of business.255

(3) AN UNREGISTERED ORGANIZATION WITH MORE THAN ONE PLACE OF BUSINESS.

An unregistered organization having more than one place of business is deemed located at its chief executive office.256 “Chief executive office” is not defined by Article 9. However, Official Comment 2 to Revised § 9-307 states that it means “the place from which the debtor manages the main part of its business operations or other affairs.”

(4) REGISTERED ORGANIZATIONS.

A registered organization is located in the state in which it is registered.257 Registered organizations include corporations, limited liability companies, limited partnerships, etc. That is, it is any organization that is required to maintain a public record showing it has been organized.258

254 Revised § 9-307 (b).
255 Id.
256 Id.
257 Revised § 9-3047 (e).
258 The New Article 9, at 48.
(5) FOREIGN DEBTORS.

If the debtor is located outside of the United States and is not subject to a public filing system, the debtor is deemed to be located in the District of Columbia.259

B. PERFECTION AND PRIORITY – EXCEPTIONS TO GENERAL RULE.

Revised Article 9 does contain some exceptions to the General Choice of Law rule governing perfection for some specific types of collateral.

(1) POSSESSORY SECURITY INTERESTS.

The perfection and priority of security interests perfected by possession are governed by the local law of the jurisdiction where the collateral is physically located.260

(2) FIXTURES.

The perfection and priority of a security interest perfected by a fixture filing are governed by the law of the jurisdiction where the fixtures are located.261

(3) AGRICULTURAL LIENS.

The local law of the jurisdiction in which farm goods are located governs the perfection and priority of any agricultural liens on those goods.262

259 Revised § 9-307 (c); Official Comment 3 to Revised § 9-307.
260 Revised § 9-301 (2).
261 Revised § 9-301 (3) (a) and (c); Official Comment 5(b) to Revised § 9-301.
262 Revised § 9-302.
(4) GOODS COVERED BY CERTIFICATES OF TITLE.

The perfection and priority of goods covered by a certificate of title are governed by the law of the jurisdiction under whose certificate of title the goods are covered. The law of that jurisdiction controls for a specified period: "from the time the goods become covered by the certificate of title until the goods cease to be covered by the certificate of title."²⁶³ Goods become covered by a certificate of title "when a valid application for the certificate of title and the applicable fee are delivered to the appropriate authority."²⁶⁴ The goods cease to be covered by the certificate of title upon the happening of either of two events: (1) if the title ceases to be effective under the law of jurisdiction which issued it, or (2) if the goods subsequently become covered by a certificate of title issued by another jurisdiction.²⁶⁵

It is crucial to note, however, if the titled goods are inventory, the choice of law rule for perfection and priority is that of the debtor's location.²⁶⁶

(5) DEPOSIT ACCOUNTS.

The perfection and priority of a security interest in a deposit account are governed by the jurisdiction in which the bank maintaining the

²⁶³ Revised § 9-303 (c); Official Comment 3 to Revised § 9-303.
²⁶⁴ Revised § 9-303 (b).
²⁶⁵ Id.
²⁶⁶ Revised § 9-311 (d); Official Comment 5 to Revised § 9-303; The New Article 9, at 48.
deposit account is located. Section 9-304 of Revised Article 9 has very specific, detailed rules for determining the jurisdiction in which a bank is located.

(6) INVESTMENT PROPERTY.

Where a security interest in investment property has been perfected by filing, the choice of law rule is the jurisdiction in which the debtor is located. Where the security interest is perfected by a method other than filing and the collateral is a certificated security, the local law of the jurisdiction where the security certificate is located governs. Where the security interest is perfected by a method other than filing and the collateral is an uncertificated security, the local law of the issuer's jurisdiction governs. For security interests in a security entitlement or securities account, the local law of the jurisdiction where the securities intermediary is located governs. Finally, the local law of the commodity intermediary governs the perfection and priority of a security interest in a commodity contract or commodity account.

(7) LETTER-OF-CREDIT RIGHTS.

The perfection and priority of a security interest in letter-of-credit rights are governed by the law of the jurisdiction of the issuer or other

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267 Revised § 9-304 (a).
269 Revised § 9-304(a) (1).
270 Revised § 9-304 (a) (1).
271 Revised § 9-304 (a) (3).
272 Revised § 9-304 (a) (4).
nominated person, as long as that jurisdiction is a state. If the jurisdiction is not a state, then the law of jurisdiction where the debtor is located governs.

X. POST-CLOSING CHANGES WITH REGARD TO DEBTOR AND COLLATERAL.

Collateral frequently does not remain in one location indefinitely. Likewise, debtors do not always remain static in their locations. In fact, debtors not only change their locations on occasion, but additionally sometimes change their identities and corporate structure. Both Current Article 9 and Revised Article 9 address the effect of some of these changes. Revised Article 9, however, goes even further, particularly in addressing changes involving the debtor.

A. CHANGE OF LOCATION OF COLLATERAL.

Under Current Article 9, if collateral in which a security interest was perfected by filing is moved to a new jurisdiction, the security interest remains perfected for four months. Within that time period, the secured party is required to perfect its security interest in the new jurisdiction to maintain continuous perfection. Revised Article 9 eliminates this rule. The simplified new general choice of law rule requires filing in only one place for most types of collateral: the jurisdiction in which the debtor is located. Thus, choice of law no longer pivots

273 Revised § 9-306 (a).
274 Current § 9-103 (1) (d).
upon the location of the collateral, and there is no need to re-perfect when the location of the collateral changes.\textsuperscript{275}

**B. CHANGE OF THE DEBTOR’S LOCATION.**

For individuals and unregistered corporations, Revised Article 9 continues the rule of Current Article 9. If the debtor moves to a new jurisdiction, the security interest remains perfected for four months, unless the perfection lapses before the expiration of four months. To continue the perfection without lapse, the secured party must perfect the security interest in the new jurisdiction within the four month period.\textsuperscript{276}

On the other hand, a registered organization cannot, by definition, cease to exist. Revised Article 9 states that a registered organization continues to be located in the jurisdiction in which it is registered even if it dissolves, winds up or cancels its existence.\textsuperscript{277}

**C. TRANSFER OF COLLATERAL TO A DEBTOR LOCATED IN A NEW JURISDICTION.**

Revised Article 9 specifically addresses the transfer of collateral perfected in one jurisdiction to a person located in another jurisdiction. As explained in Section III of this paper, any person or entity that has an ownership interest in collateral subject to a security interest is a “debtor,” under Revised Article 9.\textsuperscript{278}

The security interest perfected in the jurisdiction of the transferor remains perfected for one year. To continue the perfection without lapse, the secured

\textsuperscript{275} Revised § 9-103; The New Article 9, at 50.

\textsuperscript{276} Current § 9-103 (3) (e); Revised § 9-316 (a).
party must re-perfect in the jurisdiction to which the collateral has been transferred within the one year.\textsuperscript{279}

**D. TRANSFER OF COLLATERAL SUBJECT TO A SECURITY INTEREST TO A NEW DEBTOR WHO PROCEEDS TO GRANT A SECURITY INTEREST IN THE SAME COLLATERAL TO ANOTHER SECURED PARTY.**

Revised Article 9 incorporates a new rule to deal with competing security interests in transferred collateral. Specifically, Revised Section 9-325 addresses the conflict that arises where a debtor transfers collateral subject to a perfected security interest to a new debtor and the new debtor proceeds to grant a security interest in the same collateral to a different secured creditor. In such an instance, there will be competing security interests between the transferor's secured creditor and the transferee's secured creditor. Revised Section 9-325 provides that the security interest held by the transferee's secured creditor is \textit{subordinated to} the security interest held by the transferor's secured creditor, as long as the following conditions are met: (1) the security interest held by the transferor's secured party was perfected when the transferee acquired the collateral; and (2) there was no period thereafter in which the security interest was unperfected.

**E. TRANSFER OF COLLATERAL SUBJECT TO A SECURITY INTEREST TO A NEW DEBTOR WHO BECOMES BOUND BY THE TRANSFEROR'S SECURITY AGREEMENT.**

Revised Article 9 incorporates the concept of a "new debtor." A "new debtor" is a new term incorporated and defined by Revised § 9-102 (a) (56) as a person who becomes legally bound by another debtor's security interest. This

\textsuperscript{277} Revised § 9-307 (g).
\textsuperscript{278} Revised § 9-316 (a) (3); Official Comment 2 to Revised § 9-316.
\textsuperscript{279} Id.
commonly occurs where the debtor changes its identity or corporate structure; as for example, when a corporate debtor merges with another corporate entity or a partnership decides to incorporate. Changes in corporate structure or identity inherently involve a transfer of assets from the original entity to the new entity. A “new debtor” is also created whenever another entity contractually assumes the obligations under a security agreement.280

Current Article 9 deals with this situation by requiring a new UCC-1 financing statement filing if the existing financing statements are seriously misleading as a result of the change. That process has been criticized, however, as failing to satisfactorily address the situation.281

Revised Article 9 is more expansive than Current Article 9, specifically addressing the issues of attachment and perfection of a security interest in collateral transferred to a “new debtor.” The issue of whether the new debtor takes the collateral subject to the old debtor’s security interest hinges on whether the new debtor becomes bound by the security agreement by operation of law other than Article 9 or by contract.282 If the new debtor becomes legally or contractually bound, the security interest attaches to the collateral and after-acquired property, if applicable, in the hands of the new debtor.283 Additionally, “where the transferee becomes generally liable for the debts of the transferor debtor by law or by contract, the transferee becomes bound by the original

280 Revised § 9-102 (a) (56); Revised § 9-203; “It’s...new! It’s...(somewhat) complicated! It’s...(going to be) law! It’s UCC Article 9 Revisions,” at 5-6.
281 “It’s...new! It’s...(somewhat) complicated!...” at p. 6; See also “Acquiring Collateral Under Revised Article 9,” at 5-6.
282 Revised § 9-203 (d); Official Comment 7 to Revised § 9-263.
debtor's security agreement, both for existing and, if applicable, after-acquired collateral.\textsuperscript{284} If the new debtor is not, however, bound by the original debtor's security agreement, and has not \textit{generally} assumed the debts of the original debtor, the new debtor's assets will not be subject to the security interest.\textsuperscript{285}

With regard to perfection, the security interest will generally remain perfected. The rules regarding the effectiveness of a financing statement filed while the collateral was in the hands of the original debtor is covered by Part V of Revised Article 9, and outside of the scope of this paper. If, however, the new debtor is located in a different jurisdiction, Revised § 9-316 (a) provides a one year grace period to continue perfection in collateral existing at the time of the transfer to the new debtor.\textsuperscript{286} To continue the perfected status of the security interest, the secured party must file a new financing statement in the new jurisdiction within that one year period.

Where the transferred collateral takes subject to a security interest held by the new debtor's secured creditor, the first-to-file priority rule does not apply. Thus, even where the new debtor's secured party has perfected its security interest by filing before the original debtor's secured party perfected, the original debtor's secured party will prevail with regard to the transferred collateral.\textsuperscript{287}

\textsuperscript{283} Revised § 9-203 (d).
\textsuperscript{284} The New Article 9, at 51 (explaining Revised § 9-203 (d) (emphasis added); Official Comment 7 to Revised § 9-203; "Acquiring Collateral Under Revised Article 9," at 6-7.
\textsuperscript{285} "Acquiring Collateral Under Revised Article 9," at 6.
\textsuperscript{286} Revised § 9-316 (a) (3); The New Article 9, at 52.
\textsuperscript{287} Revised § 9-325; The new Article 9, at 52.
XI. CONCLUSION.

In conclusion, Article 9 has undergone extensive changes to achieve the goals of simplicity, uniformity and consistency with current technology. The changes to Article 9 impact attachment, perfection, and priority of security interests, as well as expand the scope of Article 9 in terms of collateral, definitions, parties and transactions. Preparations for these changes now will avoid missteps under the Revised Article, as it’s effective date quickly approaches.
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SECTION K
CONFERENCE ON LEGAL ISSUES FOR FINANCIAL INSTITUTIONS
APRIL 21, 2001

SECRETARY OF STATE FILING RULES

I. Filing Rules Under Revised Article 9 Part 5

A. Place to file

KRS 355.9-501(1) establishes the Office of the Secretary of State as the place to file financing statements for all collateral except as-extracted collateral or timber to be cut or if the financing statement is filed as a fixture filing.

B. Information Required for Effective Financing Statements

Revised Article 9 retains the concept of notice filing. What is required to be filed is only a record providing the name of the debtor, the name of the secured party and an indication of collateral. A debtor signature is no longer required. This facilitates electronic filing. KRS 355.9-502 and Official Comment 2 to 9-502.

C. Name of Debtor and Secured Party

Revised Article 9 explains what a debtor’s name is for purposes of a financing statement. If a debtor is a registered organization, then the debtor’s name is the name that appears on the records of the debtor’s jurisdiction of organization. Trade name only is insufficient. If an unregistered organization has a name, that name is the correct name to put on a financing statement. If the unregistered organization does not have a name, then the financing statement should include the names of individuals or entities that comprise that organization. If a debtor is a decedent’s estate, the financing statement must provide the name of the decedent and indicate that the debtor is an estate. If the debtor is a trust or a trustee, the financing statement must provide the name specified for the trust in its documents or if no name is specified provide the name of the settlor or indicate in the debtor’s name or otherwise that the debtor is a trust. KRS 355.9-503(1).
D. Effect of Errors

1. A financing statement that substantially complies with Part 5 is effective even if it contains minor errors provided the errors do not make the financing statement seriously misleading. KRS 355.9-506(1).

2. Errors in Debtor’s Name

A financing statement that fails sufficiently to provide the name of the debtor in accordance with 9-503(name in articles of incorporation) is seriously misleading as a matter of law. There is one exception: if the financing statement nevertheless would be discovered under the debtor’s correct name using the filing office’s standard search logic, then as a matter of law the incorrect name does not make the financing statement seriously misleading. A financing statement that is seriously misleading is ineffective even if it disclosed by using search logic other than that of the filing office. KRS 355.9-506 and Official Comment 2.

3. Standard Search Logic

The Secretary of State will adopt the search logic of the model rules promulgated by the International Association of Corporation Administrators (“IACA”). This search logic only allows full name searches. No partial name searches are permitted under the standard search logic adopted by the IACA. Kentucky will certify only full name searches, but will continue to permit partial name searches over the web.

The following rules apply to standardized searches. Standardized search results are produced by the application of standardized search logic to the name presented to the filing officer. Human judgment does not play a role in determining the results of the search.

a. There is no limit to the number of matches.
b. No distinction is made between upper and lower case letters.
c. Punctuation marks and accents are disregarded.
d. Words and abbreviations at the end of a name that indicate the existence or nature of an organization are disregarded.
e. The word “the” at the beginning of the search criteria is disregarded.
f. All spaces are disregarded.
g. For first and middle names of individuals, initials are treated as the logical equivalent of all names that begin with such initials.
E. Exclusive Grounds for Refusal of UCC Record

Revised Article 9 sets forth exclusive grounds upon which a filing office can reject a record. The filing office must reject on these grounds only and no others. KRS 355.9-516.

1. Means of Communication. The record is not communicated by a method authorized by the office.

2. Debtor name and address. An initial financing statement or an amendment that adds a debtor shall be refused if the record fails to include the name and address for a debtor.

3. Fee. An amount equal to or greater than the filing fee is not tendered.

4. Additional debtor information. An initial financing statement or an amendment adding a debtor shall be refused if the record fails to identify whether each debtor is an individual or organization, if the last name of each individual is not identified, or if, for each debtor identified as an organization, the record does not include the organization’s type, state of organization or organization number, or a statement that it does not have one.

5. Secured party name and address. An initial financing statement, an amendment adding a secured party or an assignment will be refused if the record fails to include a secured party or assignee name and address.

6. Lack of identification number. A UCC record other than an initial financing statement will be refused if the record does not provide a file number of a financing statement.

7. Identifying information. A UCC record that does not identify itself as an amendment or identify an initial financing statement to which it relates is an initial financing statement.

8. Timeliness of continuation. A continuation will be refused if it is not received during the six-month period prior to lapse.
F. Grounds Not Warranting Refusal

1. Errors. The UCC record contains a misspelling or other erroneous information.

2. Incorrect names. The UCC record appears to identify a debtor incorrectly or the UCC record identifies a secured party incorrectly.

3. Collateral description. The UCC incorrectly identifies collateral, or contains an illegible description of collateral or appears to contain no such description.

4. Excessive fee. The record is accompanied by funds in excess of the filing fee.

G. Refusal Errors

If a secured party demonstrates that a UCC record that was refused should not have been refused, the Secretary of State will file the UCC record with a filing date and time assigned when the filing occurs. The Secretary of State will also file a statement that states that the effective date and time of filing is the date and time that the UCC record was originally tendered for filing and sets forth such date and time. KRS 355.9-516(4) and 355.9-520(2).

H. Correction Statement

Revised Article 9 provides a means for a debtor to correct a financing statement or other record that was inaccurate or wrongfully filed by filing a correction statement. A correction statement becomes part of the financing statement file, but the filing does not affect the effectiveness of the initial financing statement or any other filed record. KRS 355.9-518.

I. Duties of Filing Office

1. Indexing Records

The filing office must assign a unique file number that consists of a check digit. This ensures against transposition errors. The filing office must be able to retrieve the records by debtor name and file number. Additionally, the information management system must associate an initial financing statement and each filed record relating to the initial financing statement. KRS 355.9-519(1), (2), (3). This contemplates that the searchers and not the filing office will determine the effectiveness of filed records. The filing office is prohibited from deleting names from the index until one year after lapse. KRS 355.9-
2. Time of Filing

UCC records may be tendered for filing to the Secretary of State as follows:

a. Personal delivery at the filing office’s street address-filing time is when the UCC record is accepted by the filing office.

b. Courier delivery at the filing office’s street address-filing time is 5:00 on the day of delivery.

c. Postal service delivery to the filing office’s mailing address-filing time is 5:00 on the day of delivery.

d. Electronic delivery- UCC records excluding correction statements may be transmitted electronically using XML techniques or on-line entry-filing time is time that the Secretary of State’s system analyzes the relevant transmission and determines all required elements of the transmission have been received in a required format and are machine-readable.

J. Performance Standard

Revised Article 9 requires the filing office to file a record within 2 days and to reject a record within 2 days. KRS 355.9-519(8) and KRS 355.9-520(2).

K. Refusal to Accept

Revised Article 9 requires the filing office when it refuses to file a record to provide to the filer the date and time the record would have been filed if the filing office accepted it. KRS 355.9-520(2). If the filing office wrongly rejects a record, the filer officer must the UCC record with a filing date and time assigned when the filing occurs. The filing officer shall also file a filing officer statement that states the effective date and time of filing which shall be the date and time the UCC record was originally tendered for filing. The record is effective except as to a purchaser in good faith who relies on a search of the index.
L. Approved Forms

1. Kentucky adopted the national forms in Revised Article 9. KRS 355.9-521. The Secretary of State will require the use of the national form because it designates separate fields for individual and organization names and separate fields for first, middle and last names and suffixes. The use of the national form diminishes the possibility of filing office error and helps assure that filers' expectations are met.

2. Data Entry Procedures

The administrative regulations will require that organization names be entered into the UCC information management system exactly as set forth on the UCC record, even if it appears that multiple names are set forth or it appears that the name of an individual has been included in the field designated for an organization name. Individual names are entered exactly as forth on the record. Inclusion of names in an incorrect field or failure to transmit names accurately may cause the filing to be ineffective.

M. Acknowledgements

Under Revised Article 9, the filing office is only required to acknowledge the filing of a written record upon request of the filer. The filing office must acknowledge the filing of an electronic filing even in the absence of a request. KRS 355.9-523.

N. Fees

1. The filing fees set forth in Revised Article 9 are as follows.

   a. $10.00 for all written financing statement and amendments
   b. 5.00 for all electronic financing statements and amendments
   c. 20.00 for all written financing statements and amendments over two pages
   d. $5 for certified search results
   e. The fee for copies of UCC records is $.10 per page.
2. Methods of Payment

   Filing fees and fees for copies may be paid by the following methods:
   
   a. Cash
   b. Checks made payable to the Kentucky State Treasurer
   c. Electronic Funds Transfer- while not yet available the Secretary of State has specified this method in the rules to allow it when it becomes available for the state in the future.
   d. Prepaid accounts- a remitter may open an account by submitting an application and prepaying a minimum of $250. The Secretary of State will issue an account number to the applicant and to each authorized representative of the applicant.
   e. Debit and credit cards-The Secretary of State will accept payment by debit cards and credit cards issued by approved issuers.

3. Overpayment and Underpayment policies

   a. Overpayment- the Secretary of State will refund the amount of an overpayment exceeding $10 to the remitter. The Secretary of State will refund an overpayment of $10 or less only upon the written request of the remitter.
   b. Underpayment-the Secretary of State can return the filing or can contact the filer and give them 10 days to send the full fee.

O. Model Rules

Revised Article 9 requires the Secretary of State to promulgate rules to implement Article 9. KRS 355.9-526. The Secretary of State is required to consult with other filing offices and the model rules promulgated by the International Association of Corporation Administrators in adopting the filing office rules.

The administrative regulations drafted to implement Revised Article 9 in Kentucky will be filed on July 2, 2001. A draft of the rules will be on the Secretary of State’s web site. The address is www.sos.state.ky.us/
P. Electronic Filing

1. XML Records
An "XML" record means a UCC record transmitted from a remitter to the Secretary of State by XML techniques. The XML format as adopted by the International Association of Corporation Administrators is adopted for use in Kentucky for electronic transmission of UCC records except correction statements. At the request of an authorized XML remitter, the Secretary of State must identify which versions and releases of the XML are acceptable to the filing office. A remitter may be authorized for XML transmission upon authorization from the Secretary of State.

2. Direct On-line Data Entry Procedures

A UCC record except correction statements may be filed electronically by accessing the Secretary of State’s web site. A financing statement or amendment filed electronically on-line may contain only one secured party and a maximum of two debtors. A filing is made by completing a web based UCC financing statement form or amendment form and charging the fee either to a prepaid account or an approved credit or debit card.

II. Kentucky Lien Information System

The Kentucky legislature repealed KRS 355.9-401A effective July 14, 2000. This was the section that required secured parties to send copies of the UCC filings made at the county to the Secretary of State for inclusion on the Kentucky Lien Information System. A person can still request a copy of the data indexed on the Kentucky Lien Information System by contacting the IT section of the Secretary of State’s Office. The requirement was repealed to allow the Secretary of State sufficient time to implement central filing in Kentucky by July 1, 2001.
INTANGIBLE FINANCING UNDER REVISED ARTICLE 9

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INTANGIBLE FINANCING UNDER REVISED ARTICLE 9

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SECTION L
Intangible Financing Under Revised Article 9

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I. Introduction: Revised Article 9 includes a number of changes intended to make more types of transactions involving intangible collateral subject to the provisions of the U.C.C. The revisions expand the scope of Article 9, introducing several new types of intangible collateral. The revisions also provide detailed provisions which overcome the effect of anti-assignment provisions and govern the rights of account debtors and other third parties to intangible collateral.

A. Intangible Collateral: As used in this outline, “intangible collateral” refers to collateral other than goods. Current Article 9 categories of intangible collateral include accounts, instruments, documents, chattel paper, investment property and general intangibles.

B. Reason for Changes: In large part, these changes are intended to provide certainty in asset securitization transactions. Asset securitization refers to a transaction structured as a sale by the originator of the assets of intangible assets (the borrower in a traditional financing arrangement) to a separate entity (a “special purpose vehicle” or “SPV”). The SPV raises the purchase price of the assets through a sale of debt or equity instruments in the market. Like a traditional factoring agreement, asset securitization enables the company seeking financing to liquidate its receivables rather than simply grant a security interest in them. The deals are structured as sales rather than security interests in an effort to insure that the assets do not become property of the estate in a bankruptcy of the originator. See Christopher W. Frost, Asset Securitization and Corporate Risk Allocation, 72 Tulane L. Rev. 101 (1997); Healthcare Financing In Bankruptcy: Sales or Liens? Where You Stand Depends on Where You Sit, 24 Cal. Bankr. J. 185 (1998).

The popularity of asset securitization has expanded the ability to finance non-traditional types of collateral. Examples include, health care insurance receivables, royalty agreements, and payment obligations under franchise agreements. The inapplicability of Article 9 to sales of these types of obligations created confusion among lending attorneys regarding the appropriate methods of perfecting interests in these assets.

II. Scope of Revised Article 9: The revisions substantially expand the types of transactions in intangible collateral that are subject to the provisions of Article 9.
A. **Current Article 9:** Current Article 9 applies to security interests in all types of intangible collateral. In addition, 9-102(1)(b) provides that Article 9 applies to sales of accounts or chattel paper. The application of the sale provisions in current Article 9 recognize that sales of accounts and chattel paper, in reality, operate as financing transactions. Therefore, the current code requires filing to perfect the buyer’s interest in this type of asset.

B. Revised Article 9: Revised Article 9 continues to apply to security interests in all types of intangible collateral. The change in scope relates to the types of sale transactions that are subject to the provisions of Revised Article 9. RUCC 9-109(a)(3) provides that in addition to sales of accounts and chattel paper, the article applies to sales of “payment intangibles” and “promissory notes.” In addition, Revised Article 9 expands the definition of “accounts.”

1. **Royalty Agreements:** RUCC 9-102(a)(2) expands the definition of “accounts” to include monetary obligations for property “sold, leased, licensed, assigned or otherwise disposed of.” This broadens the definition of accounts to encompass rights to payment arising from intellectual property licensing agreements, for example. Current Article 9 would categorize such rights as “general intangibles.” See RUCC 9-102, comment 5.a. The effect of this change is that a buyer of such intangible rights to receive payment must file to perfect its interest.

2. **Health-Care-Insurance Receivables:** The definition of accounts under Revised article 9 also includes “health-care-insurance receivables,” a new type of collateral. RUCC 9-102(a)(46) defines health-care-insurance receivables as rights to payment under a policy of insurance for health-care goods or services provided. This change enables hospitals and other health care providers to use their rights to reimbursement from third-party payors (Blue Cross, Medicare, Medicaid, and the like) as collateral for loans.

3. **Payment Intangibles:** Current Article 9 does not apply to sales of general intangibles, but does apply to the grant of a security interest in such collateral. Revised Article 9 subdivides general intangibles through a new definition of “payment intangible.” RUCC 9-102(a)(61) defines payment intangible as “a general intangible under which the account debtor’s principal obligation is a monetary obligation.” The reason for this change is to include sales of loan repayment obligations (which would not fall within the definition of accounts) within the scope of Article 9.

4. **Promissory Notes:** For the reasons described in connection with payment intangibles, Revised Article 9 subdivides the definition of instruments
through a new definition of "promissory notes." RUCC 9-102(a)(65) defines promissory notes as "an instrument that evidences a promise to pay a monetary obligation..." Sales of promissory notes now fall within the scope of Revised Article 9.

5. Effect on Loan Participations: The new definitions of payment intangibles and promissory notes, described above, coupled with the expansion of the scope of Revised Article 9 to cover sales of these types of assets, subject loan participations to the provisions of Revised Article 9. RUCC 9-309(3) and (4) provide for automatic perfection of the buyer's interest in these types of assets, however. Thus filing is not necessary for traditional loan participations.

6. A Note on Deposit Accounts: One expansion to Article 9's scope that is not directly related to the rise of asset securitization, but is nonetheless important, is the inclusion of deposit accounts as original collateral subject to Revised Article 9. Under Current Article 9, deposit accounts could serve as collateral only if the deposits constituted identifiable proceeds of Article 9 collateral. This limitation created concerns that co-mingling of proceeds in a deposit account with non-proceeds could destroy the interest of the lender in the entire account. See UCC 9-306(4) (limiting the security interest in proceeds in a co-mingled deposit account where the debtor has instituted insolvency proceedings).

By permitting deposit accounts to serve as original collateral, Revised Article 9 has substantially alleviated this concern. If an accounts receivable lender wants to assure that its security interest in the accounts continues in proceeds, the lender may take a security interest in the deposit accounts into which the account debtors' payments will be deposited.

III. Effectiveness of Sale: One of the most important questions in any asset securitization is whether the asset securitization effectively severs the accounts from the originator. If the asset transfer has the attributes of a sale, the transfer will extinguish the originator's interest in the assets -- insulating them from the originator's bankruptcy. In Octagon Gas v. Rimmer, 995 F.2d 948 (10th Cir. 1993), cert. denied 114 S. Ct. 554 (1993), the court held that Current UCC 9-102(1)(b) effectively converts all sales of accounts and chattel paper into secured loans. This ruling created a furor in the asset securitization industry because it seemed to prevent the separation of accounts from the originator that is so central to the concept of asset securitization.
Although, the Octagon result was not followed by any other courts, the drafters of Revised Article 9 included a provision that is designed to make clear that the application of Article 9 to sales of accounts, chattel paper, payment obligations and promissory notes does not mean that the transaction should be treated as a sale treatment for all purposes. RUCC 9-318 provides, “A debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold.” This section effectively overrules the Octagon result.

IV. Rights of Account Debtors and other Third Parties: Part 4 of Revised Article 9 collects in one location all of the Article 9 rules dealing with rights of third parties. In general, the provisions are designed to address the effect of security interests on the rights of non-debtor parties to payment obligations (accounts, payment intangibles, instruments, etc.) or general intangibles that might be pledged as collateral.

A. Discharge of Account Debtor: Revised Article 9 continues substantially unchanged Current Article 9’s treatment of discharge of the account debtor. In general, RUCC 9-406 permits the account debtor to continue to pay the assignor of the accounts until the assignor or the assignee notifies the account debtor of the assignment. Upon notification, the account debtor must pay the assignee to obtain a discharge of its obligations under the account.

B. Claims and Defenses of Account Debtor Against Assignee: Here again, Revised Article 9 does not impose any radical changes to the structure created by current Article 9. RUCC 9-404 provides that the rights of the assignee against the account debtor are subject to claims arising from any agreement relating to the account. Thus, a bank that has taken a security interest in, or purchased, an account arising from the sale of goods would be subject to a breach of warranty defense by the account debtor if the breach relates to the goods giving rise to the account. In addition, RUCC 9-404 provides that the assignee of an account is subject to claims or defenses that do not relate to the transaction giving rise to the account if the claim or defense accrues before the account debtor receives notification of the assignment.

C. Contract Modifications: Revised Article 9 provides in RUCC 9-405, that a modification of a contract giving rise to an assigned account is effective against the assignee if the modification is made before the assignor’s right to payment has

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1 As used in both Revised and Current Article 9, assignor refers to the borrower or seller of the accounts, and assignee refers to the lender or buyer of the accounts.

2 For simplicity, this section refers only to accounts. In reality, the sections relating to account debtors also cover obligations under accounts, chattel paper and general intangibles.
been earned by performance. If the assignor’s obligations to the account debtor have been fully performed, the modification will still be effective if it occurs before notification of the assignment.

D. Restrictions on Anti-Assignment Provisions: Part 4 of Revised Article 9 increases the types of property that may serve as collateral while, at the same time, protecting the rights of the non-debtor party obligated under the contract giving rise to the intangible. It accomplishes this by limiting the effect of anti-assignment provisions in most types of contracts and licenses. Often, licensors of intellectual property, governmental agencies and lessors will try to maintain control over the property or governmental grant by prohibiting the licensee, grantee or lessee from transferring its interest. To the extent these types of restrictions affect the ability of the debtor to grant a security interest, Revised Part 4 renders the provisions unenforceable.

1. Current Article 9: Current Article 9 rendered some types of anti-assignment provisions enforceable. UCC 9-318(4) provides, “A term in any contract between an account debtor and an assignor is ineffective if it prohibits assignment of an account or prohibits creation of a security interest in a general intangible for money due or to become due or requires the account debtor’s consent to such assignment or security interest.”

This section provided protection to secured lenders only when the collateral could be clearly characterized as an account or a general intangible for money due. In addition, debtor’s attorneys were often concerned that the language of UCC 9-318(4) would not be sufficient to protect the debtor from a breach of contract claim if an account were assigned in violation of a prohibition against such assignment.

2. Revised Article 9: In a series of provisions, Revised Article 9 renders ineffective such contractual restrictions for all types of intangible collateral to the extent that the restrictions prohibit the assignment of, or grant of a security interest in, the debtor’s rights in the intangible property. In addition, these provisions also clearly render ineffective any term that provides that an assignment or grant of a security interest will constitute a breach of the agreement giving rise to the intangible right.

3. An Example: To use an example from the revised comments, assume that the debtor is a licensee of software under a licence agreement that prohibits the debtor/licensee from transferring or assigning any of its rights under the agreement. Under Current UCC 9-318(4), the licensee could not grant a security interest in its right to maintain possession and use the software since that right is not a "general intangible for money due
or to become due." RUCC 9-408(a)(1) provides that the term is ineffective to the extent that it would impair the creation of a security interest in the debtor's rights under the licensing agreement.

4. **Legal Restrictions on Assignability:** RUCC 9-408 also renders provisions of law that restrict the assignability of promissory notes, health care insurance receivables or general intangibles ineffective to the extent that they prohibit the creation or perfection of a security interest. This may permit the lender to obtain a security interest in governmental licenses notwithstanding statutory provisions that prohibit assignment. For example, Kentucky law prohibits the transfer of a liquor license by the licensee without prior authorization by the appropriate state administrator. K.R.S. 243.630. The section defines transfer to mean the transfer of 10% or more "ownership interest." It is unclear whether this section would preclude the grant of a security interest. Assuming that it does, RUCC 9-408 would eliminate the prohibition.

5. **Limitations on the Rights Obtained by the Secured Party:** While Revised Article 9 provides a virtually unlimited right to take a security interest or assignment of these types of rights, the revision severely limits the lender's ability to fully realize the debtor's rights under the license or contract. RUCC 9-408(d) provides that where Revised Article 9 has rendered an anti-assignment provision ineffective, the security interest:

   a. is not enforceable against the person obligated on the promissory note or the account debtor;

   b. does not impose a duty or obligation on the person obligated on the promissory note or the account debtor;

   c. does not require the person obligated on the promissory note or the account debtor to recognize the security interest, pay or render performance to the secured party, or accept payment or performance from the secured party;

   d. does not entitle the secured party to use or assign the debtor's rights under the promissory note, health-care-insurance receivable, or general intangible, including any related information or materials furnished to the debtor in the transaction giving rise to the promissory note, health-care-insurance receivable, or general intangible;
e. does not entitle the secured party to use, assign, possess, or have access to any trade secrets or confidential information of the person obligated on the promissory note or the account debtor; and

f. does not entitle the secured party to enforce the security interest in the promissory note, health-care-insurance receivable, or general intangible.

These limitations are intended to protect the non-debtor party from any change in its transaction with the debtor that might otherwise be caused by the presence of a secured creditor. In the software example discussed above, under RUCC 9-408(d) our secured party could not enforce the software license agreement, nor would the security interest entitle the secured party to take possession or dispose of the software or impose any obligation or duty on the licensor. In essence, the licensor will be protected against any ill-effects of the security interest.

The substantial limitation on the secured creditor’s enforcement rights in such collateral obviously diminishes the utility of such a security interest. The only advantage that a secured creditor might gain from taking the security interest is the assurance that if the general intangible were sold or assigned during the debtor’s bankruptcy, the secured creditor would have a claim to the proceeds of the collateral. See RUCC 9-408 comment 7.

6. A Cautionary Note: The dramatic expansion of Revised Article 9’s limitations on anti-assignment provisions may have effects that were not anticipated by the drafters. For example, on the eve of Kentucky’s enactment of the provision, it was discovered that the limitation threatened to impair the beneficial tax treatment of structured settlements of workers compensation awards and “special needs medicaid trusts.” This late discovery required an amendment to make clear that such arrangements were outside of the scope of Revised Article 9. Given the sweeping changes in this area, it is impossible to determine whether similar problems may arise.
PART 7

TRANSITION RULES FOR REVISED ARTICLE 9
(What To Do Before And After July 1, 2001)

[ KRS 355.9-702 - 9-709 ]

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SECTION M
TRANSITION RULES FOR REVISED ARTICLE 9
(What To Do Before And After July 1, 2001)

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SECTION M
1. Security interest perfected by a financing statement filed before July 1, 2001

A. What happens to perfection on July 1, 2001—KRS 355.9-705(3)

- Security interest is perfected by a pre-effective-date (PED) filing which is effective to perfect the security interest under old 9; PED filing is not effective to perfect the security interest under Kentucky revised 9 because revised 9 requires filing with the secretary of state; nevertheless SECURITY INTEREST REMAINS PERFECTED until earlier of remaining period of perfection under old 9 or June 30, 2006

EXAMPLE—SP perfects a security interest in debtor’s equipment by filing financing statement on August 1, 2000, in the Kentucky county clerk’s office of the county of debtor’s residence; revised 9 takes effect on July 1, 2001; under revised 9, financing statement in equipment would be filed in secretary of state’s office, thus filing is not effective under revised 9; security interest remains perfected until July 31, 2005, (the earlier of normal lapse date under old 9 or June 30, 2006) regardless of lack of post-effective-date filing

PRACTICAL EFFECT—SP can do nothing and security interest perfected by PED filing remains perfected

- Perfection remains effective even if the PED financing statement has been continued by a PED continuation statement

EXAMPLE—PED financing statement filed in January, 1996; continuation statement filed in January 2001; security interest remains perfected, without action, until January 2006 (the earlier of normal lapse date under old 9 or June 30, 2006)

ACTION—before July 1, 2001, file continuation statements locally for security interests whose six month continuation statement window opens before July 1, 2001; security interest remains perfected until June 30, 2006
• PED perfection is effective for collateral acquired after July 1, 2001, attached through an after-acquired property clause in a PED security agreement

EXAMPLE—Security interest in equipment and after-acquired equipment perfected by filing in November 2000; debtor acquires additional equipment in November 2001; perfection is valid for all equipment until November 2005; no action required before November 2005

B. Continuing perfection, after revised 9 takes effect, of security interest perfected by filing under old 9—KRS 355.9-706 & 9-705(4)

• Security interest perfected by PED filing cannot be continued beyond lapse date by filing revised 9 continuation statement—9-705(4)

EXCEPTION—PED filing can be continued by timely filing a revised 9 continuation statement if PED filing was in the filing office designated by revised 9; the continuation statement and the PED financing statement must satisfy revised 9 requirements for an initial financing statement—9-705(4) & (6)

PRACTICAL EFFECT—exception is of little value to security interests perfected by filing in Kentucky because PED filing typically is a county clerk’s office filing and effective revised 9 filing is a secretary of state’s office filing, thus effective filings would not be made in the same office; exception applicable to multi-state secured transactions where choice of law rules of both old 9 and revised 9 specify same jurisdiction and same office

• Continuing effectiveness of PED filing is accomplished by filing an initial financing statement “in lieu” of filing a continuation statement—9-706

EXAMPLE—SP perfects a security interest in Kentucky debtor’s equipment by filing a PED financing statement in county of debtor’s residence on August 1, 2000; revised 9 takes effect on July 1, 2001, and thereunder the Kentucky secretary of state’s office is the proper filing office; on November 11, 2004, SP files, in.
the Kentucky secretary of state's office, an initial financing statement (KRS 355.9-502) that satisfies the requirements of 9-706(3) to continue the PED filing; SP's PED filing is continued for five years from November 11, 2004, and SP's priority date relates back to the original priority date

WHERE TO FILE—In Kentucky the "in lieu" statement is filed in the secretary of state's office, the filing office designated by revised 9

WHEN TO FILE—The "in lieu" statement can be filed any time prior to lapse of effectiveness of PED financing statement; this filing is not restricted to the normal six month window for filing continuation statements

- The "in lieu" statement continues the effectiveness of the PED financing statement for five years from the date of filing the "in lieu" statement, not five years from the normal lapse date of the PED filing

WHAT TO FILE—The "in lieu" statement must: 1) satisfy the revised 9 requirements for an initial financing statement (names, addresses, description; KRS 355.9-502); 2) identify the PED filing by filing office, date of filing, and file numbers of the PED filing and most recent continuation statement (if any); and 3) indicate that the PED filing remains effective

- The "in lieu" statement can continue the effectiveness of more than one PED filing against the same debtor provided the "in lieu" statement properly identifies all the affected filings

C. Amendment of PED filing—KRS 355.9-707

- Amendment, under the revised 9 definition, includes any filings made to a financing statement after filing the initial financing statement, e.g., add or delete collateral, continue or terminate the financing statement, add or delete debtors/secured parties

WHERE TO FILE—File amendment in office and jurisdiction specified by revised 9 (in Kentucky, the secretary of state's office) regardless of place of PED filing
EXAMPLES—PED financing statement filed locally in Kentucky, post-revised 9-effective-date amendment can be filed only in Kentucky secretary of state’s office; in multi-state secured transaction—PED filing made, for example, in Ohio under old 9’s choice of law rules; revised 9’s choice of law rules designate Kentucky as the proper jurisdiction; post-effective-date amendment can be filed only in Kentucky secretary of state’s office

EXCEPTION—can terminate effectiveness, i.e., a termination statement, of PED filing in accordance with law of jurisdiction where PED filing is made—9-707(2) & (5); effect of exception is that locally filed financing statement can be terminated by a local filing; termination “exception” is not available if SP has filed a post-effective-date initial financing statement in office designated by revised 9

WHAT TO FILE—File an initial financing statement (names, addresses, and description) that provides the amended information and also the information required in an “in lieu” statement (9-706(3)); can also amend by filing two documents: the initial financing statement that also includes the “in lieu” information, and the amendment;

EXCEPTION—If the PED financing statement and the amendment are filed in the same office specified by revised 9, then amendment is only filing required; this exception is not generally applicable in Kentucky since PED filing is local, and the post-effective-date amendment filing is central; possible in multi-state secured transactions where PED filing office is same as revised 9 filing office

2. Security interest enforceable and perfected under revised 9 and old 9—KRS 355.9-703(1)

- A security interest that was enforceable and perfected under old 9, or other applicable law 9, e.g., PED transaction is outside the scope of old 9, is a perfected security interest under revised 9 if, when revised 9 becomes effective, the applicable requirements for
enforceability and perfection under revised 9 are satisfied without further action

EXAMPLES—purchase money security interest in debtor's consumer goods automatically perfected upon attachment under old 9 and revised 9; security interest in non-inventory motor vehicle perfected by notation on certificate of title under old 9 and revised 9; security interest in debtor's instruments perfected by possession under old 9 and revised 9; security interest in debtor's securities account perfected by control under old 9 and revised 9

3. Security interest enforceable and **perfected under old 9 other than by filing**, but not perfected under revised 9—KRS 355.9-703(2)

EXAMPLES—Sale of a promissory note was not covered by old article 9, but is covered by revised 9; assignment of a deposit account was not covered by old 9, but is by revised 9

• Security interest that is enforceable and perfected under old 9 but does not satisfy the revised 9 requirements for perfection remains perfected for one year after revised 9 takes effect

• Security interest remains enforceable thereafter if security interest becomes enforceable under revised 9 requirements before the year expires

• Security interest remains perfected thereafter if security interest becomes perfected under revised 9 requirements before the year expires

EXAMPLE—SP takes a security interest in debtor's right to proceeds of a written letter of credit; SP perfects by possession of the letter of credit (effective under old 9-305); revised 9 becomes effective; possession of letter of credit does not perfect such security interest under revised 9 requirements; security interest remains perfected until June 30, 2002; perfection lapses on June 30, 2002, unless effective perfection action taken between July 1, 2001, and June 30, 2002
4. Security interest enforceable but not perfected before effective date of revised 9—KRS 355.9-704

- Security interest is enforceable under old 9 but is not perfected under old 9 when revised 9 becomes effective; security interest remains enforceable for one year after revised 9 becomes effective regardless of whether security interest satisfies enforcement requirements of revised 9.

- Security interest remains enforceable thereafter if revised 9 enforceability requirements are satisfied during the year; if requirements not satisfied during the year, security interest lapses.

- Security interest becomes perfected under revised 9 when revised 9 perfection requirements are satisfied, with or without action by the secured party.

EXAMPLE—SP takes a security interest in debtor’s instruments under a security agreement signed by debtor describing the collateral as “debtor’s instruments”; SP fails to take possession of the instruments and is not perfected under old 9; when revised 9 takes effect the security remains enforceable for one year and thereafter since the authenticated security agreement satisfies the enforceability requirements under both old 9 and revised 9; SP can perfect under revised 9 either by taking possession of the instruments or by filing a financing statement covering instruments; if, prior to revised 9 effective date, SP takes action that is ineffective to perfect the security interest under old 9, but effective under revised 9, e.g., files a financing statement that satisfies revised 9’s requirements, the security interest becomes perfected immediately upon revised 9 becoming effective; this possibility is less likely in Kentucky since Kentucky filing office will change from local filing under old 9 to central filing under revised 9.
5. Applicability of revised 9 over pre-effective-date (PED) transactions—KRS 355.9-702

- On July 1, 2001, revised 9 immediately applies to PED transactions and liens within scope of revised 9 regardless of whether the transaction was covered by old article 9

EXCEPTION TO APPLICABILITY OF REVISED 9—9-702(3) revised 9 does not affect an action, case, or proceeding, i.e., litigation, commenced before revised 9 takes effect; if litigation involving a security interest is commenced before July 1, 2001, the requirements of old 9 for enforceability, perfection, priority, enforcement, etc., apply in the proceeding regardless of whether revised 9 changes those requirements

- Effect is that secured party must comply with revised 9 requirements to insure continued validity of PED transaction

SAVING CLAUSE—9-702(2) except as otherwise provided by the transition rules (these “otherwise provided” rules include preservation of perfection, and continuation of perfection, discussed supra), transactions and liens not governed by old 9 remain valid without the necessity of action; they can be terminated, completed, consummated and enforced under either revised 9 or law applicable otherwise, at option of secured party

EXAMPLE—agriculture liens are not covered by old 9 but are within scope of revised 9; on July 1, 2001, a PED agriculture lien is governed by the requirements of revised 9, thus necessitating the lienholder’s compliance with revised 9; saving clause effect is that the lien remains valid under revised 9 without any action by the lienholder, and lienholder can choose to enforce lien under either revised 9 or PED applicable law; however, lienholder must, to maintain perfection, comply with revised 9 perfection requirements before June 30, 2002
6. Priority of security interest—KRS 355.9-709

• Revised 9 priority rules determine the priority of conflicting claims regardless of whether the claim arises before or after the effective date of revised 9.

EXAMPLE—SP 1 takes a security interest in debtor's equipment that attaches on May 1, 2000, but never perfects it; revised 9 takes effect; SP 2 takes a security interest in the same equipment on August 1, 2001, and perfects it on August 5, 2001; the priority rules of revised 9 determine the priority of the competing claims; SP 2 has priority.

EXCEPTION—9-709(1) if the relative priorities of the claims are established before the effective date of revised 9, then old 9 determines the priorities; revised 9 does not define when “relative priorities” are “established,” but the official comments to 9-709 indicate that relative priorities are established whenever two or more entities have an interest in the same collateral; priorities are established regardless of whether or when an actual conflict over the collateral arises.

EXAMPLE—SP 1 takes a security interest in debtor's equipment on May 1, 2000, and perfects it on May 7, 2000; SP 2 takes a security interest in the same equipment on August 1, 2000, and perfects it on August 5, 2000; these priorities are established before the effective date of revised 9 and are determined by the priority rules of old 9; SP 1 has priority.

• Claimant's action taken after the effective date of revised 9 can change relative priorities established under old 9 resulting in revised 9 determining the relative priorities.

EXAMPLE—SP 1 and SP 2 have unperfected security interests in debtor's equipment prior to effective date of revised 9; old 9 determines the priorities because the relative priorities are established prior to revised 9; SP 1 has priority; after effective date of revised 9, SP 2 perfects its security interest by filing a financing statement; the post-effective-date action of SP 2...
changes the relative priorities which are now determined by the priority rules of revised 9; SP 2 has priority

- The mere taking effect of revised 9 cannot change relative priorities established under old 9; in a situation where PED action of the claimant is not effective to perfect a security interest under old 9, but is effective to perfect a security interest under revised 9, the relative priorities are not reestablished upon the effective date of revised 9; priority is determined under old 9

EXAMPLE—in March 2000, SP 1 takes a security interest in debtor’s right to payment for lottery winnings, a general intangible under old 9, but files a financing statement describing the collateral as “accounts” and is not perfected under old 9; in August 2000, SP 2 takes a security interest in the same collateral and files a financing statement describing the collateral as “accounts and general intangibles” and is perfected under old 9; the relative priorities are established and SP 2 has priority; under the accounts definition of revised 9 (9-102(2)), a right to payment for lottery winnings is an account; when revised 9 becomes effective, SP 1’s financing statement is effective to perfect its security interest under revised 9 (assuming all other revised 9 perfection requirements are satisfied; this is unlikely in Kentucky because revised 9 requires filing with secretary of state); if revised 9 were to govern priority, the first to file or perfect rule would award priority to SP 1 since it was the first to file, and SP 1 is now perfected; however, the relative priorities are not reestablished and SP 2 has priority
CHECKLIST OF SECURED PARTY’S ANTICIPATORY ACTION

Existing Security Interests

1. Check perfected status of existing security interests; if not perfected, perfect under rules of old article 9—local filing.

2. Check calendar system to insure lapse dates of filed financing statements are noted.

3. Continue effectiveness of filed financing statements lapsing before July 1, 2001, or whose six month continuation statement window opens before July 1, 2001, by filing a continuation statement under rules of old article 9—local filing.


5. Prepare or obtain form for “in lieu” initial financing statement to be used to continue effectiveness of filed financing statements lapsing after July 1, 2001.

Security Interests Created Between Now and July 1, 2001

1. Perfect security interest under rules of old article 9—file financing statement with appropriate county clerk.

2. Secured party gains no advantage by also filing financing statement under rules of revised article 9.
REVISED ARTICLE 9: PARTS 5 & 6
&
CHANGES IN THE TITLE LIEN SYSTEM

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SECTION N
PART 5 - PERFECTION BY FILING

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SECTION N(a)
PART 5 - PERFECTION BY FILING

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SECTION N(a)
PART 5 – PERFECTION BY FILING.

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A. WHERE TO FILE.

The rules on where to file undergo minor changes at the national level and major changes at the local level. A primary change is the switch from Part 4 to Part 5.

1. National Changes

Under existing Article 9, except mobile goods and intangibles, a secured creditor must follow its debtor and file in all jurisdictions in which collateral is located. Not only must the secured party track its collateral, it must familiarize itself and subject itself to the multiple variations of filing laws, fees, and forms.

Revised Article 9 replaces the multiple filing requirement with a single filing in the jurisdiction of the debtor's place of business, or its chief executive office if it has more than one place of business. A debtor that is a “registered organization” is deemed to be located in the state of its original registration. Revised Article 9 simplifies filing in many respects, however, when a Kentucky company, that is a Delaware corporation, grants a security interest to a Kentucky bank, the bank must perfect the security interest by filing with the Delaware Secretary of State. The drafters selected the state of registration in order to provide certainty and to prevent arguments over where a principal place of business or chief executive office is located. If a debtor changes its state of incorporation, or registration, the four month rule for a new filing applies.

Organizations created under federal law are deemed to be a resident of the state designated in their charter document, or, if none is designated, they are deemed to be located in the District of Columbia. Foreign corporations (non-U.S. debtors) that are located in a foreign jurisdiction without a public filing system are deemed to be located in the District of Columbia.
Individuals are located at their principal place of residence. Make sure you know the principal place of residence of your debtor. More than a few “Kentuckians” principally reside in Tennessee or Florida.

2. Real Estate Related Collateral

A security interest in fixtures, “as extracted collateral,” or timber to be cut is perfected by filing a financing statement in the office of the county clerk of the county in which a mortgage on the related real estate would be filed. Timber, once cut, is no longer “to be cut” and requires filing in the office of the secretary of state (possibly another state if a registered organization of that state). For as extracted collateral, because the security interest does not attach until extraction, the filing in the county clerk’s office continues to be effective after extraction. A filing on goods that are or are to become fixtures is one of the few filings that a prudent creditor will make twice. The financing statement filed as a “fixture filing” is filed in the office of the county clerk where the real estates for the property are located. However, fixtures are also goods, and the belt and suspenders approach dictates a second filing with the secretary of state.

3. Kentucky Changes

Except for the real estate related collateral discussed above, if the law of Kentucky governs perfection of a security interest, the office in which to file a financing statement to perfect the security interest is the office of the Secretary of State. This includes a financing statement covering fixtures if the financing statement is not filed as a fixture filing. The change in Kentucky’s filing system is the greatest in the nation because Kentucky is the only state that now permits only local filing.

B. WHAT TO FILE.

The requirements for a financing statement, or another document, such as a mortgage, that may substitute for a financing statement, are found at KRS 355.9-502. A financing statement is sufficient only if it:

(1) provides the name of the debtor;

(2) provides the name of the secured party or a representative of the secured party; and

(3) indicates the collateral covered by the financing statement.
If the financing statement covers as extracted collateral or timber to be cut, or is filed as a fixture filing and covers goods that are or are to become fixtures it must also:

(1) indicate it covers this type of collateral;

(2) indicate that it is to be filed in the real property records;

(3) provide a description of the real property to which the collateral is related (does not require a meets and bounds description); and

(4) if the debtor does not have an interest of record in the real property, provide the name of a record owner.

A mortgage may be effective as a fixture filing or a financing statement covering as extracted collateral or timber to be cut if:

(1) the instrument indicates the goods or accounts that it covers;

(2) the goods are to become fixtures related to the real property, or the collateral is related to the real property, or is as extracted collateral or timber to be cut;

(3) the instrument satisfies the other requirements for a financing statement and

(4) the instrument is recorded.

However, the bare bones requirements set out in 9-502 may result in rejection by a filing officer under the standards of 9-516 which require such additional information as addresses for the debtor and secured party. The model form financing statement set out at 9-521 requires even more information, such as a T.I.N. and an organizational number. The secured party will be best served to completely fill out the model form and put “N/A” in any section that does not apply to that debtor.

C. WHEN TO FILE.

As under the prior law, a secured party may file a financing statement before its debtor authenticates a security agreement, or a security interest otherwise attaches to the collateral. However, because the debtor's signature is no longer necessary on a financing statement, the secured party must ensure that if it files the financing statement before the debtor authenticates the security agreement, that it obtains the written authority of the debtor to file a financing statement.
D. IDENTITY OF THE DEBTOR.

If the debtor is a registered organization, the financing statement must provide the name of the debtor “indicated on the public record of the debtor’s jurisdiction of organization which shows the debtor to have been organized; . . .” A financing statement that provides only the debtor's trade name does NOT sufficiently provide the name of the debtor. This change in statutory law effectively overrules some court decisions that have allowed trade name filing. In other cases the financing statement is sufficient if it provides the individual or organizational name of the debtor. A financing statement may provide the name of more than one debtor.

The section on the debtor's identity does not require the debtor’s address, however, a filing officer can reject an initial financing statement on which the debtor’s mailing address does not appear.

A debtor may be identified by taxpayer identification number (employer identification number or social security number). However, the new statute does not require the identification number. Kentucky's current requirement for taxpayer identification numbers on financing statements, effective July 15, 1998, is repealed effective July 1, 2001.

If the debtor's name is incorrect, it is deemed seriously misleading if it cannot be found with the filing officer's “standard search logic.”

E. NAME OF THE SECURED PARTY.

KRS 355.9-502 requires only the name of the secured party, however, KRS 355.9-516 authorizes a filing officer to reject a record that does not provide the secured party's address. If the transaction involves multiple secured parties (e.g., a syndicated or participated credit) the financing statement must disclose only a representative secured party.

F. DESCRIPTION OF COLLATERAL.

A major change permits what is known as “super generic” descriptions of collateral. An indication that the financing statement covers all assets or all personal property is sufficient. Otherwise, a description of collateral is sufficient if it lists the collateral by:
(1) specific listing;  
(2) category;  
(3) type of collateral defined by the UCC; and  
(4) quantity.

The super generic description is permitted only through the concept of notice filing. Super generic descriptions are NOT sufficient to grant a security interest.

Types of collateral that must be specifically identified include commercial tort claims, consumer goods or other collateral taken in consumer transactions, securities entitlements, securities accounts, and commodity accounts. Neither super generic nor category descriptions pick up these forms of collateral.

G. OTHER PARTIES.

Where appropriate, financing statements may use the terms consignor, consignee, lessor, lessee, bailor, bailee, licensor, licensee, owner, registered owner, buyer, seller, or words of similar import.

H. MINOR ERRORS RULE.

Not only is the minor errors rule carried over from the old Code, Revised Article 9 expands it. A financing statement has always been deemed to satisfy the requirements of the section on filing, even if it has minor errors or omissions, unless the minor errors or omissions make the financing statement seriously misleading. This concept remains. Under the prior Code the minor errors exceptions applied only to the UCC-1 document. However, Revised Article 9 defines “financing statement” as “any filed record relating to the initial financing statement.” Thus, Revised Article 9 brings continuation statements, amendments, and other UCC filings under the protection of the minor errors exception.

KRS 355.9-506(3) specifically deals with minor errors in the debtor's name: “If a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic, if any, would disclose a financing statement that fails sufficiently to provide the name of the debtor in accordance with KRS 355.9-503(1), the name provided does not make the financing statement seriously misleading.”
I. CHANGE IN THE DEBTOR'S NAME.

If a debtor's name changes such that it becomes seriously misleading, the financing statement will not be effective to perfect a security interest in collateral acquired by the debtor more than four months after the name change. This is a change from current Kentucky law. Under Revised Article 9 the four-month period will begin to run on the date of the name change. Under current Kentucky law (non-uniform) the four-month period begins to run when the secured party is put on written notice of the name change. House Bill 133, introduced by Rep. Bruce in the 2001 session of the Kentucky Legislature, amended KRS 355.9-507 to change the model language and return the Kentucky rule to the standard that has been in place since 1987, the four-month period to amend the debtor's name following a name change will begin to run when the debtor notifies the secured party in writing of the name change. Secured parties must still be diligent in policing their debtors because a trustee or competing secured party will argue that a change in stationary, a copy of the year end financial statement, or any other document bearing the new name, is written notice of the name change. Overall, the language of the pending amendment probably best protects Kentucky's bankers.

J. PERSONS ENTITLED TO FILE A FINANCING STATEMENT.

A person may file an initial financing statement, or an amendment that adds collateral or another debtor, if authorized by the debtor "in an authenticated record." The single sentence above represents two significant changes in the law: (1) a debtor's signature is no longer required on a financing statement and (2) the "record" authorizing the filing must only be "authenticated." "Authenticate" means signed or "to execute or otherwise adopt a symbol, or encrypt or similarly process a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record."

If you have the status of a secured party, by virtue of a security agreement, you have the right to file a financing statement. To pre-file a financing statement you should obtain specific authority. The key in Revised Article 9 is an authorized filing. Rather than require the debtor's signature, Article 9 approaches the issue from the other side and prohibits and penalizes unauthorized filings.
K. AMENDMENT OF FINANCING STATEMENTS.

Any person entitled to file a financing statement may add or delete collateral covered by the financing statement, continue or terminate the effectiveness of the financing statement, or otherwise amend information in the financing statement through filing an amendment. The amendment must identify, by its file number, the initial financing to which the amendment relates.

An amendment that either adds collateral or adds a debtor is only effective from the date of the amendment. Amendments do not extend the effective period of a financing statement.

L. TERMINATION OF FINANCING STATEMENT.

If the financing statement covers consumer goods, the secured party must terminate when there is no obligation secured by the collateral and no commitment to an additional obligation. The termination must be within one month after the payoff or, if earlier, within 20 days after an authenticated demand from the debtor.

In other cases the financing statement must provide the debtor with a termination statement (or file the termination statement) within 20 days after an authenticated demand from the debtor if there is no longer an obligation secured by the collateral and no commitment to make additional advances.

M. DURATION OF FINANCING STATEMENTS.

Financing statements remain effective for five years after the date of filing. A secured party may file a continuation statement only within six months before the expiration of the five-year period. The continuation statement extends the effectiveness for five years commencing on the date the financing statement would otherwise have expired. There is no change from existing law.

A mortgage that meets the standards for a financing statement, and is used for a fixture filing, remains effective until it is terminated.

N. DUTIES OF THE FILING OFFICER.

A filing officer must accept a record, and a record is filed, once it is communicated to the filing office and a fee equal to or greater than the amount required for the filing is tendered.
Revised Article 9 adopts a set of objective standards for rejection of records by a filing officer. Filing officers may refuse to accept a record for the following reasons:

1. the record has not been communicated by an authorized method or medium;
2. an amount equal to or greater than the applicable fee is not tendered;
3. the filing officer is unable to index the record because: (a) the record does not provide the name of the debtor; (b) in the case of an amendment the record does not properly identify the initial financing statement to which it relates; or identifies an initial financing statement whose effectiveness has lapsed; (c) the record does not sufficiently describe real property to which it relates;
4. a name and address are not provided for the secured party;
5. as to the debtor the financing statement does not (a) provide a mailing address, (b) indicate whether the debtor is an individual or organization; or (c) if the financing statement indicates the debtor is an organization it does not provide the type of organization, jurisdiction of organization of the debtor, or an organizational identification number for the debtor or indicate that the debtor has one.
6. in the case of an assignment does not provide a name and mailing address for the assignee; or
7. in the case of a continuation statement is not filed within the six-month period.

As a matter of law, a record does not provide sufficient information if a filing office is unable to read or decipher the information.

A record that is communicated to the filing office with the proper fee, but which the filing office refuses to accept for a reason other than those specified, is effective as a filed record except as against a purchaser of the collateral who gives valuable in reasonable reliance upon the absence of the record from the files. However, the failure of the filing office to index a record correctly does not affect the effectiveness of the filed record.
O. INACCURATE OR WRONGFULLY FILED RECORDS.

A person may file a correction statement with respect to a record indexed under the person's name if the person believes the record is inaccurate or wrongfully filed. The correction must identify the record to which it relates by file number, indicate that it is a correction statement, and provide the basis for the persons belief that it is inaccurate. This section was adopted primarily in reaction to the bogus financing statements filed against public officials by extremist organizations.

P. ACCEPTANCE AND REFUSAL TO ACCEPT A RECORD.

A filing office may refuse to accept a record for filing for any of the reasons set forth in section 526, conversely, it may only refuse to accept a record for filing for one of those reasons. If the filing office refuses to accept a record, it is required to communicate with the person who presented the record and inform them of the reason for the refusal and the date and time the record would have been filed if not for the deficiency. Notice to the filer must be no more than two business days after the filing office receives the record.

Q. SAFE HARBOR WRITTEN FORMS.

Although sections 516 and 520 limit the basis on which a filing office can refuse to accept records, the drafters of Revised Article 9 also provide sample written forms that a filing office must accept. The following model forms are adopted as a matter of Kentucky law:

(1) UCC Financing Statement;
(2) UCC Financing Statement Addendum;
(3) UCC Financing Statement Amendment; and
(4) UCC Financing Statement Amendment Addendum.

R. INFORMATION FROM FILING OFFICE.

Upon request, a filing office must provide an acknowledgment of a filing and an image of the record showing the number assigned and the date and time of filing or, in substitution, simply note upon a copy of the record the number assigned and the date and time of filing. If the filing is electronic, the filing office must communicate similar information to the filer. The fee for issuing a certificate showing whether there is on file any financing statement naming a particular debtor is $5.
The filing office shall also communicate whether there is on file, on a date and time specified, but no earlier than three business days prior to the request, any financing statement that designates a particular debtor.

S. FEES.

The filing fee structure is set to discourage lengthy filings and encourage electronic filings. The Kentucky Secretary of State is authorized to charge $10 if the record to be filed is in writing and consists of no more than two pages, $20 for a written record of more than two pages, but only $5 if a record is communicated by other than written media.

T. FILING OFFICE RULES.

The Kentucky version charges the Secretary of State with promulgating administrative regulations to implement Revised Article 9 as it relates to the Secretary of State. Revised Article 9 further directs the Secretary of State to adopt such regulations and practices that are harmonious with those of other jurisdictions and to keep the technology used by its office compatible with the technology used by filing offices in other jurisdictions. The rules adopted by the Kentucky Secretary of State will closely track model filing rules adopted nationally and will soon appear on that office’s web site.
PART 6 - DEFAULT, REMEDIES AND ENFORCEMENT

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SECTION N(b)
PART 6 - DEFAULT, REMEDIES AND ENFORCEMENT

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SECTION N(b)
Existing Part 5, now Part 6 of Revised Article 9, has been a major source of controversy and litigation. Terms such as “breach of the peace” and “commercially reasonable” were practically made for lawyer arguments. Revised Article 9 does not tackle all of the existing subjects of disputes but attempts to resolve many matters that have arisen in UCC litigation.

Part 6 on default, enforcement, and remedies will be retroactive to all transactions. Security interests taken and perfected under the old law, if enforced after June 30, 2001, will be subject to the new law. With a small change regarding repossession titles for motor vehicles, Kentucky enacted the model version of Part 6. Uniformity is important because the law of the jurisdiction where the collateral is located will govern enforcement rights.

A. DEFAULT.

Default triggers a secured party’s rights under Part 6. However, Revised Article 9 does not define default. What constitutes default remains a matter of contract between the parties.

B. DEBTORS, OBLIGORS AND GUARANTORS.

All parties to a secured transaction are placed on equal status in terms of their rights after default. For the purpose of Part 6, a “debtor” is the person who owns or has an interest in the collateral, not necessarily the person who owes the debt. An “obligor” is the person who owes the payment obligation and may be the same person as the debtor. A “secondary obligor” is one whose obligation is secondary, primarily a guarantor. Each of these parties is clearly entitled to post default and repossession rights, including a notice of sale. Revised Article 9 prohibits clauses in guaranty agreements that waive the right to a notice of sale or a secured party’s duty to conduct a sale in a commercially reasonable manner.
C. AGREEMENT ON STANDARDS CONCERNING RIGHTS AND DUTIES.

To the extent that Revised Article 9 places duties on a secured party, or gives debtors and obligors rights, a security agreement may set the standards and determine fulfillment of those rights and duties as long as the standards are not manifestly unreasonable. The lone exception is that secured parties and debtors cannot form an agreement relating to the secured party's duty to refrain from breaching the peace in the act of self-help repossession.

D. COLLECTION AND ENFORCEMENT BY SECURED PARTY.

1. Collection and Enforcement of Accounts

Revised Article 9 adds to the secured party's arsenal by specifically giving the secured party the right to enforce the obligations of an account debtor or other person obligated on collateral, and to exercise the rights of the debtor with respect to enforcement of an account including the right to act against property that secures the obligations of the account debtor to the secured party. The secured party is required to proceed in a commercially reasonable manner if it undertakes to collect from or enforce an obligation of an account debtor. The new sections recognize the emergence of asset based lending and the importance of accounts as collateral.

2. Self-Help Repossession is Alive and Well

A secured party may, after default, take possession of its collateral, or render equipment unuseable, pursuant to judicial process, or without judicial process, if the secured party proceeds without breach of the peace. Except for rewording, the rights of a secured party under KRS 355.9-609 are identical to the existing rights under KRS 355.9-503. Unfortunately, the drafters struggled with but failed to define "breach of the peace."

3. Security Consisting of Real Property or Fixtures

A secured party may proceed under Part 6 regarding personal property of mixed real estate without affecting any of its rights with respect to the real property. Alternatively, the secured party may elect to proceed as to both the personal property and real property in accordance with its rights with respect to the real property.
E. DISPOSITION OF COLLATERAL AFTER DEFAULT.

1. Commercially Reasonable Disposition

Every aspect of a disposition of collateral, including the method, manner, time, place, and other terms must be commercially reasonable.

2. Preparation of Collateral for Sale

Courts have taken various positions on whether a secured party is required to clean up or fix collateral prior to sale. The new statute specifically authorizes disposition of the collateral “in its present condition or following any commercial reasonable preparation or processing.” However, Official Comment 4 to KRS 355.9-610(1) takes back part of that right and holds that a secured party may not dispose of collateral “in its then condition” when, taking into account the costs and probable benefits of preparation or processing and the fact that the secured party would be advancing the costs at its risk, it would be commercially unreasonable to dispose of the collateral in that condition. E.g., for want of a battery, prospective purchasers cannot start the engine of a car or construction equipment. Secured parties should document their decision on whether to invest in clean-up/fix-up expenses.

3. Purchase by Secured Party

A secured party may continue to bid on its own collateral at any public disposition and now, at a private disposition if the collateral is of a kind customarily sold on a recognized market or the subject of widely distributed standard price quotations.

4. Sale Warranties by the Secured Party

The sale of collateral by a secured party includes all warranties relating to title, possession, and quite enjoyment unless they are specifically disclaimed by the secured party. Specific requirements and methods of warranty disclaimers are found at KRS 355.9-610(5)and (6).

5. Repossession Title is Not a Disposition

A nonuniform section, KRS 355.9-610(7) provides: “The acquisition of a repossession title by a secured party shall not be deemed a disposition of collateral under this...
section.” The purchaser of a motor vehicle at a wholesale auction expects to receive immediate title. To maximize the price repossessed vehicles bring at auction sale, most secured parties obtain a repossession title in their own name prior to the auction. Imaginative debtors' lawyers have argued that the repossession title constitutes a disposition without notice or is a de facto strict foreclosure. Subsection (7) is a legislative fix for that problem.

F. NOTICE OF SALE.

The notice of sale provisions, formerly contained in KRS 355.9-504 (Article 9 § 504) are now found at KRS 355.9-611. Watch for references to the old statute in existing forms. The new statute governs all foreclosure sales after June 30, 2001.

A secured party that disposes of collateral must notify:

(1) the debtor;

(2) any secondary obligor; and

(3) if the collateral is other than consumer goods, any other secured party that 10 days before the date of the notice of sale had a security interest perfected by filing a financing statement that reasonably identified the collateral, was indexed under the debtor's name, and was filed in the proper office; or a security interest perfected under other state or federal statute (title liens, aircraft liens, etc.).

This is a major change in Article 9. The original article on secured transactions required a notice to other creditors, however, the 1972 revisions (adopted in Kentucky effective 1987) removed this requirement. Revised Article 9 returns to the original version. Thus, the foreclosing creditor, regardless of lien position, must notify other secured parties. The drafters hope this will limit post-foreclosure disputes between secured parties and will be facilitated by the greater certainty in where to file and the availability of computer search systems.

Most secured creditors believe that a notice of sale is timely if sent ten days or more before the earliest time of disposition. However, Article 9 and case law interpreting Article 9 are devoid of any reference to a ten-day notice being per se commercially reasonable. For commercial transactions, Revised Article 9 adopts the ten-day standard. Unfortunately, for other transactions, the statute holds that whether a notification is sent within a reasonable time is a question of fact. See KRS 355.9-612.
G. SAFE HARBOR NOTICES OF SALE.

1. 355.9-613 Contents and Form of Notification Before Disposition of Collateral: General. (Effective July 1, 2001)

Except in a consumer-goods transaction, the following rules apply:

(1) The contents of a notification of disposition are sufficient if the notification:

(a) describes the debtor and the secured party;

(b) describes the collateral that is the subject of the intended disposition;

(c) states the method of intended disposition;

(d) states that the debtor is entitled to an accounting of the unpaid indebtedness and states the charge, if any, for an accounting; and

(e) states the time and place of a public disposition or the time after which any other disposition is to be made.

(2) Whether the contents of a notification that lacks any of the information specified in subsection (1) of this section are nevertheless sufficient is a question of fact.

(3) The contents of a notification providing substantially the information specified in subsection (1) of this section are sufficient, even if the notification includes:

(a) information not specified by that subsection; or

(b) minor errors that are not seriously misleading.

(4) A particular phrasing of the notification is not required.
(5) The following form of notification and the form appearing in KRS 355.9-614(3), when completed, each provides sufficient information:

"NOTIFICATION OF DISPOSITION OF COLLATERAL"

To: ........<Name of debtor, obligor, or other person to which the notification is sent>

From: ......<Name, address, and telephone number of secured party>

Name of Debtor(s): ......<Include only if debtor(s) are not an addressee>

<For a public disposition:>

We will sell <or lease or license, as applicable> the <describe collateral> <to the highest qualified bidder> in public as follows:

Day and Date: ............
Time: .............
Place: .............

<For a private disposition:>

We will sell <or lease or license, as applicable> the <describe collateral> privately sometime after ......<day and date>.

You are entitled to an accounting of the unpaid indebtedness secured by the property that we intend to sell <or lease or license, as applicable> <for a charge of $....>. You may request an accounting by calling us at ......<telephone number>.”

2. 355.9-614 Contents and form of Notification Before Disposition of Collateral: Consumer-Goods Transaction (Effective July 1, 2001)

In a consumer-goods transaction, the following rules apply:

(1) A notification of disposition must provide the following information:

(a) the information specified in KRS 355.9-613(1);

(b) a description of any liability for a deficiency of the person to which the notification is sent;
(c) a telephone number from which the amount that must be paid
to the secured party to redeem the collateral under KRS
355.9-623 is available; and

(d) a telephone number or mailing address from which additional
information concerning the disposition and the obligation
secured is available.

(2) A particular phrasing of the notification is not required.

(3) The following form of notification, when completed, provides
sufficient information:

```
"......<Name and address of secured party>
......<Date>

NOTICE OF OUR PLAN TO SELL PROPERTY

<Name and address of any obligor who is also a debtor>

Subject:   <Identification of Transaction>

We have your ......<describe collateral>, because you broke promises in our
agreement.

<For a public disposition:>

We will sell ......<describe collateral> at public sale. A sale could include a lease or
license. The sale will be held as follows:

Date: .........
Time: .........
Place: .........

You may attend the sale and bring bidders if you want.

<For a private disposition:>

We will sell ......<describe collateral> at private sale sometime after ...... <date>. 
A sale could include a lease or license.
```
The money that we get from the sale (after paying our costs) will reduce the amount you owe. If we get less money than you owe, you will still owe us the difference. If we get more money than you owe, you will get the extra money, unless we must pay it to someone else.

You can get the property back at any time before we sell it by paying us the full amount you owe (not just the past due payments), including our expenses. To learn the exact amount you must pay, call us at ......<telephone number>.

If you want us to explain to you in writing how we have figured the amount that you owe us, you may call us at ......<telephone number> or write us at ......<secured party's address> and request a written explanation. <We will charge you $... for the explanation if we sent you another written explanation of the amount you owe us within the last six (6) months.>

If you need more information about the sale call us at ......<telephone number> or write us at ......<secured party's address>.

We are sending this notice to the following other people who have an interest in ......<describe collateral> or who owe money under your agreement:

.....<names of all other debtors and obligors, if any>”

(4) A notification in the form of subsection (3) of this section is sufficient, even if additional information appears at the end of the form.

(5) A notification in the form of subsection (3) of this section is sufficient, even if it includes errors in information not required by subsection (1) of this section, unless the error is misleading with respect to rights arising under this article.

(6) If a notification under this section is not in the form of subsection (3) of this section, law other than this article determines the effect of including information not required by subsection (1) of this section.

H. NOTICE OF SURPLUS OR DEFICIENCY.

If in a consumer goods transaction the debtor is entitled to a surplus, or is liable for a deficiency, Revised Article 9 requires the secured party to send its customer an explanation. The explanation must be sent no later than the time that the secured party
accounts for and pays a surplus, or the time of its first written attempt to collect the deficiency. If the debtor or consumer obligor requests an explanation, it must be sent within 14 days of receipt.

The explanation to which the customer is entitled must be in writing and must provide the following information in the following order:

1. the aggregate amount of obligations secured by the security interest, and, if the amount reflects a rebate of unearned interest or credit service charge calculated on a day not more than 35 days before the secured party takes possession of the collateral;

2. the amount of proceeds of the disposition;

3. the amount of the obligations after deducting the amount of proceeds;

4. the amount in the aggregate or by type, and types of expenses, including expenses of retaking, holding, preparing for disposition, processing, and disposing of the collateral, and attorneys' fees secured by the collateral which are known to the secured party and relate to the disposition;

5. the amount, in the aggregate or by type, and types of credits, including rebates of interest or credit service charges, to which the obligor is known to be entitled and which are not reflected in the aggregate amount of obligations secured by the collateral; and

6. the amount of the surplus or deficiency.

Specific wording is not required, and an explanation complying substantially with the requirements of KRS 355.9-616 is sufficient, even if it includes minor errors that are not seriously misleading.

If a debtor or consumer obligor has requested and received an explanation of surplus or deficiency within the prior six months, and sends a second request, the secured party may assess a charge not exceeding $25 for the response.
I. THE RIGHT OF STRICT FORECLOSURE IS STRENGTHENED.

Strict foreclosure, the ability of a secured party to accept its collateral in lieu of debt, provided for under former KRS 355.9-505, is expanded under Revised Article 9. Secured parties may choose to use the remedy if it is unlikely that a deficiency claim can be collected or if attempting to collect a deficiency would result in excessive legal expense or risk.

Current Article 9 allows only acceptance of collateral in complete satisfaction of a debt. The Revised Article allows a secured party, in a commercial claim, to offer to accept collateral in partial satisfaction. Revised Article 9 also eliminates the requirement for possession of the collateral subject to strict foreclosure. This expands the right of strict foreclosure to the area of intangible collateral.

Strict foreclosure is not available for consumer collateral where 60% of the cash price has been paid in the case of a purchase money security interest, or 60% of the principal amount of the obligation secured has been paid in the case of a non-purchase money security interest in consumer goods. In these instances, the secured party must act to properly dispose of the consumer collateral within 90 days of taking possession or within any longer period to which the debtor and all secondary obligors have agreed.

J. NOTIFICATION OF PROPOSAL TO ACCEPT COLLATERAL.

A secured party that chooses to use the remedy of strict foreclosure, and accept the collateral in full or partial satisfaction of an obligation, must send its proposal to:

(1) any person from which the secured party has received notice of a claim in the collateral;

(2) any other secured party that held a secured interest or lien on the collateral perfected by filing a financing statement that identified the collateral, was indexed under the debtor's name, and filed in the proper office; and

(3) any secured party that held a security interest perfected by compliance with another state or federal statute.

Debtors, obligors, and secondary obligors are all entitled to a notice. No safe harbor notice has been promulgated.
If no one entitled to notice objects to the secured party's proposal of acceptance of collateral in lieu of debt, the acceptance of the collateral:

1. discharges the obligation to the extent consented to by the debtor;
2. transfers to the secured party all of a debtor's rights in the collateral; and
3. discharges the security interest of any subordinate secured party.

**K. PENALTIES ON THE SECURED PARTY FOR FAILURE TO COMPLY WITH ARTICLE 9.**

Remedies available to the debtor include:

1. seeking a court order to restrain collection and enforcement or disposition of collateral;
2. a claim for damages caused by the secured party's failure to comply with Article 9 including any loss resulting from the debtor's inability to obtain, or increase costs of alternative financing; and
3. in the case of consumer transactions, a person that was a debtor or secondary obligor, may recover actual damages plus an amount not less than the credit service charge plus 10% of the principal amount of the obligation for the time price differential plus 10% of the cash price.

**L. DEFICIENCY JUDGMENTS AND THE REBUTTABLE PRESUMPTION RULE.**

Revised Article 9 adopts the “rebutable presumption rule” for non-consumer transactions and leaves consumer transactions to the law of the state. Kentucky adopted the rebuttable presumption rule for all classes of transactions in the Kentucky Supreme Court decision of *Peoples Bank of Mt. Washington v. Holt*. The rebuttable presumption rule means that in the event of any non-compliance with sale procedure, a presumption is created that the collateral is equal to the unpaid balance of the debt. However, the secured party has the
opportunity to rebut the presumption and prove that a technical deficiency in sale procedure did not harm the debtor or other obligor and that the secured party is entitled to recover a deficiency. The rebuttable presumption rule in Kentucky replaced an absolute bar rule. Revised Article 9, in other states, eliminates the absolute bar rule in commercial transactions and leaves it to the case law of the state for consumer transactions.

M. WHAT IS COMMERCIALLY REASONABLE?

The fact that a greater amount could have been obtained by disposition of collateral at a different time or in a different manner from that used by the secured party does not preclude the secured party from establishing a deficiency. As a matter of law, Revised Article 9 holds that a disposition is commercially reasonable if it is made:

(1) in the usual manner on any recognized market;

(2) at the price current in any recognized market at the time of disposition; or

(3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.

A proposed disposition may also be approved in a judicial proceeding or by a creditors' committee or representative of creditors.

If a secured party, or an entity related to the secured party, or a secondary obligor acquires collateral at foreclosure sale, and the amount of sale proceeds of the disposition is significantly below the range of proceeds that disposition to another person might have brought, a surplus or deficiency will be calculated based on the amount of proceeds that would have been realized in a disposition that properly complied with Part 6.
CHANGES IN THE TITLE LIEN SYSTEM

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SECTION N(e)
CHANGES IN THE TITLE LIEN SYSTEM

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SECTION N(c)
CHANGES IN THE TITLE LIEN SYSTEM.

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A. HISTORY AND PURPOSE OF THE TITLE LIEN.

Until July 1, 1987, security interests in titled property, primarily motor vehicles, were perfected through filing a UCC-1 Financing Statement. Titled property was removed from the UCC system as part of the last major amendment to Article 9. The Title Lien Statement (formerly known as the Motor Vehicle Lien Statement) was adopted as the means by which a secured party transmitted information to a county clerk for inclusion in the Automated Vehicle Information System and to appear on the face of the Kentucky title. There is no requirement that county clerks file or keep a permanent record of Title Lien Statements. The test for perfection is not whether the Title Lien Statement was tendered to the clerk, but whether the lien appears on the Certificate of Title.

B. FEE INCREASE.

To keep the changes brought about by Revised Article 9 from adversely impacting Kentucky's county clerks (revenue neutral in legislative parlance), and to pay for the clerks' additional duties under the title lien system, and continued duties regarding UCC records already on file in the clerk's offices, the fee for noting a security interest on a Kentucky Certificate of Title is increased from $8 to $12. The $3 state tax, and advance collection of the $5 release fee remain unchanged for a total of $20 to be paid to the county clerk at the initiation of a title lien. As noted by the clerks, this is the first fee increase for title liens since the 1986 Legislature established the fee.

C. WHERE TO FILE TITLE LIENS.

KRS 186A.190 simply referenced the filing location rules of existing Article 9 Section 401. However, the change to Secretary of State filing for UCC liens required the wholesale movement of those rules into Chapter 186A. The complete rules are found at KRS 186A.190(2). If the debtor is a natural person, the title lien is tendered to the county clerk of the county in which the debtor resides. A corporation is deemed a resident of the county in which its registered office is located. (Because the real test for perfection is whether the lien appears on the title, this rule will not be the problem that it was for filing financing...
D. CONTENTS OF THE TITLE LIEN STATEMENT.

A Title Lien Statement must list the name and address of the debtor, the name and address of the secured party, describe the collateral, and, where applicable, list the year, make, and identification number of the collateral.

E. TIME TO FILE TITLE LIEN (PROPERTY PREVIOUSLY TITLED IN THE NAME OF THE DEBTOR).

KRS 186A.200 currently requires a secured party to, within 15 days, after execution of a security agreement, obtain the Certificate of Title in the name of the debtor and present the certificate to the county clerk, together with a Title Lien Statement, to record the lien on the title. Senate Bill 11 amends the 15-day period to 20 days to make the period consistent with other sections of the law.

F. ASSIGNMENT OF A SECURITY INTEREST IN TITLED PROPERTY.

KRS 186.045(1) is repealed. That statute requires that whenever a perfected security interest in titled property is assigned, the assignor must within 30 days present a copy of the assignment to the county clerk in whose office the security interest was noted on the Certificate of Title and pay a $10 fee for entry of the assignment into the AVIS system. For practical purposes, this statute prevents the securitization of automobile retail paper in Kentucky. Without the required $10 fee, and the burdensome paperwork, it is anticipated that portfolios of Kentucky retail paper will be more readily saleable.

G. THE SUNSET RULE.

Under current law a title lien remains effective until it is discharged by the secured party. Kentucky consumers and county clerks have encountered problems with evergreen title liens when the secured party has gone out of business or merged and upstreamed
through multiple layers so that it is difficult to locate. Under existing law, the only way to remove the title lien is through an action in Kentucky's courts. To remedy this problem, a sunset provision is enacted.

1. Duration of Title Liens

Title liens on all forms of property other than manufactured homes, remain effective for seven years from the date on which the security interest is noted on the Certificate of Title. For manufactured homes, the initial period is 14 years from the notation date. House Bill 133, passed by the 2001 session of the Kentucky Legislature, amends KRS 186A.190 to provide that the notation of a security interest on a certificate of title for a manufactured home shall remain effective for a period of 30 years rather than the 14 years in Senate Bill 11 in the 2000 Legislature. The change will correspond to the perfection period for manufactured homes that is contained in the Model Act.

2. Continuation of Title Lien

A secured party may file a continuation statement with the county clerk that noted the title lien on the Certificate of Title within the six months preceding the expiration of the initial period of the title lien. A continuation statement extends the expiration date for seven additional years. The continuation period is seven years no matter what form of property is involved.

3. Transition Rule for Title Lien

In a non-codified transition rule, S.B. 11 provides that the sections on title liens are retroactive in nature and apply to notations on Certificates of Title already in existence on the effective date of the new law. The effectiveness of existing title liens that would otherwise expire on the effective date, or within the first six months thereafter, is extended through December 31, 2001. Secured parties may file continuation statements between July 1, 2001, and December 31, 2001, to extend the effective date of a title lien for seven additional years from the date on which it would have otherwise expired (NOT SEVEN YEARS FROM JULY 1, 2001, OR THE DATE THE CONTINUATION STATEMENT IS FILED). This provision primarily affects title liens on property other than manufactured homes because of the 14-year effective period for title liens on manufactured homes. Only title liens perfected on manufactured homes during the first six months of the title lien statute (July 1, 1987, through December 31, 1987) will fall under the terms of this statute.
4. Administrative Regulations

The Transportation Cabinet is developing administrative regulations for continuation statements in the title lien system. The administrative regulations will be promulgated before July 1, 2001, but are not yet available.

5. Alternative Perfection for Boats

If a secured party is taking boats as collateral on financial obligations that exceed seven years, an alternative to a title lien is to use a First Preferred Ship Mortgage administered by the United States Coast Guard through the National Vessel Documentation Center. Many banks that finance boats on Kentucky lakes use this system that does not require a tickler to remind the secured party that a continuation statement is due.